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CENTRAL BANK OF MALTA

OUTLOOK FOR THE MALTESE ECONOMY

2025:1

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The Bank's projections for the Maltese economy are based on information available up to 6 February 2025. Figures in tables may not add up due to rounding.

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OUTLOOK FOR THE MALTESE ECONOMY 2025-2027

Overview[1,2]

Economic activity in Malta remained relatively buoyant during 2024. High-frequency data suggest that the conjunctural situation remains strong despite the uncertain external environment. Indeed, the Bank's Business Conditions Index has recently stood close to but above its historical average.

Nevertheless, economic growth is expected to moderate from the very high rates experienced in the last four years, broadly converging to potential output growth by the end of the projection horizon.

At the same time, the disinflationary process has gathered pace, and by January 2025 HICP inflation stood below 2%. Inflation is expected to remain stable around the ECB's inflation target. This, together with the recently enacted widening of the income tax bands, will boost real disposable income growth, which should remain robust and support private consumption.

The Bank's latest economic projections have a cut-off date of 6 February 2025, and thus pre-date the latest release of the national accounts of 27 February 2025.[3]

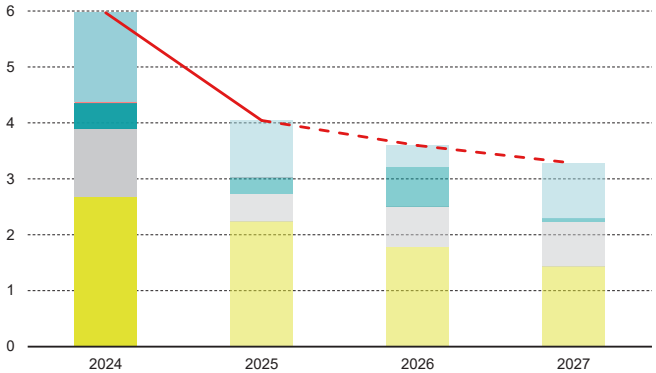
Economic outlook

According to the Bank's latest forecasts, Malta's real GDP growth should ease from 6.0% in 2024, to 4.0% in 2025 (see Table 1). Growth is set to moderate further in the following two years, reaching 3.3% in 2027. Compared to the Bank's previous projections, GDP growth is being revised up by 0.1 percentage points in 2025 and is revised down by 0.1 percentage points in 2027.

The marginal upward revision in GDP growth in 2025 reflects a higher contribution from both domestic demand and net exports. The downward revision in 2027 is driven by net exports.

Over the projection horizon, domestic demand is expected to be the main driver of growth (see Chart 1). The latter is expected to be led by private consumption, which is projected to continue to grow at a brisk pace, while private investment should continue to recover. Furthermore, net exports are 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 of domestic demand.

Chart 1
GDP GROWTH PROJECTIONS
(annual percentage change; percentage point contributions)



Source: Central Bank of Malta.

[1] The Bank's projections for the Maltese economy take into account the ECB technical assumptions transmitted on 6 February 2025.
[2] See Central Bank of Malta Outlook for the Maltese Economy 2024:4.
[3] See NSO *News Release* 035/2025 published on 27 February 2025 about gross domestic product Q4/2024.

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

	2024[2]	2025	2026	2027
Real economic activity (% change)				
GDP	6.0	4.0	3.6	3.3
Private consumption expenditure	5.7	4.8	3.8	3.1
Government consumption expenditure	7.3	2.8	4.2	4.6
Gross fixed capital formation	2.4	1.5	3.8	0.4
Exports of goods and services	5.3	4.0	3.6	3.6
Imports of goods and services	4.7	3.7	3.8	3.3
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	4.4	3.0	3.2	2.3
Net exports	1.6	1.0	0.4	1.0
Changes in inventories	0.0	0.0	0.0	0.0
Balance of payments (% of GDP)				
Goods and services balance	18.0	18.3	18.2	18.8
Current account balance	6.3	6.3	6.2	6.6
Labour market (% change)[3]				
Total employment	5.1	2.7	2.3	2.3
Unemployment rate (% of labour supply)	3.2	3.1	3.0	3.0
Real disposable income	5.0	5.5	3.6	2.7
Household saving ratio	10.7	11.2	11.1	10.8
Prices and costs (% change)				
GDP deflator	3.2	2.3	2.3	2.3
RPI	1.7	1.8	1.8	1.8
Overall HICP	2.4	2.1	2.0	2.0
HICP excluding energy	2.6	2.3	2.2	2.1
Compensation per employee	5.9	3.6	3.6	3.5
ULC	5.0	2.2	2.3	2.5
Business cycle				
Potential output (% change)	5.3	4.5	4.0	3.7
Output gap (% of GDP)	1.2	0.8	0.4	0.0
Technical assumptions				
EUR/USD exchange rate	1.08	1.04	1.04	1.04
Oil price (USD per barrel)	82.0	74.7	70.3	68.7

Sources: NSO; Central Bank of Malta.

[1] Data on GDP were sourced from NSO *News Release 035*/2025 published on 27 February 2025, while RPI and HICP data were sourced, respectively, from NSO *News Releases* 012/2025 and 009/2025 (published on 22 January 2025 and 17 January 2025). Also, Eurostat's January flash estimate was taken into consideration during this projection round.

[2] Actual National Accounts data. BOP is Bank's projection.

[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.

Private consumption growth is set to moderate, reflecting an expected continued normalisation in consumer demand following strong growth in recent years. Nevertheless, it is set to remain strong, as household disposable income in 2025 will be supported by the significant widening of the income tax bands. This will in turn boost private consumption growth, though there will also be

some upturn in the saving ratio, as higher income households with a lower average propensity to consume would save some of the foregone taxes. In the following years, the saving ratio is envisaged to decline marginally but remain broadly stable at 2024 levels (see Box 1).

Real government consumption growth is set to decline to 2.8% in 2025. Growth is then set to pick up to above 4% in 2026 and 2027. This profile is mainly driven by that of compensation to public sector employees. In 2025 the latter is impacted by a negative base effect stemming from high payments of allowances in 2024 due to newly signed collective agreements. This impact is set to subside in subsequent years as the impact of a collective agreement for the civil service, effective from 2025, gains relevance.

Overall investment is projected to grow by 1.5% in 2025 before it picks up to 3.8% in 2026. Investment is projected to grow by only 0.4% in the outer year as government investment is projected to decline strongly that year.

Private investment began to recover in 2024. Growth is expected to remain above 3% throughout the forecast horizon, standing at 3.5% in 2025 and 3.2% in the outer years. Growth in residential construction is expected to remain muted in the forecast horizon as investment outlays remain high from a historical perspective. Moreover, growth in non-dwelling private investment is expected to remain close to 4%. The latter is below historical rates as the ongoing weakness in the private non-residential construction sector will persist.

Government investment is forecast to decline by 6.8% in 2025. This is due to the expected profile of domestically-financed investment. Government investment is then set to grow by 7.0% in 2026 and to decline by 12.2% in 2027. This is mainly due to the profile of EU-funded investment, which is set to increase in 2026 but to drop in 2027, once projects financed by the Recovery and Resilience Facility (RRF) are completed.

