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# CENTRAL BANK OF MALTA
# OUTLOOK FOR THE MALTESE ECONOMY

2024:3

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*The cut-off date for information in this publication is 19 August 2024. Figures in tables may not add up due to rounding.*

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# OUTLOOK FOR THE MALTESE ECONOMY 2024-2026

## Overview[1,2]

*Incoming information suggests that economic activity in Malta remained relatively resilient during the first half of this year, although showing signs of moderation. In particular, the tourism sector and professional services continue to show strong momentum, while domestic demand has been generally robust. Furthermore, high-frequency data suggest that the conjunctural situation since the June 2024 projections has continued to stabilize somewhat, with the Bank's Business Conditions Index (BCI) recently fluctuating in a narrow range around its historical average.*

*Economic growth is expected to moderate from the very high rates experienced in the last three years, broadly converging 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 (see Box 1 and Box 2 for further information). The moderation in inflation is set to result in a significant recovery in real disposable income growth this year, with further growth expected in the following two years. This should support private consumption.*

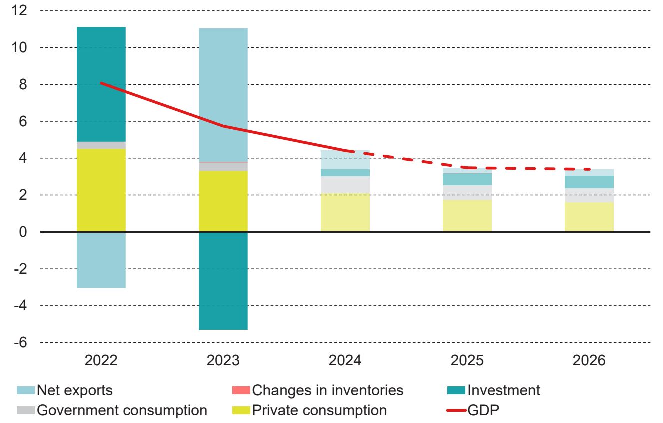
*This projection round is characterised by only minor revisions to the previous projections, as incoming data generally confirmed our earlier expectations. However, historical data could be revised somewhat in the next publication of the national accounts, as this will feature a benchmark revision. Therefore, significant revisions to these projections could arise in forthcoming rounds.[3]*

## Economic outlook

According to the Bank's latest forecasts, Malta's real gross domestic product (GDP) growth should moderate from 5.7% in 2023 to 4.4% in 2024, before easing further to 3.5% and 3.4% in the subsequent years (see Table 1). Compared to the Bank's previous projections, GDP growth is being revised marginally up by 0.1 percentage point in 2024, and down by 0.1 percentage point in 2026. The small GDP revision in 2024 is driven by an upward revision in exports, which outweighs an upward revision in imports. On the other hand, GDP growth for 2026 was revised marginally downwards, due to a smaller contribution from net exports.

While net exports were the main contributor to GDP growth in 2023, as from 2024, domestic demand is expected to become the main driver of growth (see Chart 1). The latter is expected to be led by private consumption, which is projected to continue to

**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 19 August 2024. Technical assumptions were transmitted by the European Central Bank (ECB).

[2] See https://www.centralbankmalta.org/site/Publications/Outlook-2024-2.pdf.

[3] See https://nso.gov.mt/events/benchmark-revision-in-national-accounts/.

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

| | 2023[2] | 2024 | 2025 | 2026 |
|---|---|---|---|---|
| **Real economic activity (% change)** | | | | |
| GDP | 5.7 | 4.4 | 3.5 | 3.4 |
| Private consumption expenditure | 7.8 | 4.9 | 4.0 | 3.7 |
| Government consumption expenditure | 2.5 | 5.3 | 4.5 | 4.3 |
| Gross fixed capital formation | -21.3 | 2.0 | 3.5 | 3.7 |
| Exports of goods and services | 8.7 | 4.5 | 3.2 | 3.0 |
| Imports of goods and services | 4.7 | 4.4 | 3.4 | 3.2 |
| **Contribution to real GDP growth (in percentage pts)** | | | | |
| Final domestic demand | -1.5 | 3.4 | 3.2 | 3.1 |
| Net exports | 7.3 | 1.0 | 0.3 | 0.3 |
| Changes in inventories | 0.0 | 0.0 | 0.0 | 0.0 |
| **Balance of payments (% of GDP)** | | | | |
| Goods and services balance | 16.1 | 16.5 | 16.3 | 16.2 |
| Current account balance | 0.9 | 1.1 | 1.0 | 0.9 |
| **Labour market (% change)[3]** | | | | |
| Total employment | 6.7 | 3.9 | 2.6 | 2.4 |
| Unemployment rate (% of labour supply) | 3.1 | 3.0 | 3.1 | 3.0 |
| **Real disposable income[4]** | 0.3 | 4.6 | 3.7 | 3.6 |
| **Household saving ratio[4]** | 20.1 | 20.0 | 19.7 | 19.6 |
| **Prices and costs (% change)** | | | | |
| GDP deflator | 5.3 | 2.9 | 2.5 | 2.3 |
| RPI | 5.1 | 2.1 | 1.9 | 1.8 |
| Overall HICP | 5.6 | 2.5 | 2.1 | 2.0 |
| HICP excluding energy | 5.9 | 2.7 | 2.2 | 2.1 |
| Compensation per employee | 1.7 | 5.1 | 3.8 | 3.2 |
| ULC | 2.6 | 4.6 | 3.0 | 2.2 |
| **Business cycle** | | | | |
| Potential output (% change) | 7.6 | 5.2 | 4.3 | 3.5 |
| Output gap (% of GDP) | 1.9 | 1.1 | 0.3 | 0.2 |
| **Technical assumptions** | | | | |
| EUR/USD exchange rate | 1.08 | 1.08 | 1.08 | 1.08 |
| Oil price (USD per barrel) | 83.7 | 83.4 | 76.7 | 73.5 |

Sources: NSO; Central Bank of Malta.

[1] Data on GDP were sourced from NSO *News Release 099*/2024 published on 29 May 2024, while RPI and HICP data were sourced, respectively, from NSO *News Releases* 134/2024 and 130/2024 (published on 22 July 2024 and 17 July 2024).

[2] Actual data.

[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.

grow at a brisk pace, while private investment should begin to recover from the sharp contraction recorded in 2023, which mostly reflected base effects to an exceptional factor in the aviation sector. Furthermore, 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.

