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CENTRAL BANK OF MALTA
OUTLOOK FOR THE MALTESE ECONOMY

2022:2

Address
Pjazza Kastilja
Valletta VLT 1060
Malta

Telephone
(+356) 2550 0000

Fax
(+356) 2550 2500

Website
www.centralbankmalta.org

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

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OUTLOOK FOR THE MALTESE ECONOMY 2022–2024

Overview[1,2]

The international economic environment has deteriorated considerably since the Central Bank of Malta published its macroeconomic projections in its Annual Report 2021. The Russian invasion of Ukraine represents a major headwind to economic growth and adds considerable upward inflationary pressures, although fiscal measures in Malta have cushioned to an extent these impacts. Moreover, China's zero-COVID policy has excerbated supply-chain disruptions and shortages of key vital inputs.

In this latest set of projections, the war in Ukraine is assumed not to escalate with NATO involvement, and its intensity is assumed to ease by the end of this year. However, sanctions on Russia are envisaged to persist until 2024, with adverse consequences on world trade and demand. In addition, given Russia's and Ukraine's major roles in the supply of energy and non-energy commodities, the conflict is envisaged to exacerbate supply chain disruptions and add pressure on commodity prices throughout this year, while leaving energy supplies largely intact.[3] As the intensity of the conflict eases, commodity prices are assumed to moderate from the current high levels, though these are expected to remain higher than those prevailing before the war until the end of the projection horizon.

Given the very limited trade and financial links with the two countries, the Russia-Ukraine war is expected to have relatively limited direct effects on the Maltese economy but potentially significant indirect effects. In particular, the conflict is expected to adversely affect Malta's economic growth due to weaker demand in Malta's main trading partners as well as higher uncertainty. In addition, the increase in commodity prices will exert significant upward pressure on the prices of imported consumer goods and domestic costs of production with additional adverse consequences on manufacturing output and consumer expenditure.

On the other hand, the easing of pandemic-related restrictions and the normalisation of travel rules are expected to continue to support economic recovery. Moreover, the strong Government support to limit the pass-through from high commodity prices to energy and food inflation will also cushion the impact on inflation and growth.

Economic outlook

Malta's GDP is projected to grow by 5.4% in 2022, 4.9% in 2023, and 3.8% in 2024. When compared to the Bank's previous projections, this represents a downward revision of 0.6 percentage point in 2022 and 0.4 percentage point in 2023 (see Table 1). In 2022, the downward revision reflects a lower contribution from domestic demand. Gross fixed capital formation was revised down in 2022 due to stronger base effects from higher than expected exceptional investment in aviation in 2021. Moreover, in view of the upward revision to inflation and the increase in

[1] The Bank's projections for the Maltese economy are based on information available up to 24 May 2022.

[2] See https://www.centralbankmalta.org/site/Publications/Projections-2022-1.pdf and https://www.centralbankmalta.org/site/Publications/AR-2021.pdf.

[3] The projections take into account the EU's embargo on Russian coal, the embargos of other advanced countries on oil and assumes that the EU moves gradually to stop importing Russian oil, in the process substituting Russian oil with oil from other suppliers. Disruptions to gas supplies are assumed to be limited.

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

	2021[2]	2022	2023	2024
Real economic activity (% change)				
GDP	9.4	5.4	4.9	3.8
Private consumption expenditure	6.2	5.6	4.7	4.7
Government consumption expenditure	6.1	5.7	4.0	4.6
Gross fixed capital formation	19.3	-6.0	4.1	1.6
Exports of goods and services	8.2	5.4	3.6	3.1
Imports of goods and services	7.6	3.6	3.1	3.2
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	8.0	2.2	3.7	3.3
Net exports	1.8	3.2	1.3	0.5
Changes in inventories	-0.4	0.0	0.0	0.0
Balance of payments (% of GDP)				
Goods and services balance	3.2	4.9	5.1	5.0
Current account balance	-5.9	-4.4	-3.9	-3.6
Labour market (% change)[3]				
Total employment	1.6	2.9	2.5	1.9
Unemployment rate (% of labour supply)	3.5	3.3	3.4	3.5
Real disposable income[4]	3.8	2.2	3.1	3.3
Household saving ratio[4]	31.0	28.6	27.5	26.6
Prices and costs (% change)				
GDP Deflator	1.7	3.0	2.4	1.9
RPI	1.5	4.9	2.9	1.7
Overall HICP	0.7	5.0	2.9	1.8
HICP excluding energy	0.9	5.3	2.9	2.0
Compensation per employee	5.5	4.2	3.6	2.7
ULC	-2.1	1.7	1.1	1.0
Business Cycle				
Potential output (% change)	3.6	4.4	3.8	3.7
Output gap (% of GDP)	-0.4	0.6	1.7	1.7
Technical Assumptions				
EUR/USD exchange rate	1.20	1.10	1.10	1.10
Oil Price (USD per barrel)	71.1	105.8	93.4	84.3

Sources: NSO; Central Bank of Malta.