Export growth is set to slow down to 4.0% in 2025 and edge down further to 3.6% in the outer years. While growth in services exports is expected to moderate following an extended period of robust growth, goods exports are set to recover somewhat from the declines of 2023 and 2024. This reflects some recovery in foreign demand, though the latter is envisaged to remain muted from a historical perspective even in the absence of trade tariffs by the U.S. on EU goods.

Growth in imports is expected to moderate in 2025, falling to 3.7%, before edging down to 3.3% in 2027. This profile is conditioned significantly by that of investment. Similar to services exports, growth in services imports is expected to decline throughout the forecast horizon.

Partly reflecting the large surplus recorded in the first half of the year, the current account in the balance of payments is expected to show a surplus of 6.3% this year. This is underpinned by a strongly positive trade balance as well as net inflows on the secondary income account. The current account is set to remain in surplus and above 6% in the rest of the projection horizon.

BOX 1: HOUSEHOLD DISPOSABLE INCOME AND SAVING RATE – NEW MEASURE AND A COMPARISON WITH THE EUROPEAN UNION[1]

Introduction

Household saving is an important determinant of the availability of funding for investments by both the private sector and government. The lower the household saving rate the lower the funding available to finance such investment and hence economic growth. In 2024, the National Statistics Office (NSO) started publishing a full sequence of non-financial accounts for the period 1995 to 2023.[2,3] As part of these accounts, the NSO has published an annual time series of households' disposable income and savings rate. These series will now be published on an annual basis along with other sector accounts data.[4]

As disposable income is a key determinant of private consumption, prior to the official publication of such variable, the Central Bank of Malta used to produce its own estimate. Disposable income is an important component of the macroeconometric framework of the Bank and is an explanatory variable in the private consumption equation within STREAM, the flagship model used to produce the Bank's projections.[5] Projections of disposable income as well as the saving ratio are regularly transmitted to the ECB as part of the bi-annual Eurosystem staff projections and published in the Bank's quarterly projections publication.

Following the publication of the sequence of non-financial accounts by the NSO, the Bank decided to replace its internal estimates and instead switched to the official series of disposable income and saving rate. However, since previously the Bank could not follow the official methodology to estimate disposable income due to some data limitations, its past estimate differs somewhat from that published by the NSO.

This box compares the Bank's historical estimates of disposable income and the savings rate with the new official series. It also compares the savings rate for Malta with that of the European Union (EU).

A brief outline of the methodology underlying the official estimate of disposable income

The disposable income of each sector within the national accounts framework is derived as a balancing item from a set of ordered sequence of accounts, which describe the different stages of economic processes: production, generation of income, its distribution and redistribution, its use and asset accumulation. Each account has its 'uses' and 'resources' information, which are brought to balance with a balancing item. The uses refer to items

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1 Prepared by Abigail Marie Rapa, a principal economist within the Economic Analysis Department of the Central Bank of Malta.

2 See NSO *News Release* 198/2024 published on 23 October 2024.

3 Data on disposable income was only provided in the National Accounts up to 1999. Thereafter readings for this series were not publicly available. See: Grech, O., "A New Measure of Household Disposable Income for Malta", *Annual Report*, Central Bank of Malta, 2013, pp. 42-48. Also, a discussion of the saving rate in Malta between 1970 and the late 1990s can be found in Grech, A. G., "The Private and Public Saving Gaps in Malta and their Impact on the Current Account", *Quarterly Review*, 33(1), Central Bank of Malta, 2000, pp. 51-61.

4 The non-financial accounts by institutional sector describe the accounts of non-financial (S11) and financial (S12) corporations, general government (S13), households (S14) and non-profit institutions serving households (NPISH) (S15) and their relationships between them and with the rest of the world.

5 See STREAM.

payable from the relevant sector, while resources are receivables by the sector. For our purposes, we are particularly interested in the accounts of households and non-profit institutions serving households (NPISH) (sectors 14 and 15).

Households' disposable income includes wages and salaries, mixed income (income from self-employment and unincorporated enterprises), income from social benefits other than those in kind, other current transfers, and income from financial investments. It is netted of taxes on income, wealth, social security contributions paid by employees, the self-employed and the unemployed as well as interest on financial liabilities. The term gross implies the inclusion of depreciation costs.

$$ypd = yemp+socbenc+currtran -ssc-hhdirtax+totinv+ selfempinc \quad (1)$$

where;

ypd = nominal disposable income

yemp = wage bill

socbenc = social benefits excluding in kind

currtran = other current transfers

ssc = social security contributions

hhdirtax = household direct taxes

totinv = total investment income (net)

selfempinc = self-employed income, including imputed rents

While the publication of the Sector Accounts by the NSO is essential, this still poses some challenges going forward. First, the Bank's macroeconometric model STREAM is estimated using data at quarterly frequency and given that the availability of official disposable income figures are at annual frequency, the quarterly measure to be used in the Bank's forecasting model needs to be interpolated. We utilize the Chow-Lin generalised least squares regression-based interpolation technique to transform each annual disposable income sub-component into quarterly frequency. This method is used for temporal disaggregation or interpolation of time series data, and it involves distributing a series to a higher frequency while maintaining the sum, average, first or last observation over each period.

Secondly, annual sector accounts are published yearly consistent with the second vintage (Q2) of national accounts published in August. However, most components of the nominal disposable income series shown in equation 1 are subsequently revised in each national accounts vintage. To maintain consistency with other components of the national accounts (such as private consumption) that are revised at quarterly intervals, we revise disposable income elements on a quarterly basis where possible. Hence, in between these vintages, the Bank could show slightly different values for disposable income and the savings rate than those published officially by the NSO. In the charts, this measure is referred to as 'latest estimate'. Nevertheless, in each December projection round, from now on the Bank's disposable income and saving rate will be consistent with the official sector accounts data published in the preceding October.

As the Bank takes into account all available quarterly releases of national accounts, its historic series of disposable income and the savings rate will also cover a longer time period than the sector accounts.

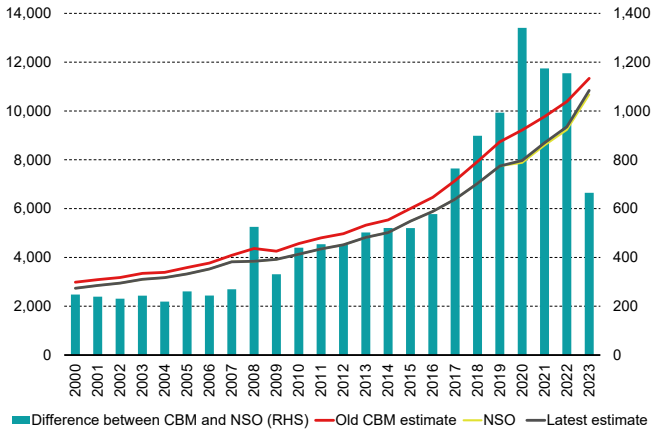
Outcome

This section compares the Bank's estimate of disposable income based on the old methodology but using the latest quarterly national accounts data (Old CBM estimate), with the official measure of disposable income published by the NSO in the sector accounts. Chart 1 shows that the Bank's estimate of nominal disposable income based on the previous methodology was higher in level terms than the one which was published by the NSO. This is the case throughout the time series, although the difference was particularly pronounced from 2017 onwards.