A detailed analysis of the components of GDP reveals that private consumption growth is set to moderate from 7.8% 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 should 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 below 20% throughout the forecast horizon.

Government consumption is set to rise by 5.3% in 2024. Growth is set to slow down to 4.5% and 4.3% in the outer years. The relatively strong increase in 2024 mostly reflects the expected slow-down in growth in revenue from sales, which is netted out of government consumption expenditure. Thereafter, growth is set to be driven by a moderation in growth in intermediate consumption, which was in 2023 boosted by unusually higher outlays on contractual services and residential care.

Growth in overall investment in 2024 is expected to turn positive, standing at 2.0%. This represents a partial recovery from 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.

Private investment is expected to increase by 2.7% in 2024 following a decline of 26.0% in 2023. Growth is then projected to pick up marginally to 3.3% in 2025, and 3.2% in 2026. Residential construction is set to decline for the second year in a row, falling by 1.3% in 2024. These declines follow a period of rapid growth. Dwelling investment is then projected to increase by 0.4% on average in the outer years, as incoming permit data signals moderating activity in the sector. Non-dwelling private investment is expected to grow by around 4% annually throughout the forecast horizon, largely driven by equipment investment. Following declines in the last four years, non-residential construction investment is expected to be broadly unchanged in 2024. It is then expected to grow, though at below historical rates in the following two years.

Government investment is estimated to decline by 1.1% 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 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 from 8.7% in 2023 to 4.5% in 2024. It is set to slow gradually to 3.0% by 2026. Growth in tourism exports is expected to slow down as the sector is already well above its pre-pandemic levels. Nevertheless, growth is still expected to remain strong especially in 2024, reflecting expanded flight capacity and a more balanced 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.

In 2024, imports are projected to grow by 4.4%, with growth easing gradually to 3.2% by the end of the forecast horizon. Growth in imports is driven by both goods and services with the former registering marginally higher rates than services.

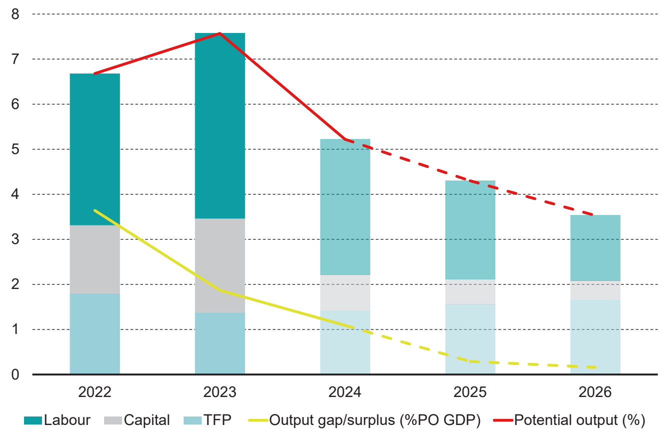
Largely mirroring expected developments in external trade, the current account in the balance of payments is expected to show a surplus of 1.1% this year, which represents a slight improvement over the surplus of 0.9% in 2023, underpinned by a marginal improvement in the trade balance. It is expected 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 7.6% in 2023 to 5.2% in 2024, 4.3% 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.

## 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. Inflows of foreign workers are also expected to slow down somewhat due to the introduction of recently announced policies vis-à-vis certain sectors, such as the introduction of skills card requirements and the moratorium on food couriers and cab drivers. Employment growth is thus expected to stand at 3.9% this year, down from 6.7% in 2023. It is projected to moderate gradually to 2.4% by 2026, as GDP growth slows down.

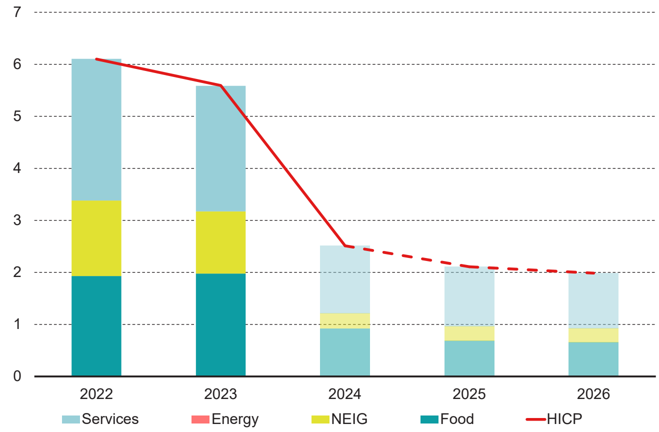
The unemployment rate is forecast to hover between 3.0% and 3.1% throughout the projection horizon. Thus, the labour market is envisaged to remain tight, and, given that the NAIRU is projected at around 3.3% in 2026, the unemployment gap is forecast to be slightly negative.

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 3.8% in 2025, and 3.2% in 2026. The strong pick-up in nominal wages reflect 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

Annual Harmonised Index of Consumer Prices (HICP) inflation is projected to moderate further this year, as pipeline pressures are expected to continue to fade. Indeed, annual HICP inflation eased from 3.7% in December 2023 to 2.2% in June 2024, with the flash estimate for July standing at 2.3%. 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 2.5% in 2024, 2.1% in 2025, and 2.0% in 2026. Meanwhile, HICP inflation excluding energy and food, is projected to stand at 2.2% in 2024, 2.0% in 2025 and 1.8% in 2026.

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




Source: Central Bank of Malta.

Compared to the Bank's previous forecast publication, HICP inflation was revised up by 0.1 percentage point in 2024, 2025 and 2026 reflecting recent outcomes, which led to a re-assessment of services inflation. Incoming data, though partial, shows an acceleration in the latter component, which contrasts with the deceleration anticipated in the previous exercise. The upward revisions in services inflation are broad-based across most sub-components, except communication services. They are mainly driven by recreational, housing and transport services inflation. Revisions to the other components are small and downwards.

Food inflation has been revised downwards because of lower-than-expected outcomes in recent months. Processed food prices are projected to increase by 4.1% 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 Stabbiltà scheme in February 2024. Processed food inflation is set to moderate further in the outer years of the projection horizon, reaching 2.9% in 2026. Similarly, unprocessed food inflation is set to decline to 4.9% this year from 8.5% in 2023. It is set to moderate to 3.5% by 2026. Reflecting these developments, overall food inflation is set to moderate to 4.3% in 2024, 3.2% in 2025, and 3.0% in 2026, also in line with expected developments in international commodity prices.