[1] Data on GDP were sourced from NSO *News Release* 037/2022 published on 1 March 2022, while RPI and HICP data were sourced, respectively, from NSO *News Releases* 069/2022 and 087/2022 (published on 25 April 2022 and 18 May 2022).

[2] Actual data.

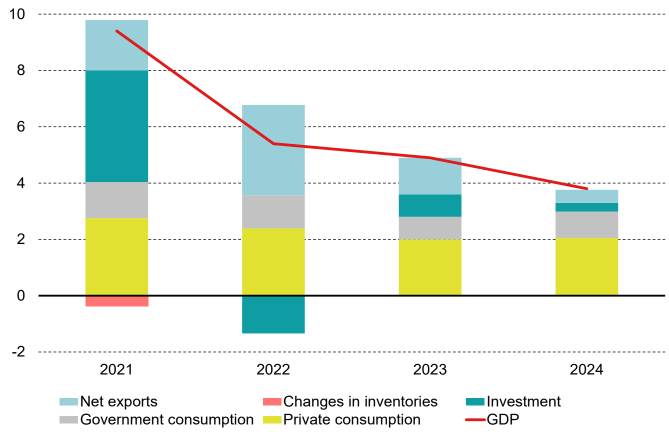
[3] Employment data are consistent with the national accounts. The unemployment rate is based on the number of unemployed and employed as reported in the Labour Force Survey.

[4] Central Bank of Malta estimates.

uncertainty related to the war, growth in private consumption was also revised downwards. These offset an upward revision in the net export contribution, partly reflecting downward revisions to growth in goods imports, mirroring the aforementioned re-assessment of capital intensive imports in the aviaton sector. Export growth was revised down in 2022 on account of the impact of the conflict on goods exports as well as some downward revision to tourism exports.

The downward revision in GDP growth for 2023 mainly reflects less dynamic private consumption growth as well as a lower contribution from net exports, with the latter reflecting the impact of lower foreign demand on goods exports.

Chart 1
GDP GROWTH PROJECTIONS
(annual percentage change)



Source: Central Bank of Malta.

Net exports are expected to be the main driver of growth in 2022, reflecting the correction in import-intensive investment outlays from the exceptionally high levels reached in 2021 (see Chart 1). The contribution of domestic demand is expected to be positive but significantly lower compared to that of 2021 (approximately a fourth of it), reflecting the fact that activity has now returned to pre-pandemic levels.

In the following years, domestic demand is expected to lead the expansion in economic activity, reflecting especially a foreseen strong contribution from private consumption. At the same time, the contribution of net exports is projected to remain positive, reflecting the gradual normalisation of tourism exports and growth in foreign demand more generally.

Private consumption growth is set to moderate somewhat in 2022, which primarily reflects the envisaged slowdown in real disposable income and the impact of uncertainty from the war on households. Despite the forecasted moderation, private consumption growth remains buoyant from a historical perspective, and is thus set to outpace the Bank's estimate of real disposable income growth. Households are expected to absorb part of the increase in inflation by running down excess savings accumulated during the pandemic. Private consumption growth is set to moderate slightly further in 2023. The saving ratio is envisaged to retreat from recent peaks but it is still projected to remain above 2019 levels.

Government consumption is set to rise by 5.7% in 2022, due to higher outlays on compensation of employees and intermediate consumption. These two items are however projected to grow at a slower rate than in 2021, which featured one-off outlays on allowances and on treatment and vaccination for COVID-19. In 2023 and 2024, growth in government consumption is projected to stand at 4.0% and 4.6% respectively, driven by lower COVID-related outlays and the profile of sales revenue.

Investment is projected to decline by 6.0% this year due to developments in private sector outlays. Investment is set to grow by 4.1% in 2023 and 1.6% in 2024.