Despite such level differences, Chart 2 shows that developments in terms of annual growth rates are broadly similar, except in a few years. In particular, we noticed a relatively strong difference in annual growth developments in 2023 (6.4 percentage points), 2008 (-6.2 percentage points) and 2009 (4.7 percentage points).

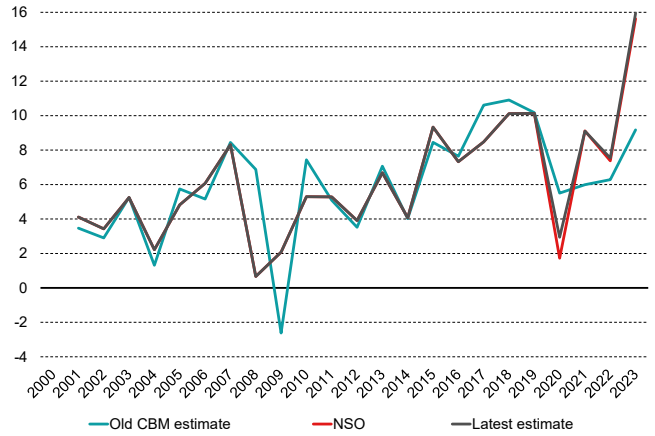
The largest contributors to such differences emanate from divergent growth developments in the total investment and self-employed income components. Information for both these subcomponents was relatively scarce prior to the publication of the annual sector accounts, and hence, the Bank produced its own estimates that are likely to have suffered from relatively non-negligible statistical errors. Nevertheless, the dynamics of both series are qualitatively similar and mainly driven by the wage bill.

Chart 1
NOMINAL DISPOSABLE INCOME
(EUR million)



Sources: NSO; author's calculations.

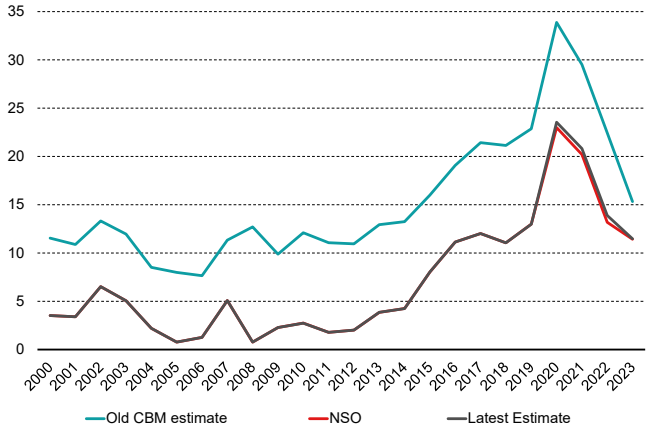
Chart 2
NOMINAL DISPOSABLE INCOME GROWTH RATES
(annual percentage change)



Source: Author's calculations.

Chart 3 shows the implied differences in the saving ratio between the Bank's old estimate and the official saving ratio. In view of the above-mentioned scarce information about certain subcomponents of disposable income (particularly self-employed income), the Bank had benchmarked the 2015 saving ratio with the 2015 Household Budget Survey (HBS).

Chart 3
SAVING RATE
(per cent of disposable income)



Sources: NSO; author's calculations

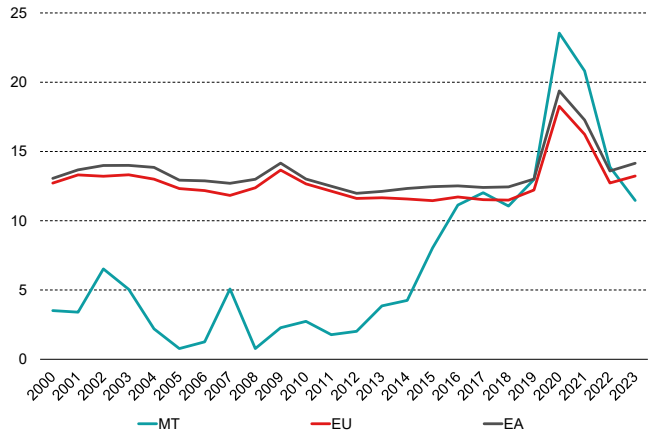
As the Bank's old estimate of disposable income was higher than the one published by the NSO, its saving ratio was also higher throughout the whole period. Chart 3 shows that while according to the Bank's old estimate, the saving ratio peaked at 34% in 2020, the peak of the NSO series is 23%. Nonetheless, the dynamics of the two savings rates derived by the two disposable income measures are very similar. This result mirrors the fact that the dynamics in terms of the two measures of disposable income were very similar.

Furthermore, from the charts above one can note that if disposable income is re-estimated, and the saving rate is derived using the latest national accounts data, the deviation from the sector accounts' series is small.[6] The next section of this short study uses the 'latest estimate' as Malta's figures.

Comparison with the EU and EA

Looking at the developments in the saving rate in Malta and the EU one can note that the latter registered higher saving rates until 2017, by which time Malta's saving rate started exceeding the EU average. This also holds for the euro area (EA). As shown in Chart 4, for most of the early 2000s

Chart 4
SAVING RATE
(per cent of disposable income)



Sources: Eurostat; author's calculations.

[6] The difference between the NSO estimate and the latest estimate occurs from 2020 onwards as the national accounts data is revised from 2020 onwards.

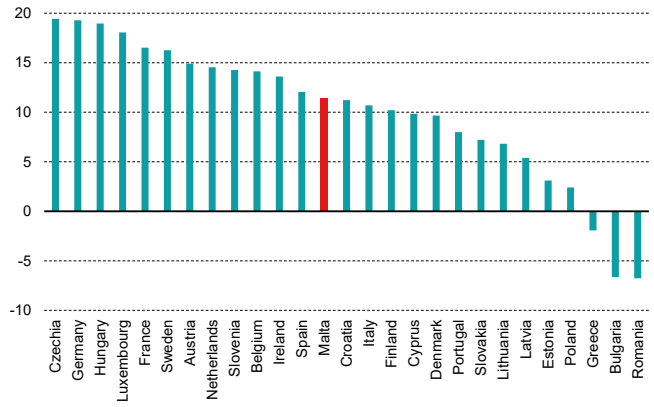
the saving rate for Malta stood lower than 5% while that of both the EU and EA hovered between 10% and 20%. Following the accession of Malta to the euro area, Malta's saving rate started to catch up with the EA average, fully catching up by 2017. Both the EU and EA rates were relatively stable during this period.