NEIG inflation has also been revised marginally downwards, and is expected to fall from 4.4% in 2023, to 1.1% in 2024. This reflects normalising international supply-chain conditions, which are reflected in a moderation of imported inflation, as well as in domestic producer price pressures. So far, supply chain disruptions arising from ongoing geopolitical tensions are not having a major impact on import costs which affect 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.

Following the latest upward revisions, services inflation is expected to ease significantly from 5.1% in 2023, to 2.8% this year and then moderate gradually to 2.4% by 2026.

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

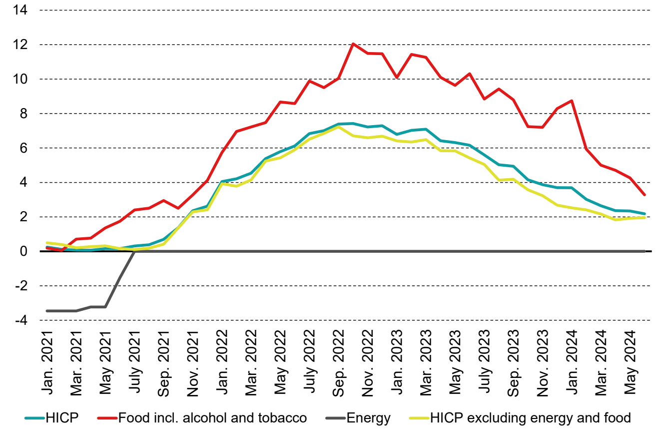
## BOX 1: AN ANALYSIS OF FOOD INFLATION IN MALTA OVER THE LAST THREE YEARS[1]

### Introduction

Food inflation (including alcohol and tobacco) was one of the main contributors to the strong rise in headline inflation since the end of 2021, although this followed a period of below-average inflation rates. It accounts for around 22% of expenditure in the overall HICP basket and is widely considered as a necessity, meaning that the surge in HICP food inflation had negative implications for household purchasing power, particularly those with lower incomes (Grech et al., 2024).[2] Food inflation reached a historical peak of 12.0% in October 2022 (see Chart 1). Since then, it has declined, falling to 3.3% in June 2024, close to its pre-pandemic long-term average of 3.2%.

This box examines the main factors behind recent food price developments, going over the factors that led to the increase and analysing the slowdown thereafter.

**Chart 1**
**DEVELOPMENTS IN CONSUMER FOOD PRICES**
*(annual percentage change)*

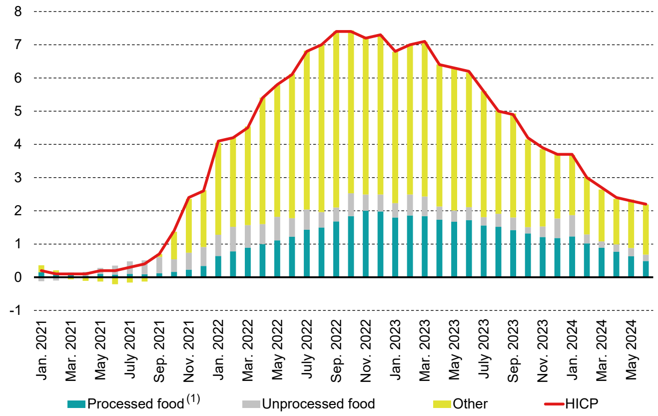



Source: Eurostat.

### Recent developments in food inflation

Chart 2 shows that the contribution of food prices to overall HICP rose from an average of 0.4 percentage point in 2021 to around two percentage points in 2022 and 2023. The strong rise in food inflation was observed for both main components: processed and unprocessed food. Processed food products account for the largest share of consumer expenditure on food (77% in 2024) with

**Chart 2**
**HICP INFLATION AND ITS MAIN COMPONENTS**
*(annual percentage change; percentage point)*




Source: SDW.
(1) Processed food includes alcohol and tobacco.

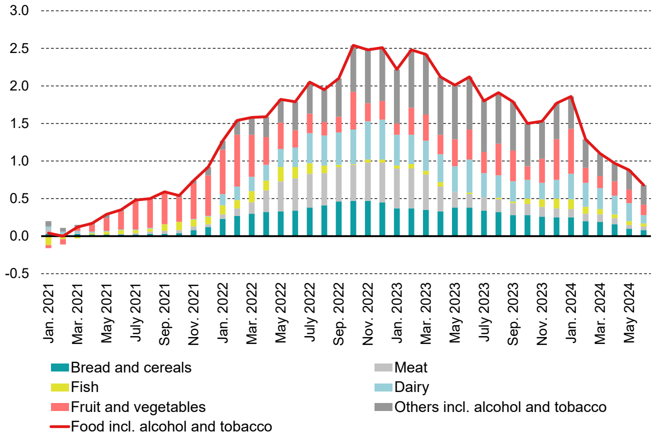
[1] Prepared by Tiziana M. Gauci, Principal Economist within the Economic and Projections and Conjunctural Analysis Office.
[2] Grech, A.G., Borg, I. and Antonaroli, V. (2024). The cost of inflation: How has the recent surge in inflation impacted lower-income households in Malta? Central Bank of Malta *Policy Note* January 2024.

unprocessed food accounting for the rest. The largest contribution towards overall food inflation was recorded in processed food products. As from February 2024, food inflationary pressures started to ease with food inflation declining considerably. Indeed, as of June 2024, the contribution of food prices to overall HICP inflation stood at 0.7 percentage point.

The deceleration in food inflation reflects developments in most subcomponents, although the largest drops stemmed from meat, bread and cereals, and dairy products (see Chart 3). At the peak of food inflation in Malta, these three sub-components contributed 1.4 percentage points to overall HICP inflation. Moreover, the 'other' component also moderated markedly, mainly reflecting movements in the prices of 'oils and fats', as well as 'sugar and confectionary items'. As of June 2024, their contribution eased to 0.3 percentage point. Fruit and vegetables prices have also eased during the period in consideration with their contribution falling to 0.1 percentage point in June 2024.