Private sector equipment investment will be affected by the aforementioned base effects in the aviation sector. Thus, this component is expected to decrease in 2022 before returning to positive growth in the following two years. Conversely, investment in construction is envisaged to pick up somewhat in 2022 and maintain a similar growth rate in 2023, before easing slightly in 2024.

EU funds, in particular Next Generation EU (NGEU) funds, will provide a substantial boost to government investment in the projection horizon. Indeed, growth in government investment is foreseen to reflect increased outlays on EU-financed projects, especially in 2022 and 2023.

In 2022, export growth is set to slow down markedly in line with the envisaged moderation in foreign demand. Growth in goods exports is expected to remain low by historical standards, which reflects the impact of supply bottlenecks, the sharp rise in input costs, as well as lower foreign demand. On the other hand, services exports are expected to remain buoyant, reflecting the continued recovery in tourism exports as well as the resilience of the non-travel services sectors.

Services exports are projected to grow by 5.9% in 2022 following growth of 10.8% in 2021, on account of some envisaged moderation in non-travel services exports. The latter are however expected to remain resilient to the Russia-Ukraine war. Indeed, these exports have surprised on the upside in 2021, underscoring the fact that these sectors tend to perform more strongly than overall international trade dynamics would suggest. With regard to tourism exports, these are also projected to grow markedly this year as containment measures related to travel are removed. Nevertheless, tourism exports in 2022 are being revised down in this projection round to 66% of 2019 levels from the 75% envisaged in the Bank's previous projections round. The downward revision primarily reflects the impact of higher inflation on household disposable income in Malta's main tourism markets as well as increased uncertainty.

Goods exports are more directly affected by the war, reflecting lower demand from trading partners, prolonged supply bottlenecks, as well as the effect of the steep increase in input and transport costs on export prices. Exports of goods are expected to grow modestly in 2022, by 2.2%, following two years of contraction. Goods exports are set to grow less rapidly than foreign demand in the following two years.

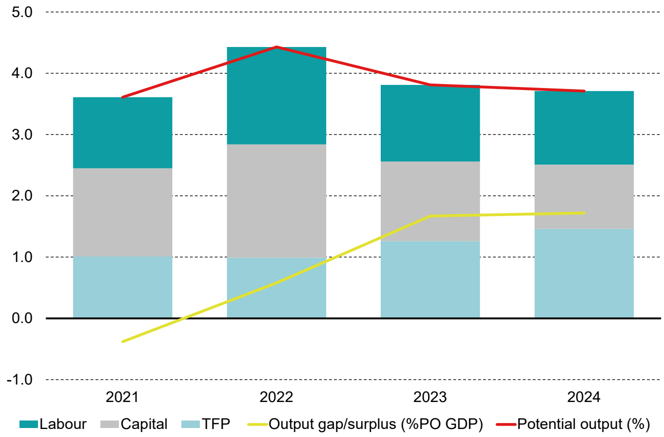
With regard to imports, these are expected to slow down sharply this year and slightly further in 2023. Goods imports are projected to contract in 2022 due to the envisaged decline in import-intensive investment in transport equipment. In the following years, goods imports are projected to grow in line with final demand, while services imports are projected to grow in line with services exports.

Potential output

Potential output is expected to pick up further this year. It is projected to grow by 4.4% in 2022, up from 3.6% in 2021 (see Chart 2). This pick-up in potential output growth partly reflects a higher contribution from labour, as travel restrictions have been practically removed during May, which should improve the ability of firms to continue recruiting foreign workers, alleviating some of the labour shortages experienced last year. Moreover, the contribution of the capital stock is also expected to recover this year due to the strong pick-up in investment in 2021. The contribution of total factor productivity is envisaged to remain stable.

Potential output growth is set to moderate to 3.8% and 3.7% in 2023 and 2024, reflecting lower contributions from capital and labour.

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



Source: Central Bank of Malta.

The economy is expected to be operating slightly above potential this year, with the output gap standing at 0.6%. The output gap is expected to widen further to 1.7% next year and to remain stable in 2024, primarily reflecting the expected recovery of activity in sectors that were still subject to pandemic-related restricitions in 2021. Although the output gap is widening, it is below that estimated for the last three years before the pandemic.

Labour market

Employment growth in 2022 is expected to reach 2.9%, from 1.6% in 2021. It is set to moderate to just below 2% by 2024. This year's pick-up reflects the recovery of demand, and is supported by an assumed gradual normalisation in net migration flows, beginning in 2022. The latter should start to gradually alleviate the broad-based labour shortages that were experienced in many sectors during 2021. That said however, employment is set to grow more slowly than GDP during the whole projection horizon, as firms seek to regain some of the productivity losses experienced during the pandemic.