The saving rate spiked in 2020 for both Malta and the EU mainly due to lockdowns imposed during the COVID-19 pandemic aimed at containing the spread of the virus. Indeed, lockdowns limited the household final consumption expenditure, while government support helped to maintain the disposable income, resulting in a degree of forced savings. Following the lifting of most of the restrictions by 2022, the savings rate fell once again for all the series shown in Chart 4.

Furthermore, data for 2023 show some discrepancy in saving rate developments. While the saving rate has increased in the EU and EA between 2022 and 2023, this has continued to decline in Malta. This reflects that the robustness of Malta's private consumption growth was partly financed by past savings, in contrast to the weaknesses exhibited in most other European countries. This could also be in part due to the relatively weak transmission of the monetary policy tightening in Malta during this period, when compared to the rest of the euro area.

Chart 5 shows the saving ratios across EU countries in 2023. In most countries, households were net lenders to the economy with the only exceptions of Greece, Bulgaria and Romania, which registered negative saving rate in 2023. In 2023, the saving rate in Malta classified in the middle of the EU country distribution at 11.5%. The highest saving rate in 2023 was registered in the Czech Republic (19.4%), while the lowest rate was registered in Romania (-6.8%).

Chart 5
SAVING RATE IN 2023 BY COUNTRY IN THE EU[1]
(per cent of disposable income)



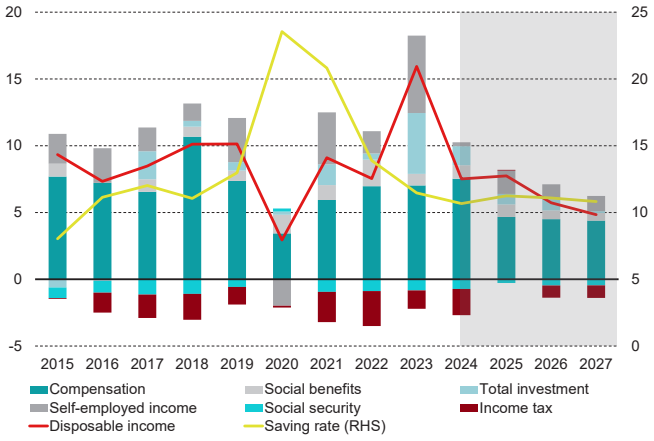
Source: Eurostat.
[1] Data for Bulgaria is based on 2022 data as 2023 figure is still to be published.

Disposable income and saving rate projections

Looking ahead, in this projection exercise, disposable income growth is expected to remain robust, but to slow down in 2024. Growth is expected to edge up to 7.7% in 2025 partly reflecting revisions in the income tax brackets. It is then set to decelerate gradually to 4.8% by 2027 (see Chart 6). Growth is expected to be supported mainly by wages and salaries, which are expected to remain the main driver of disposable income.

Furthermore, as shown in Chart 6, in 2025 we expect the saving rate to edge up, reflecting the revision in the income tax bands as announced in Budget 2025. Indeed, whilst the lower taxes are expected to boost private consumption, the saving ratio is also expected to rise slightly. It should be kept in mind that the income boost is capped for the higher income tax brackets who typically have a lower average propensity to consume. The saving rate is then expected to stabilise, after the tax cut, to around 11%.

Chart 6
NOMINAL DISPOSABLE INCOME AND SAVING RATE
(annual percentage change; percentage points; per cent of disposable income)



Source: Author's calculations.

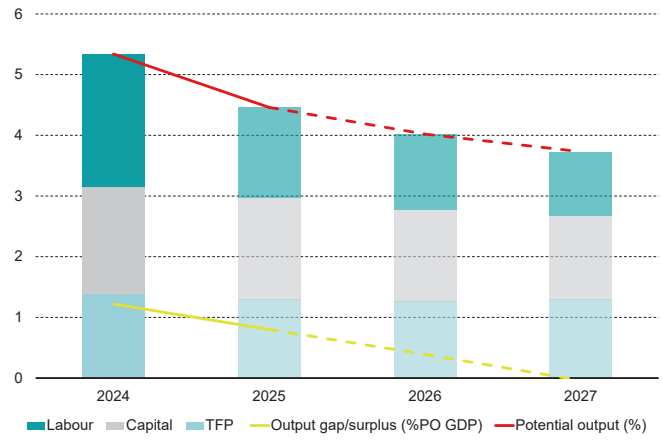
Potential output[4]

Potential output growth is expected to moderate throughout the projection horizon. It is set to slow down from 5.3% in 2024, to 4.5% in 2025, and further to 4.0% in 2026 and 3.7% in 2027. This reflects declines in the contributions of all components of potential output.

The capital contribution is expected to moderate due to relatively muted investment growth throughout the projection horizon, while the contribution from labour is envisaged to decline due to expected lower net migration flows and slower increases in participation. The contribution from total factor productivity is set to decline marginally towards its long-term average.

The positive output gap is expected to close by 2027 largely reflecting the projected slowdown in GDP growth over the projection horizon (see Chart 2).

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



Source: Central Bank of Malta.

[4] This section and Box 2 are based on national accounts figures published in the NSO *News Release* 225/2024.

BOX 2: OUTLOOK FOR LONG-TERM POTENTIAL OUTPUT[1]

Potential output is the level of output that can be generated within an economy at full and sustainable employment of its available resources without creating inflationary pressures in excess of the target. Although a useful concept in economics, it is not directly observable and therefore, needs to be estimated or inferred from other variables. There are several methods which can be applied to determine potential output. However, the Bank employs the production function approach which decomposes potential output into contributions from capital, labour, and the efficiency generated with the combined use of these factors, known as total factor productivity (TFP).[2,3]

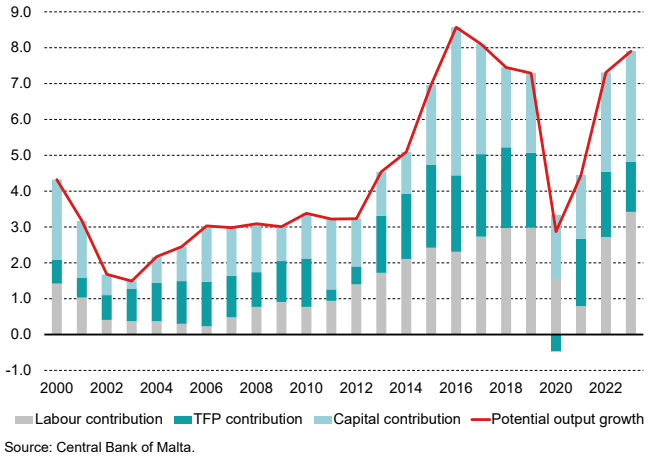
This box provides a brief overview of the Bank's estimate of historical potential output and its components, followed by an analysis of expected developments in their contribution to potential output growth in the long-term.

In view of the significant uncertainty surrounding such long-term projection, this box is complemented by an additional scenario analysis whereby the Maltese economy is assumed to transform to lower labour-intensive growth with higher investment and productivity growth.