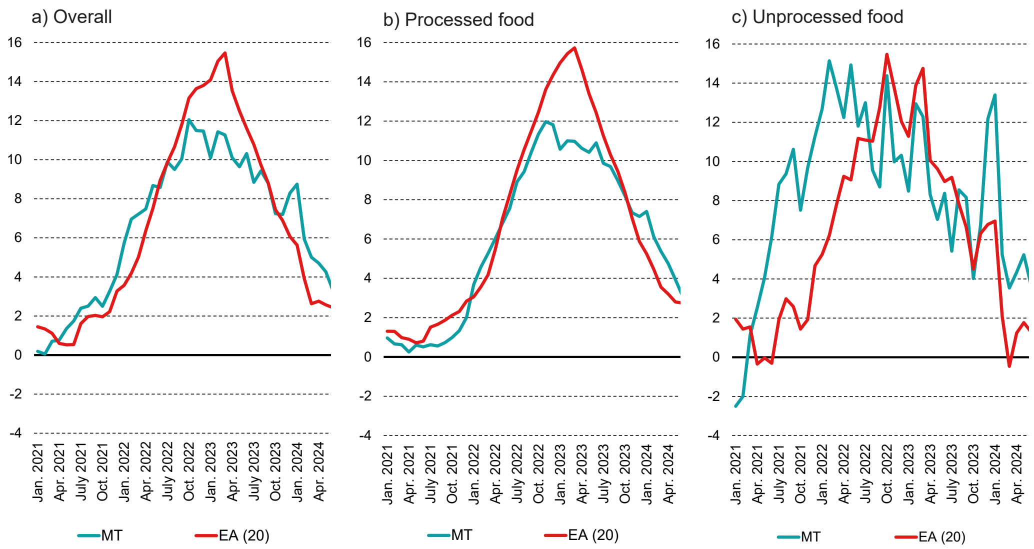
Chart 4 provides a comparison of Malta's food

**Chart 3**
**CONTRIBUTION OF FOOD INFLATION AND ITS MAIN COMPONENTS**
*(percentage point)*




Source: SDW.

**Chart 4**
**COMPARISON OF FOOD INFLATION**
*(annual percentage change)*




Source: Eurostat.

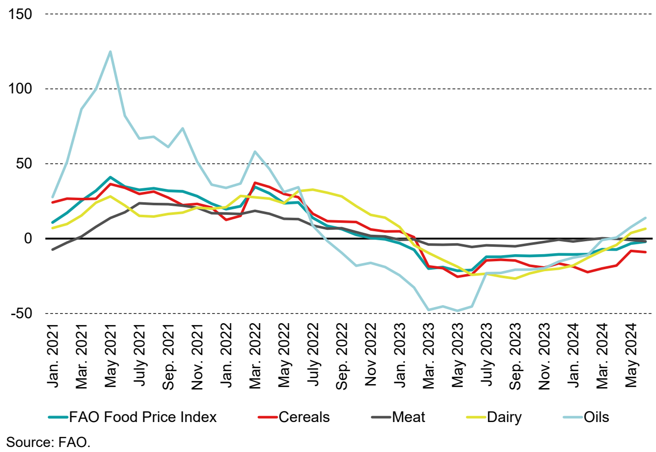
inflation with that of the euro area. The strong rise in consumer food inflation from around mid-2021 coincided with that in the euro area. While Malta's food inflation peaked in October 2022, though, food inflation in the euro area peaked in March 2023 at 15.5%. Kuik et al. (2024)[3] note that the increase in euro area food inflation stemmed from the extraordinary surge in energy costs together with higher international food commodity prices. This was coupled with both the effects of re-opening following the removal of COVID-19 related restrictions, and the effects of global supply bottlenecks. Price pressures in the food sector intensified following the Russian-Ukraine conflict (Bodnár and Schuler, 2022).[4]

Given the spatial limitations for food production, Malta imports around 70% of its food products (Rapa, 2022).[5] Consequently, the Maltese islands are particularly susceptible to developments in international food prices. Moreover, being an island in the periphery, transport costs are a key factor to retail prices. Meanwhile, food inflation in Malta tends to be more volatile than that of the euro area especially in case of unprocessed food inflation. Indeed, with regards to the latter, this has exceeded that of the euro area consistently since November 2023.

In case of processed food inflation, euro area inflation embarked on a downward trend following the peak reached in March 2023, reaching 2.4% in June 2024. In the case of Malta, processed food inflation remained higher than that in the euro area as from November 2023 onwards, although the gap between the two has narrowed considerably in recent months and stands at 0.4 percentage point in June.

The deceleration in food inflation in part reflects the slowdown in the global prices of food commodities, which led to lower imported prices. In June 2024, the Food and Agricultural Organisation (FAO) Food Price Index, which is a measure of international prices of a basket of food commodities, namely meat, dairy, cereals, oils and sugar, was down by 24.8% from its peak in March 2022, indicating easing price pressures (see Chart 5). All subcomponents recorded a decline, with the oils subcomponent almost halving followed by cereals which decreased by 32.3%.

**Chart 5**
**FAO FOOD PRICE INDEX**
*(annual percentage change)*




Source: FAO.

[3] Kuik, F., Lis, E.M., Paredes, J. and Rubene, I. (2024). What were the drivers of euro area food price inflation over the last two years? ECB *Economic Bulletin* Issue 2/2024.
[4] Bodnár, K. and Schuler, T. (2022). The surge in euro area food inflation and the impact of the Russia-Ukraine war. ECB *Economic Bulletin* Issue 4/2022.
[5] Rapa, A.M. (2022). Recent Developments and Forecasts of Food Prices in Malta. Box published in the *Quarterly Review* 2022:2 pp. 9-11.

Furthermore, a series of inflation-related support measures started being implemented towards the end of 2021 as outlined in Farrugia (2023).[6] For example, in May 2022 the Maltese government launched a subsidy scheme directly impacting the prices of food, in particular the prices for importers of cereal, flour and animal feed. Malta's food inflation started to abate in the second quarter of 2023, although it remained high by historical standards while still exceeding that of the euro area and that of the main trading partners (Demarco, 2024).[7]

Another initiative was the introduction of the Stabbiltà scheme in February 2024. The Stabbiltà scheme refers to an agreement reached between the Government of Malta and major food importers to stabilise prices of around 450 food products, from 15 categories, over the period between February 2024 and October 2024.