Overview of historical potential output

Chart 1 shows the Bank's estimate of potential growth and the contributions of its components for the past two decades. During the period 2000-2012, potential output growth is estimated to have averaged around 2.9% largely supported by contributions from capital and TFP. After 2012, potential output grew more rapidly, with its growth rate reaching 8.6% in 2016 as the contribution from all factors, especially labour, increased. This mainly arose from an increase in the working age population due to higher year-on-year flows of foreign workers compared to previous years, and a

Chart 1
HISTORICAL POTENTIAL OUTPUT GROWTH
(% growth; percentage point contribution)



Source: Central Bank of Malta.

[1] Prepared by Lynn Cumbo, a Senior Economist within the Economic Analysis Department of the Central Bank of Malta.

[2] We employ a Cobb-Douglas production function in the form $Y_t = A_t \cdot L_t^{\alpha} \cdot K_t^{1-\alpha}$ where Y_t denotes output at time t, L_t^{α} is the labour input, $K_t^{1-\alpha}$ is the capital input and A_t is calculated as a residual representing TFP. The labour input elasticity α is derived from the share of labour income (based on the compensation of employees) in total nominal Gross Value Added (GVA).

[3] See Grech, A. G. and Micallef, B. (2015). Assessing potential output growth of the Maltese economy using a production function approach, *Xjenza 3*(1), pp. 57-63.

larger contribution from the participation rate, mainly as a result of policies that boosted the female activity rate.[4]

Growth in potential output decelerated slightly in the years after 2016 due to a weaker contribution from capital. However, the labour contribution continued to increase mainly on account of a sustained inflow of migrant workers. Higher participation of females and those reaching retirement age also contributed to this increase. Hence, potential growth remained elevated from both a historical perspective and in relation to estimates available for most advanced economies.

Growth dipped to 2.9% and 4.4% in 2020 and 2021, respectively, due to pandemic-related restrictions on inward migration as reflected in the lower contribution from the labour component.[5] Furthermore, the TFP contribution turned negative in 2020 because of a sharp decline in labour productivity growth and capacity underutilisation reflecting outright shutdown or restrictions in certain activities. Nevertheless, potential output growth recovered quickly in the years following the pandemic with the gradual re-opening of all activities, reaching an estimated 7.9% growth in 2023 led by a resumption of migration flows and further gains in activity rates, as well as a significant contribution from the capital stock.

The strong GDP growth rates recorded in recent years indicate that the extraordinary conditions brought about by COVID-19 did not leave any significant scarring effects on the Maltese economy. Moreover, the recent surge in inflation due to the Russia-Ukraine war, as well as other geopolitical conflicts, did not have a major impact on Malta's potential output level.

Expected developments in the long-term contribution of labour

In the Bank's framework for estimating potential output, the labour contribution consists of the contribution from the working age population which comprises of persons aged between 15 and 74 years, the participation rate (projection obtained from a cohort model employed in forecasting the labour supply),[6] usual weekly hours worked[7] and the non-accelerating inflation rate of unemployment (NAIRU) as a proxy for trend unemployment derived from an unobserved components model (UCM).[8]

Chart 2 shows that over time, the contribution from labour is expected to diminish as increases in the participation rate become progressively smaller and growth in the working age population also slows down. This reflects an ageing indigenous population and the fact that the participation rate already exceeds the euro area average.

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4 See Micallef, B. (2018) Estimating the impact of structural reforms to increase the female participation rate in Malta, *International Journal of Social Science Studies, 6*(8), pp. 73-84.

5 Hours worked also dipped during the pandemic but had a limited effect on potential growth.

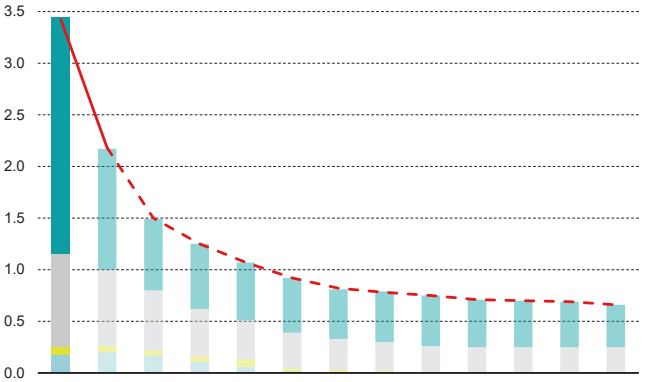
6 See Rapa, A. M. (2019). A cohort approach to project the labour participation rate in Malta. Central Bank of Malta, *Policy Note.*

7 These are a Labour Force Survey (LFS)-consistent definition of the average hours normally worked in the main job per week, inclusive of extra hours (whether paid or not), production and ancillary activities and time spent in education and training required for the main job. These differ from the average actual weekly hours which refer to the hours spent in actual work.

8 See Ellul, R. (2019). Box 1: An unobserved components model for potential output in Malta. Central Bank of Malta*, Quarterly Review* 2019:2, pp. 17-21.

Following the recent expansion of the working age population due to high net migration flows, we expect a moderation in its growth over time. This follows from an envisaged decline in inflows of foreign workers to around the average in the pre-pandemic decade, partly reflecting recent proposals in labour migration policies, and also because the working age population of Maltese nationals is expected to continue to decline due to a low birth rate. Nevertheless, by 2035, the working age population is expected to comprise around 60.0% of the total labour contribution to potential output growth; accounting for 0.4 percentage points of the 0.7 percentage points labour contribution (see Table 1).

Chart 2
COMPONENTS OF THE LABOUR CONTRIBUTION
(percentage point contributions)



Source: Central Bank of Malta.

On the other hand, the contribution of the participation rate is expected to decline initially before stabilising in the outer years at around 0.3 percentage points. Activity rates are envisaged to continue trending upwards as there is further scope for an increase in female participation in the labour market due to cohort effects. In particular, older female cohorts with typically low participation rates will exit the working age population, to be replaced by younger cohorts with higher participation rates. Moreover, the projected inflow of foreigners will continue to raise participation rates also among males as these typically enter the working age population for work purposes.

The contribution from labour hours and the NAIRU is marginal in the medium term (2027) and neutral in the longer term. Trend usual hours worked are expected to remain stable in the long term following a recovery to 2018 levels. The NAIRU is envisaged to continue declining slightly before stabilising at around 2.9% and hence, giving no contribution to growth as actual unemployment is projected to remain close to the trend.

Expected developments in the long-term contribution of capital

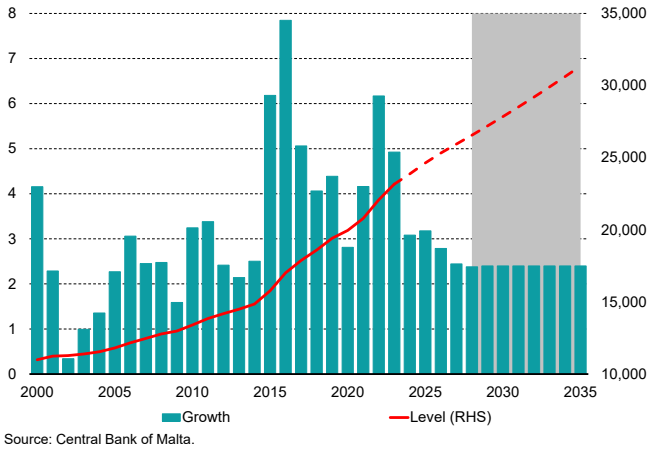
The capital stock is calculated using the perpetual inventory method whereby real public and non-dwelling private investment (i.e. capital flows), net of depreciation, are added to the existing level of the capital stock.

Chart 3 shows that the capital stock (net of depreciation) grew steadily during the period 2000-2015, with an average growth rate of 2.6%. This accelerated to almost 5.0% year-on-year growth in the following years up to 2023 due to high investment outlays particularly in machinery and equipment, which includes ICT equipment, as well as an increased

accumulation of intellectual property products in more recent years.

The outlook for the medium term is conditioned by the Bank's investment projections, which include the impact from Next-Generation EU (NGEU) funds. Beyond the standard projection horizon (2028 onwards), we assume growth in the capital stock at 2.4%, close to the 2000-2015 average (grey shaded area in Chart 3).

Chart 3
CAPITAL STOCK
(annual % growth; EUR millions)



Source: Central Bank of Malta.

There is high uncertainty on the extent and rate at which possible major structural shifts will affect businesses and their investment decisions. On the one hand, the capital stock would be boosted by a higher adoption of artificial intelligence (AI), digitalisation and the transition towards green energy. At the same time, these structural changes could also lead to a faster rate of depreciation of the existing capital stock.

Total factor productivity in the long term

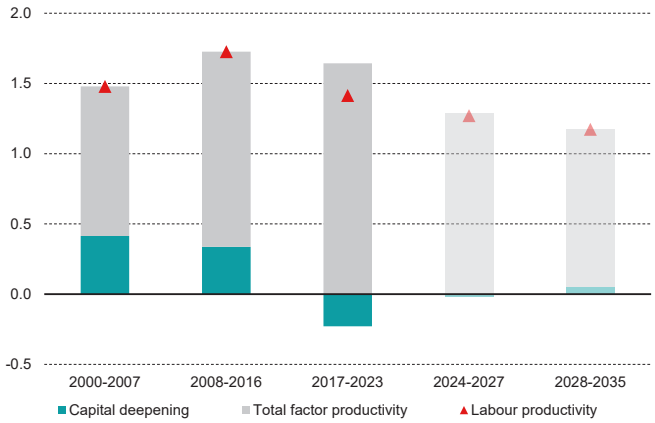
In the Bank's framework, TFP is estimated as the residual contribution to growth after considering contributions from labour and capital. It captures the efficiency at which labour and capital are used together in the production process, and therefore represents a measure of technological advancement and other gains in productivity, which are crucial for the long-term capacity of the economy. Due to its highly conceptual nature, the significance of TFP in driving long-term growth is better examined through its contribution to labour productivity growth.

By employing a growth accounting approach, labour productivity (output per worker) is decomposed into the contributions from capital deepening (capital per worker) and TFP as a residual. Chart 4 shows that the historical contribution from capital deepening declined from an average of 0.4 percentage points during the period 2000-2007 to 0.3 percentage points between 2008 and 2016 before turning negative in more recent years at -0.2 percentage points. This means that capital became more scarce in relation to persons in employment, contributing less and less to worker productivity. This partly reflects the shift towards a more service-oriented economy.

Therefore, growth in productivity has been mostly sustained by the TFP component which includes productivity gains other than those related to capital deepening. This may include efficiency gains from the reallocation of factors of production through the shift towards

new higher value-added sectors in services.[9] This economic transition may have also brought about an improvement in the quality of labour through higher education attainment[10] and training of professional personnel required in services.

Chart 4
DECOMPOSITION OF LABOUR PRODUCTIVITY GROWTH
(average % growth per person employed, average percentage point contribution)



Sources: Central Bank of Malta; author's calculations.

Considering these developments and in line with macroeconomic theory, we expect TFP to be the sole driver of labour productivity growth in the medium and long run contributing by 1.3 percentage points in the standard projection horizon (2024-2027) and by 1.1 percentage points in the longer term (2028-2035). The contribution from capital deepening remains subdued due to moderate investment growth.[11]

Potential output in the long term

The Bank's baseline projection of potential output in the long term and its contributing factors, which is largely informed by historical trends and structural reforms, is that by 2035, potential output growth will gradually reach a rate of 3.4% (see Table 1). This projection leans towards the average growth rate estimated for the period 2000-2015 since potential output during more recent years grew at exceptionally strong rates, particularly due to the developments in the working age population and investment.

The highest contribution is expected to be from TFP at 1.4 percentage points, followed by a stable contribution from capital at 1.3 percentage points. In contrast, the contribution from labour gradually drops to 0.7 percentage points by 2035 from an estimated contribution of 3.4 percentage points in 2023, mainly as a result of the expected developments in the working age population. The contribution from TFP is approximately in line with its long-term average (2000-2023) while the capital contribution is closer to the average during 2000-2015 given that the capital stock is expected to grow at a rate similar to that estimated in this period. Since the outlook for the labour component is less optimistic, its contribution by the year 2035 is almost half its long-term average.

[9] See Darmanin, J., Montebello R., and Deguara, W. (2021), The shifting structure of the Maltese economy: evidence from chain-linked data, *Mediterranean Journal of Social Sciences, 12*(4), pp. 97-111.
[10] See Gauci, T. M. (2021). An analysis of education attainment in Malta. Central Bank of Malta, *Policy Note.*
[11] While on the grounds of prudence the bank assumes a constant average of the past for the future, this may not necessarily be the case due to several possible scenarios of potential output.

Table 1

LONG-TERM POTENTIAL OUTPUT[1]

(% growth; percentage point contribution)

	Potential output growth	TFP contribution	Capital contribution	Labour contribution
2023	7.9	1.4	3.1	3.4
2024	5.3	1.4	1.8	2.2
2025	4.5	1.3	1.7	1.5
2026	4.0	1.3	1.5	1.3
2027	3.7	1.3	1.4	1.1
2028	3.5	1.4	1.3	0.9
2029	3.4	1.4	1.3	0.8
2030	3.4	1.4	1.3	0.8
2031	3.4	1.4	1.3	0.8
2032	3.4	1.4	1.3	0.7
2033	3.4	1.4	1.3	0.7
2034	3.4	1.4	1.3	0.7
2035	3.4	1.4	1.3	0.7

Source: Central Bank of Malta.

(1) Figures may not add up due to rounding.

Alternative scenario for long-term potential output

Potential output projections, both in the medium and long term, continue to be surrounded by a high level of uncertainty especially in view of emerging structural trends which can significantly influence its components in different ways. These include the adoption of AI, the green transition, digitalisation, demographic shifts and geopolitical challenges such as tensions between countries, fragmentation of trade blocs and relations and volatility in energy prices. Furthermore, the assessment of potential output during the past few years has been subject to a higher level of uncertainty due to significant revisions in national accounts and population statistics, which make it more challenging to derive projections for the supply-side in the medium-term.