Indeed, looking at the sub-indices of the products affected by the scheme, a deceleration can be observed for almost all products with some sub-indices even recording negative growth rates (see Table 1). Aggregating the sub-indices of the products affected by the

**Table 1**
**INFLATION RATES OF SUB-INDICES AFFECTED BY THE STABBILTÀ SCHEME**
*(annual percentage change)*

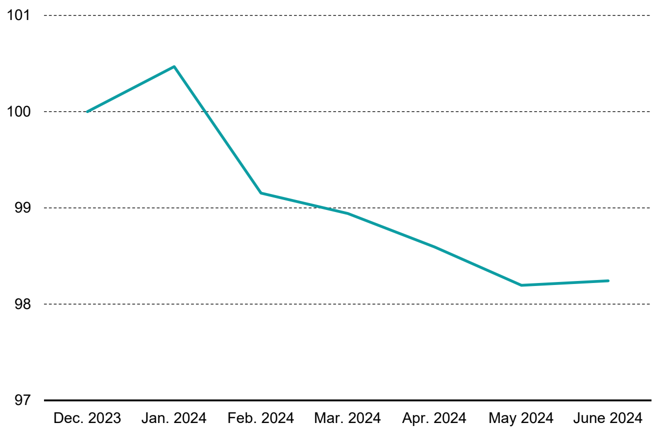
| | Jan. 2024 | Feb. 2024 | Mar. 2024 | Apr. 2024 | May 2024 | June 2024 |
|---|---|---|---|---|---|---|
| Other bakery products | 10.3 | 8.0 | 6.3 | 5.4 | 4.8 | 2.9 |
| Pasta products and couscous | 1.7 | -0.2 | -0.9 | -2.4 | -3.4 | -3.0 |
| Breakfast cereals | 6.2 | 4.1 | 1.8 | 1.5 | 1.0 | 2.1 |
| Beef and veal | 5.0 | 4.8 | 4.2 | 3.8 | 3.2 | 2.6 |
| Pork | 6.2 | 5.1 | 4.0 | 3.2 | 2.3 | 1.5 |
| Poultry | 1.1 | 0.8 | 0.9 | 1.0 | 1.9 | 1.4 |
| Dried, salted or smoked meat | 4.1 | 4.9 | 5.2 | 4.1 | 1.9 | 2.5 |
| Other preserved or processed fish and seafood and fish and seafood preparations | 11.6 | -1.5 | -2.8 | -3.9 | -5.6 | -5.9 |
| Preserved milk | 5.1 | -4.4 | -5.4 | -8.0 | -10.0 | -10.1 |
| Butter | -1.7 | -4.7 | -4.2 | -3.7 | -2.4 | -2.7 |
| Margarine and other vegetable fats | 9.2 | -4.8 | -5.6 | -5.4 | -4.7 | -4.1 |
| Frozen vegetables other than potatoes and other tubers | 13.5 | 7.3 | 7.0 | 6.6 | 5.1 | 4.9 |
| Potatoes | 17.5 | 10.9 | 8.2 | 3.6 | -6.6 | -2.1 |
| Coffee | 15.6 | 6.5 | 2.8 | 1.6 | 0.8 | 0.8 |
| Tea | 1.5 | 1.5 | 4.1 | 3.9 | 4.8 | 3.6 |

Source: Eurostat.

[6] Farrugia, J. (2023). Support Measures and their Impact on Public Finances. Box published in the *Quarterly Review* 2023:3.
[7] Demarco, A. (2024). The recent divergence of food inflation in Malta. The Malta Business Weekly Times Article. Available at: https://maltabusinessweekly.com/the-recent-divergence-of-food-inflation-in-malta/24984/.

scheme into an index, reveals that by June 2024 these products collectively were around 2 percentage points lower than their level in January 2024 (see Chart 6).

Chart 6
**INDEX OF PRODUCTS INCLUDED IN STABBILTÀ SCHEME**
*(Index 2023 = 100)*



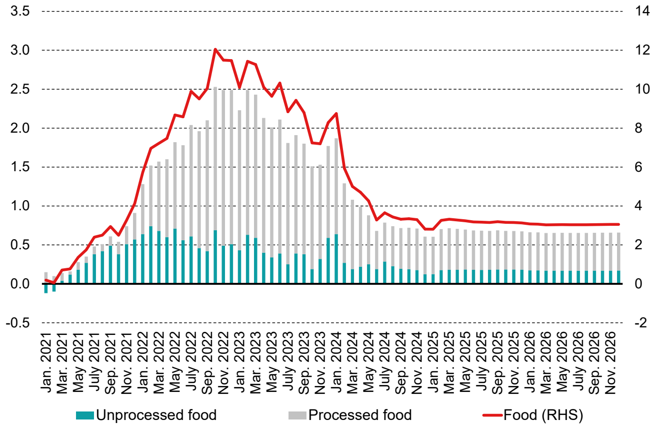

Sources: Eurostat; author's calculations.

However, figures should be interpreted with caution as the sub-indices shown here include items which were not included in the scheme. For example, poultry products in official HICP statistics include all those items related to poultry including chicken legs, chicken breast, minced chicken, and whole chicken. In the Stabbiltà scheme only a selection of these items was covered. Moreover, only certain brands were included in the scheme. Thus, these figures cannot be interpreted as showing the precise impact of the Stabbiltà scheme. That said, the reduction in food items included in Stabbiltà may have spilled over into other food items which are substitutes.

## Food price projections

According to Eurostat's flash estimate for July 2024, food inflation (including alcohol and tobacco) rose to 3.6% from 3.3% in June. The latest projection exercise indicates that food commodities prices are expected to grow at a more moderated pace during the years to come. Hence, annual food price inflation is forecasted to ease gradually to 3.0% by 2026 (see Chart 7).

Chart 7
**FOOD INFLATION FORECAST AND ITS CONTRIBUTION TO HICP**
*(annual percantage change; percentage point)*




Sources: Eurostat; Central Bank of Malta.

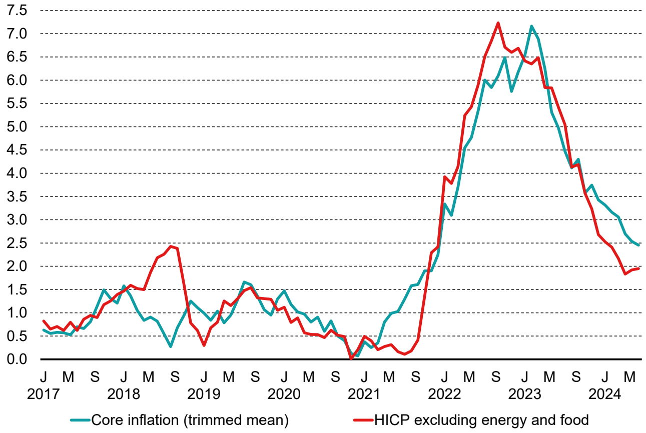
Processed food inflation is forecasted to remain on a downward path throughout the forecast horizon, moderating gradually until it reaches 2.9% in 2026, which is in line with technical assumptions for food commodities. On the other hand, unprocessed food inflation continues to exhibit significant volatility. Looking at the monthly profile, unprocessed food inflation is likely to linger at around 4.0% until November 2024. It is then projected to decline to 2.5% in December 2024 and January 2025, following the strong increases recorded a year earlier. Subsequently, it is expected to stabilise at around 3.5% by the end of the forecast horizon, which is close to the historical average.

The contribution from processed food is expected to decrease to 0.5 percentage point by 2026, while that from unprocessed food is expected to ease to 0.2 percentage point, similarly in line with historical averages. Even though unprocessed food inflation is expected to remain higher than that of processed food, the contribution of the former is lower given the weights structure of the two sub-components.

## BOX 2: DEVELOPMENTS AND DYNAMICS IN GOODS AND SERVICES INFLATION[1]

### Introduction

**Chart 1**
**CORE INFLATION**
*(annual percentage change)*




Sources: Eurostat; own calculations.

In the earlier stages of the surge in inflation, occurring towards the end of 2021, core inflation proved to be the main contributor to headline inflation. Indeed, services inflation moved from a period of negative contribution to being the largest contributor to overall HICP inflation. This was followed by NEIG inflation, whose contribution picked up strongly up until March 2023 and started to decline thereafter. Core inflation has been on a disinflationary path since the second quarter of 2023 (see Chart 1). However, while NEIG inflation has declined at a faster pace, services inflation has been somewhat sticky, and its contribution has remained elevated compared to its historical average.

This box focuses on the developments in NEIG and services inflation with the aim of a better understanding of the impact that goods and services inflation have on the disinflationary process and provide insights into the medium-term outlook for core inflation.

### Recent developments in NEIG and services inflation

Charts 2a and 2b outline a time series as well as an estimated trend for services and NEIG inflation from 2011 up to 2026, covering the projection horizon. The trend was estimated using an exponentially weighted moving average (EWMA) of past inflation rates.[2]

The estimated trend for both services and NEIG inflation increased significantly since 2022. The estimated trend for NEIG inflation is estimated to remain elevated compared to the pre-COVID average of 0.7%, declining to 1.5% by 2026. NEIG inflation has experienced a fast decline throughout 2023, partly reflecting the easing of global supply chain pressures. This slowdown was evident across all major components with durable goods experiencing the strongest decline. In June, NEIG inflation stood at 1.1%, and this is projected to decline further to 1.0% by 2026, just above its pre-COVID average (see Chart 2a).

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

[2] See Banbura, M. and Bobeica, E. (2020). “Does the Phillips curve help to forecast euro area inflation?” In ECB *Working Paper* No. 2471. This approach assumes a “statistical” trend based on a weighted average of past inflation rates. A fixed smoothing parameter of 0.05 was used.

**Chart 2a**
**NEIG**
*(annual percentage change)*

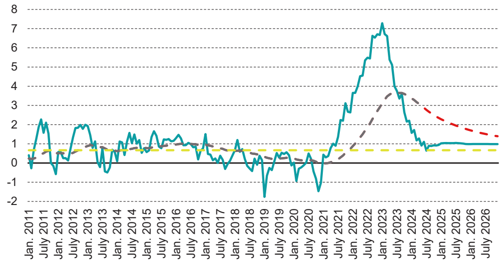
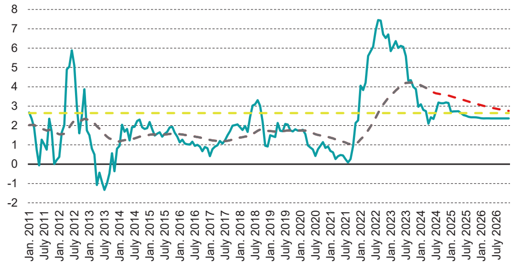



**Chart 2b**
**SERVICES**
*(annual percentage change)*




Sources: Eurostat; Central Bank of Malta; own calculations.

In the case of services, when considering the projections, the trend is estimated to gradually decline to 2.9% by 2026, which is marginally above the historical average observed pre- COVID. The decline in services inflation has been more gradual throughout 2023 when compared with that of NEIG, in part because housing and recreation prices experienced a much more sluggish decline than other items. Nonetheless, stickiness seems to have diminished during 2024. Indeed, in June, overall services inflation stood at 2.3%, 0.3 percentage point below its historical average experienced pre-COVID, driven by negative inflation in communication prices. While the flash estimate for July, standing at 2.7%, indicates a slight acceleration in services inflation, this is projected to gradually decrease to 2.4% by 2026 (see Chart 2b).

## The relative price of services vis-à-vis NEIG

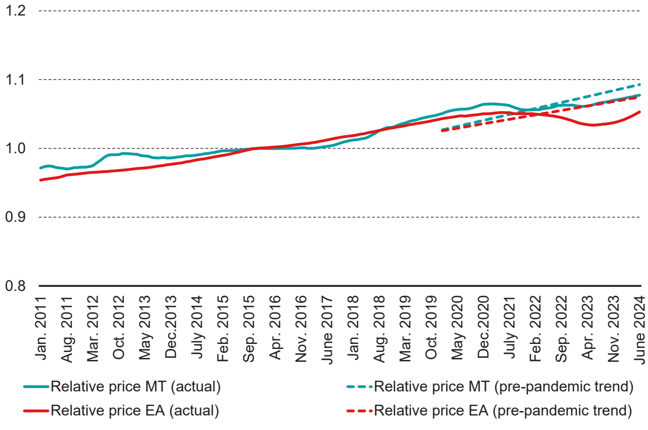
Prior to the COVID-19 pandemic, historical data indicated that the year-on-year growth rate of service prices was, on average, 1 percentage point higher than that of goods prices. This pattern highlighted an upward trend in the price of services relative to core goods, a trend observed in both Malta and the euro area.

As outlined in Amatyakul, Igan and Lombardi (2024),[3] this trend may reflect two main factors, the first being the higher income elasticity of demand for services. As income per capita rises, consumers tend to spend a larger portion of their income on services compared to goods, increasing the relative demand for services. This means that as people become wealthier, their spending patterns shift more towards services, leading to faster price increases in services components. In addition, this trend may also be explained by the Baumol cost disease effect. The latter principle suggests that wages in labour-intensive sectors like services tend to rise in line with those in more productive sectors, even if productivity in services does not increase at the same rate. This results in higher costs and prices for services compared to goods. However, the COVID-19 pandemic disrupted this long-standing trend. During the pandemic, goods prices began to rise more rapidly, driven by factors such as supply chain disruptions, and a shift away from the consumption of high contact services towards durable and semi-durable goods.