In this regard, an alternative scenario is constructed whereby it is assumed that the drivers of long-term potential output growth would be different to those shown above. In particular, it maintains the view that long-term potential output growth would stand at 3.4%, but with lower net migration flows and higher contributions from capital stock and TFP. This is a scenario in which the Maltese economy would gradually transform to lower labour-intensive growth, with higher investment and productivity. This could imply, for example, a higher rate of investment in digital technologies than assumed in the baseline, which could in turn induce higher productivity.

More specifically, foreign net migration flows are assumed to be lower than in the pre-pandemic decade to reflect a possible decline in the dependence on labour. This implies a sharper drop in the labour contribution than that envisaged above, to 0.3 percentage points

by 2035. To sustain the 3.4% potential growth in the long term, growth in the capital stock and/or TFP would also have to be higher than in the baseline scenario.[12]

Table 2 shows that long-term growth of 3.4% can also be attained if the contribution from both factors increases. In this scenario, the capital stock is assumed to grow by an annual growth of around 3.0% by 2035, which is closer (but still well below) to the growth rates observed between 2016 and 2023 and above that envisaged in the baseline scenario shown in Table 1. Hence, the contribution from the capital stock would reach 1.5 percentage points. The TFP contribution is also assumed to increase to 1.5 percentage points by 2035.

Table 2
LONG-TERM POTENTIAL OUTPUT: LOWER MIGRATION SCENARIO(1)

(% growth; percentage point contribution)

	Potential output growth	TFP contribution	Capital contribution	Labour contribution
2023	7.9	1.4	3.1	3.4
2024	5.3	1.4	1.8	2.2
2025	4.5	1.3	1.7	1.5
2026	4.0	1.3	1.5	1.3
2027	3.7	1.3	1.4	1.1
2028	3.5	1.5	1.3	0.7
2029	3.4	1.5	1.4	0.5
2030	3.4	1.5	1.5	0.4
2031	3.4	1.5	1.5	0.4
2032	3.4	1.5	1.5	0.4
2033	3.4	1.5	1.5	0.4
2034	3.4	1.5	1.5	0.4
2035	3.4	1.5	1.5	0.3

Source: Central Bank of Malta.
(1) Figures may not add up due to rounding.

[12] By targeting the capital contribution only, long-term growth in the capital stock would need to be around 3.0%-3.2% such that its contribution gradually increases to 1.7 percentage points. Alternatively, the TFP contribution would need to rise to 1.8 percentage points by 2035 if growth in the capital stock were to remain as assumed in the baseline projection.

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 policies vis-à-vis certain sectors, such as the introduction of skills card requirements, the regulation of temping agencies, and the moratorium on food couriers and cab drivers. Also, in the beginning of 2025 the Government launched the Malta Labour Migration Policy with several proposed measures to regulate the entry of third country nationals. Employment growth is expected to moderate gradually from 5.1% in 2024 to 2.3% by 2026 and 2027, as GDP growth slows down and the aforementioned factors weigh on recruitment.

The unemployment rate is forecast to edge down slightly to 3.0%. The labour market is envisaged to remain tight, as the NAIRU is projected at around 3.2%, so that the unemployment gap is forecast to be slightly negative in the outer years of the forecast horizon.

In view of tight labour market conditions, growth in compensation per employee is projected to remain relatively strong.

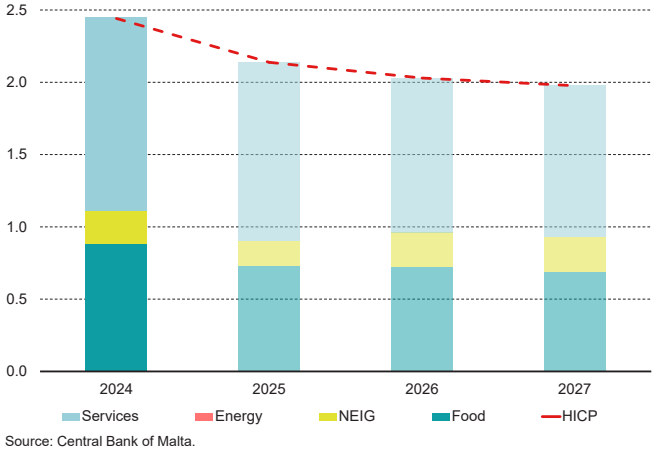
A persistently negative unemployment gap implies that labour market tightness will be a key factor driving the wage outlook. However, as tightness dissipates over time and inflation continues to moderate, this should dampen upward pressure on wages in the outer years of the projection horizon. Wage growth is expected to moderate to 3.6% in 2025 and 2026, and further to 3.5% in 2027.

Prices

In 2024, HICP inflation averaged 2.4%, down from 5.6% in the previous year. The disinflationary process gathered pace, with inflation falling below 3.0% in March 2024 and hovering around 2.3% for most of the following months.

Going forward, HICP inflation is projected to stand at 2.1% in 2025, reflecting a decline in food, NEIG and services inflation when compared to 2024 (see Chart 3). It is expected to reach 2.0% in 2026 and 2027. Meanwhile, HICP inflation excluding energy and food is projected to stand at 1.9% in 2025 and 1.8% in 2026 and 2027, with this measure mainly driven by services inflation, as goods inflation is set to be modest.

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



Source: Central Bank of Malta.

Compared to the Bank's previous forecast publication, overall HICP inflation is being revised down by 0.1 percentage points in 2025, reflecting downward

revisions in the forecast of unprocessed food inflation and NEIG inflation, while it remains unchanged in 2026 and 2027. The downward revision for this year reflects recent negative surprises in unprocessed food inflation and NEIG inflation.

Unprocessed food inflation exhibits high volatility and growth rates varied significantly along the year, varying between a high of 13.4% in January 2024 and -1.2% in December 2024, averaging 4.9%. It is set to decline to 3.7% this year and then reach 3.5% by 2027. Similarly, processed food inflation more than halved in 2024 and is set to fall further to 3.1% by the end of the forecast horizon. Reflecting these developments, overall food inflation is set to ease gradually over the forecast horizon reaching 3.4% in 2025, 3.3% in 2026 and 3.2% in 2027, also in line with expected developments in international commodity prices.

NEIG inflation has declined progressively during 2024, falling from 1.6% in January to 0.4% by the end of the year. 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 that affect this sub-component, although this remains an important risk for the inflation projections. Going forward, NEIG Inflation is expected to average 0.6% in 2025 before settling at around 0.9%, which is similar to its historical average.

Services inflation almost halved during 2024, averaging 2.8%. The deceleration reflects a moderation in all subcomponents, except for transport services. In particular, services relating to recreation as well as housing services have eased significantly during the year which possibly reflects the indirect effects from the slowdown in other components as well as a normalisation in profit margins in certain sectors. On the other hand, transport services inflation has increased during 2024, driven by higher airfares which are attributable to strong demand following the COVID-19 pandemic. Indeed, higher transport services inflation led services inflation to accelerate in the second half of 2024. While most subcomponents are expected to decelerate in 2025, communication services inflation is set to become less negative as previous cuts in the prices of mobile phone services drop out. Consequently, services inflation is expected to average 2.7% in 2025 before easing to 2.4% and 2.3% in 2026 and 2027, respectively.

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 steadily over the forecast period, decreasing from an estimated 3.7% in 2024 to 3.4% in 2025 and 2.9% in 2026, before narrowing further to 2.6% by 2027 (see Table 2). This improvement in public finances is mostly driven by a declining share of expenditure in GDP, which is primarily due to the profile of inflation-mitigation measures and capital expenditure. The forecast deficit-to-GDP ratio between 2025 and 2027 is mostly unchanged compared with the Bank's December projections.

The share of current revenue in GDP is set to remain stable between 2025 and 2027. As regards tax revenue, the ratio of current taxes on income and wealth to GDP in 2025 is expected to be lower than that recorded in the previous year. This is due to the impact of the widening of the income tax brackets as announced in the 2025 Budget. Thereafter, direct taxes are expected to

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

	2024[1]	2025	2026	2027
Headline aggregates				
Total revenue	32.4	31.5	31.7	31.3
Total expenditure	36.1	34.9	34.6	33.9
General Government balance	-3.7	-3.4	-2.9	-2.6
of which: Primary balance	-2.5	-2.2	-1.6	-1.2
General Government debt	48.9	49.6	50.1	50.1
Detailed breakdown				
Current revenue	31.3	30.4	30.4	30.4
Current taxes on income and wealth	13.0	12.0	12.0	12.1
Taxes on production and imports	9.4	9.5	9.5	9.4
Social contributions	5.1	5.1	5.0	5.0
Other current revenue[2]	3.8	3.8	3.9	3.9
Current expenditure	31.5	31.0	30.7	30.5
Compensation of employees	9.7	9.5	9.6	9.7
Social benefits	7.9	8.0	7.9	7.7
Intermediate consumption	7.4	7.5	7.5	7.4
Interest payments	1.2	1.2	1.3	1.4
Subsidies	2.7	2.4	2.0	1.8
Other current expenditure[3]	2.6	2.5	2.5	2.4
Gross savings	-0.1	-0.5	-0.3	-0.1
Capital revenue	1.0	1.1	1.3	0.9
Capital taxes	0.2	0.2	0.2	0.2
Other capital revenue[4]	0.9	0.9	1.1	0.7
Capital expenditure	4.6	3.9	3.9	3.3
Gross fixed capital formation	3.6	3.3	3.4	2.9
Capital transfers	1.0	0.6	0.5	0.5
Other capital expenditure[5]	0.0	0.0	0.0	0.0
Capital revenue net of capital expenditure	-3.6	-2.8	-2.6	-2.4
Underlying budgetary outcome				
Cyclical component	0.6	0.4	0.2	0.0
Temporary Government measures	0.0	0.0	0.0	0.0
Structural balance	-4.3	-3.8	-3.2	-2.6

Sources: NSO; Central Bank of Malta.

[1] GDP ratios are estimated as per NSO *News Release 035/2025* (published on 27 February 2025).

[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.

retain a broadly similar ratio in GDP. Both taxes on production and imports and social contributions are forecast to retain broadly stable ratios to GDP throughout the forecast period. The share of non-tax current revenue to GDP is also anticipated to remain unchanged. Capital revenue as a share of GDP is projected to peak in 2026, before declining in 2027. This reflects the profile of EU funded investment.

The share of current expenditure in GDP is forecast to steadily decline from 2025 onwards, mainly due to the profile of subsidies. This reflects lower anticipated spending on inflation-mitigation measures, in line with the assumed profile for energy prices.

Meanwhile, the ratio of compensation of employees in GDP is set to decline in 2025, largely due to a base effect stemming from the impact of a collective agreement signed with educators in the previous year. Thereafter, public wages are set to grow at a stronger pace than GDP, driven by the implementation of a new collective agreement for the civil service in 2025.

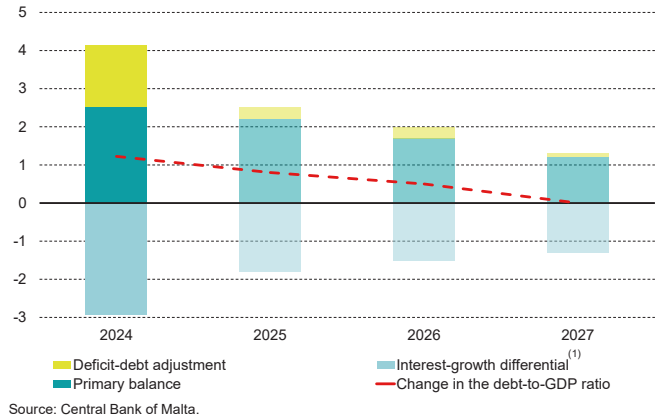
Outlays on intermediate consumption are set to increase at a rate exceeding GDP growth in 2025, before stabilising at a similar level in the outer years of the forecast. The share of interest payments in GDP is set to incrementally rise each year throughout the projection period. Meanwhile, the share of social benefits in GDP is set to marginally decline each year from 2025 onwards. This partly reflects the impact of an increase in the pension retirement age in 2026 following the pension reforms of 2006.

The share of capital expenditure in GDP is projected to decline between 2025 and 2027. This profile is mostly affected by forecasts for gross fixed capital formation. This is due to differing expectations for EU-funded GFCF and domestically-funded investment. EU-funded investment is set to increase at or above GDP growth in 2025 and 2026, driven by outlays on RRF-funded projects. Following the end of the RRF programme in 2026, EU-funded outlays are set to decline in 2027. Meanwhile, the share of domestically-funded investment to GDP is set to decline throughout the forecast period.

The structural budget deficit is projected to narrow substantially over the projection horizon, reaching 2.6% of GDP by 2027, from 3.8% in 2025.[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 up to 50.1% in 2026 and level off in 2027. This is mostly driven by the continuation of primary deficits, which are however set to decline over time (see Chart 4). Deficit-debt adjustments are also set to exert a debt-increasing impact. 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.

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

Risks

Risks to activity are broadly balanced. Downside risks largely emanate from possible adverse effects on foreign demand related to geopolitical tensions, new U.S. tariffs beyond those included in the baseline, and the possibility of retaliatory measures. A prolongation of the current elevated economic and geopolitical uncertainty could also dampen activity. 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 than envisaged. Investment could also grow faster than projected. Another upside risk could stem from a stronger consumption response to the widening of the income tax bands.

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 as well as higher input costs arising from changes in global trade policy, especially in the event of retaliation to higher U.S. tariffs. Having said that, such risks could also be counterbalanced by the subsequent monetary policy response and heightened competitive pressures in markets targeted by tariffs. Furthermore, from the domestic side, there is a risk that higher fees charged to producers and importers with respect to beverages' containers could be passed on to consumers. On the downside, imported inflation could fall more rapidly than expected if economic growth in the euro area is weaker than expected due to the adverse effects of barriers to trade on global growth.

On the fiscal side, risks are mostly 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 wages in the outer years.