[3] See Amatyakul, P., Igan, D., and Lombardi, M. (2024), "Sectoral price dynamics in the last mile of post-Covid-19 disinflation" in BIS *Quarterly Review*, March 2024.

As illustrated in Chart 3, the relative price of services compared to goods in both Malta and the euro area remains marginally above 1, indicating that services still remain relatively more expensive than goods. However, both series stand below the pre-pandemic trend calculated, which is based on data between 2015-2019. This might suggest some structural changes in consumer preferences especially related to goods inflation.

Chart 3
THE RELATIVE PRICE OF SERVICES VS. NEIG
*(Index 2015=1)*



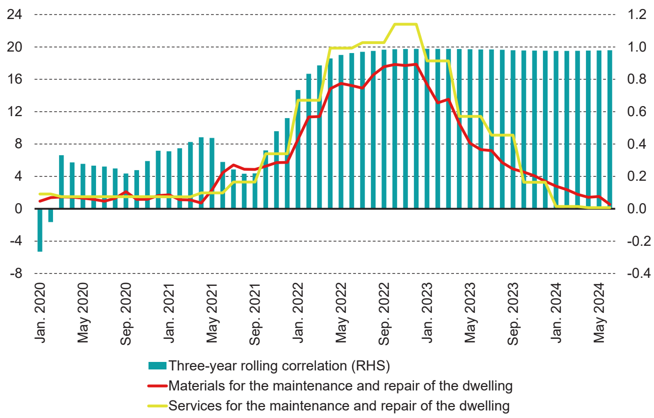

Sources: Eurostat; own calculations.

## Correlation between NEIG and services inflation

The correlation between NEIG and services inflation has increased sharply throughout this period of high inflation. This reflects the indirect effects of NEIG inflation on services inflation, particularly housing maintenance services. This relationship underscores the interconnected nature of some goods and services in the economy, where inflation in one sector can spill over and drive-up prices in another. In particular, inflation for housing maintenance services soared to double digits throughout 2022, reaching a peak of 22.8% in the last quarter of 2022 before starting to decline. This surge was significantly influenced by an increase in prices of certain items forming part of NEIG.

Indeed, Chart 4 illustrates a strong correlation between prices for materials used for housing maintenance and housing maintenance services prices beginning in January 2022. Before this period, the correlation between NEIG inflation and housing maintenance services prices was weaker. However, from January 2022 to June 2024, the correlation averaged 0.96, indicating a very strong

Chart 4
INFLATION IN MATERIALS AND SERVICES FOR HOUSING MAINTENANCE
*(annual percentage change)*




Sources: Eurostat; own calculations.

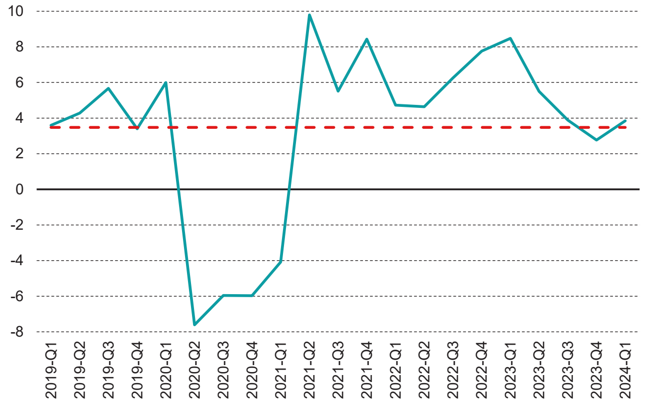
relationship between the two. This high correlation confirms the indirect effect NEIG inflation has had on services inflation, highlighting the reliance of these services on industrial goods. As the prices of materials started to rise in the second half of 2021, the costs for maintenance services also increased, suggesting that service providers passed on the higher costs onto consumers in the form of higher service prices thereby maintaining or increasing their profit margin.

### Developments in wages and profits

Both wages and profits play an important role in understanding domestic inflation dynamics. Chart 5 shows the year-on-year wage growth (LFS annual basic salaries) since 2019, and the historical average evident prior to the pandemic. Following a period of negative growth rates during the COVID-19 pandemic, wages reached an all-time growth rate of 9.8% in the second quarter of 2021. Since then, wage growth has remained elevated compared to the historical average, however it has started to moderate since the second half of 2023. In the first quarter of 2024, wage growth stood at 3.8%, marginally above the historical average of 3.5%. Additionally, information gathered from the CBM Business Dialogue, suggests that firms are expecting significant wage increases for 2024, whereby the majority of firms interviewed outlined that they are expecting wage increases of more than 5%. If such wage increases materialise, this could put upward pressure on services inflation going forward.

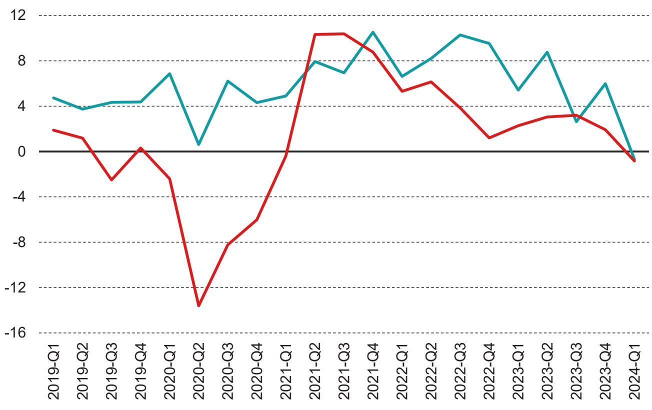
At the same time, profits, also might have contributed to core inflation dynamics. Chart 6 shows the growth rates of the two main indicators of profits being profit

**Chart 5**
**WAGE RATES – LFS ANNUAL BASIC SALARIES**
*(annual percentage change)*




Source: NSO.

**Chart 6**
**GROWTH IN THE PROFIT MARGIN AND UNIT PROFITS**
*(annual percentage change)*




Sources: NSO; own calculations.

margins and unit profits. The latter measure the average profit per unit of output while profit margins is defined as the ratio of the GDP deflator to unit labour costs. In 2021 and 2022, both unit profits and profit margins increased significantly, with the year-on-year growth averaging at 8.1% and 5.7% respectively during these two years. This surge was enabled by the reopening of the economy following the COVID-19 pandemic, leading to pent-up demand and high household savings (see Chart 6). This is corroborated by Borg (2023),[4] who highlighted strong increases in both unit profits and profit margins in 2021 and 2022. Additionally, in the latter analysis, Borg outlined that profitability is expected to moderate significantly, suggesting that costs increases will be shared between labour and businesses.

Indeed, as shown in Chart 6 both profit indicators have been moderating from the high levels seen in 2021 and 2022. Profit margins declined throughout 2023 and stood at -0.8% in the first quarter of 2024. While the decline in unit profit growth rates was more moderate throughout 2023 and remained rather elevated compared to the historical average, in the first quarter of 2024, unit profit growth declined to -0.7%. This moderation suggests that profits have been acting as a buffer to further price increases. If this pattern continues, this will help to prevent second round effects on inflation from the response of wages, and enable a further slowdown in core inflation, particularly in services inflation.

[4] See Borg, I. (2023), "Box 2: Recent developments in profits and forecast implications" in CBM Outlook for the Maltese Economy 2023:3.

## 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.

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

| | 2023[1] | 2024 | 2025 | 2026 |
|---|---|---|---|---|
| **Headline aggregates** | | | | |
| Total revenue | 33.4 | 33.3 | 33.3 | 33.5 |
| Total expenditure | 38.3 | 37.3 | 36.8 | 36.6 |
| General government balance | -4.9 | -4.1 | -3.6 | -3.1 |
| of which: primary balance | -3.8 | -2.7 | -2.2 | -1.7 |
| General government debt | 50.3 | 52.3 | 53.3 | 54.1 |
| **Detailed breakdown** | | | | |
| Current revenue | 32.3 | 32.2 | 32.2 | 32.2 |
| Current taxes on income and wealth | 12.5 | 12.6 | 12.7 | 12.7 |
| 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 | 4.2 | 4.1 | 4.1 |
| Current expenditure | 33.1 | 32.8 | 32.5 | 32.1 |
| Compensation of employees | 10.0 | 9.9 | 9.9 | 9.9 |
| Social benefits | 8.2 | 8.4 | 8.3 | 8.1 |
| Intermediate consumption | 7.8 | 7.9 | 8.0 | 8.0 |
| Interest payments | 1.1 | 1.3 | 1.3 | 1.4 |
| 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 | 0.1 |
| Capital revenue | 1.1 | 1.0 | 1.1 | 1.3 |
| Capital taxes | 0.2 | 0.2 | 0.2 | 0.2 |
| Other capital revenue[4] | 0.9 | 0.9 | 0.9 | 1.1 |
| 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 | 1.3 | 1.1 | 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 | 1.0 | 0.7 | 0.2 | 0.1 |
| Temporary government measures | 0.3 | 0.0 | 0.0 | 0.0 |
| Structural balance | -6.2 | -4.8 | -3.8 | -3.2 |

Sources: NSO; Central Bank of Malta.

[1] Actual data as per NSO *News Releases 122*/2024 (published on 5 July 2024) and 099/2024 (published on 29 May 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.

Forecasts remain mostly unchanged compared with the Bank's earlier projections in the absence of an updated fiscal plan since Budget 2024.[4]

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.

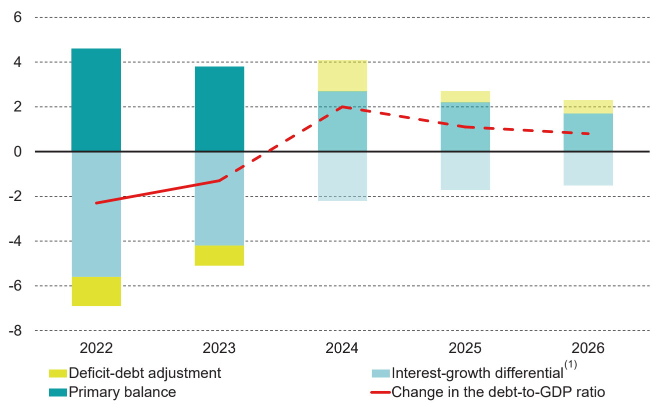
The share of current expenditure in GDP is forecast to decline throughout the forecast horizon, mainly due to projected lower subsidies. This reflects the profile of spending on inflation-mitigation measures, which is set to decrease in line with the assumed profile for energy prices. It also reflects 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 social benefits in GDP is set to rise in 2024, driven by the increase in benefit rates announced in the last year's Budget Speech. Thereafter, outlays are expected to grow by less than GDP. The share of interest payments in GDP is set to increase by the end of the forecast horizon.

The share of capital expenditure in GDP is projected to decline in 2024 and 2025, and to remain broadly constant in 2026. 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 in 2024 and 2025. These projections reflect the expected profile of EU-funded and domestically-financed capital expenditure.

The structural budget deficit is projected to narrow substantially over the projection horizon, reaching 3.2% of GDP by 2026, from 4.8% in 2024.[5] This is driven by the declining 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 54.1% by 2026. This is mostly driven by the continuation of primary deficits (see Chart 4).

**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.

[4] In line with the requirements of the new EU fiscal framework, Member States must submit a new set of medium-term plans to the European Commission, by September 2024.
[5] The structural balance is defined as the cyclically-adjusted balance, net of temporary government measures.

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 KM Malta Airlines, which replaced Air Malta. These factors offset the debt-decreasing impact of the favourable interest-growth differential.

## Risks

As the upcoming national accounts publication will include a benchmark revision, these projections could be impacted by possible material revisions to past data. Furthermore, the publication of updated fiscal plans by the Government in fulfilment of the new EU fiscal rules later this year could also have an impact. The Bank's projections could thus be revised somewhat in upcoming projection rounds when this information becomes available.

Looking beyond these factors, the overall risks to activity are broadly balanced over the projection horizon. Downside risks largely emanate from possible 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 and thus stronger output growth.

Risks to inflation are balanced over the projection horizon. Upside risks to inflation could stem from renewed supply-side bottlenecks that could be triggered by ongoing geopolitical conflicts. Furthermore, wage pressures could be stronger than envisaged in the baseline. Unfavourable weather conditions and policies supporting the green transition – in particular those requiring heavy capital investment – could also push up inflation, although such effects might be temporary. On the downside, imported inflation could fall more rapidly than expected if the global disinflation process proceeds faster than assumed.

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.