The unemployment rate is projected to decline to 3.3% this year, from 3.5% last year and is expected to hover within this range during the remainder of the outlook period.

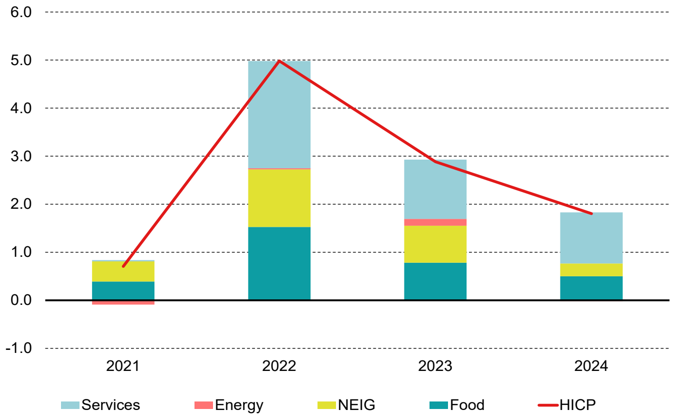
In view of the expected increase in inflation this year as well as tight labour market conditions, wage growth is projected to be relatively strong. Nevertheless, nominal wage growth is projected to remain below consumer price inflation due to some lag in the transmission from prices to wages. Growth in compensation per employee is thus set to increase by 4.2% in 2022, down from an exceptionally high rate of 5.5% in 2021, then attributable to base effects arising from the pandemic.

Over the projection horizon we expect labour market tightness to ease somewhat as net migration flows are projected to normalise as the global pandemic situation improves. This easing of labour market tightness should limit the upward pressure on nominal wages in 2023 and 2024. Hence, growth in compensation per employee is projected to slow down to 3.6% and 2.7% in the next two years.

Prices

With regard to consumer prices, annual HICP inflation is projected to accelerate to 5.0% in 2022, from 0.7% in 2021. The sharp pick-up in inflation reflects a broad-based increase across all sub-components of HICP except for energy inflation. Services inflation is envisaged to be the main contributor to HICP inflation, but food and non-energy industrial goods (NEIG) inflation are also projected to contribute strongly to inflation this year (see Chart 3).

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



Source: Central Bank of Malta.

In 2022, the acceleration in overall HICP is expected to be mainly driven by higher services inflation. The sharp pick-up in services inflation primarily reflects spill overs from high inflation in other subcomponents such as food and NEIG. In addition, labour costs are envisaged to remain buoyant.

Food prices are projected to rise strongly in 2022, largely due to higher unprocessed food inflation, although processed food prices are also expected to increase sharply (see Box 1). This reflects the indirect impact of higher import prices for most commodities.

NEIG inflation is also expected to increase strongly due to higher import price pressures both for intermediate inputs and for final consumer goods as well as higher transport costs.

Despite the increase in international energy commodity prices, energy inflation is expected to remain low during the whole projection horizon in light of announcements by the Government, which intends to keep stable energy prices until at least the end of this year. Energy prices are expected to pick up slightly in 2023, before falling marginally in the outer year of the forecast horizon, reflecting the profile of the technical assumptions for international oil prices which affects the Bank's projections for transport fuels and gas. Electricity prices are assumed to remain fixed throughout the projection exercise.

Import price pressures are expected to gradually normalise by the beginning of next year, although these are envisaged to remain high by historical standards. HICP inflation is expected to moderate to 2.9% by 2023, driven by lower contributions from all subcomponents except for energy inflation. Inflation is set to ease further in 2024, to 1.8%.

When compared with the Bank's Annual Report forecasts, overall HICP inflation has been revised up by 1.6 percentage point in 2022 and by 0.9 percentage point in 2023 but unchanged for the outer year of the projection horizon. The upward revisions in 2022 and 2023 partly reflect stronger than projected inflation outcomes in recent months. In addition, they reflect stronger upward pressures from the rise in international commodity prices, high transport costs as well as other import price pressures related to the direct importation of consumer products. Furthermore, evidence from the Bank's Business Dialogue exercise as well as the European Commission's business confidence surveys suggests that the majority of retailers expect to raise selling prices.

BOX 1: RECENT DEVELOPMENTS AND FORECASTS OF FOOD PRICES IN MALTA[4]

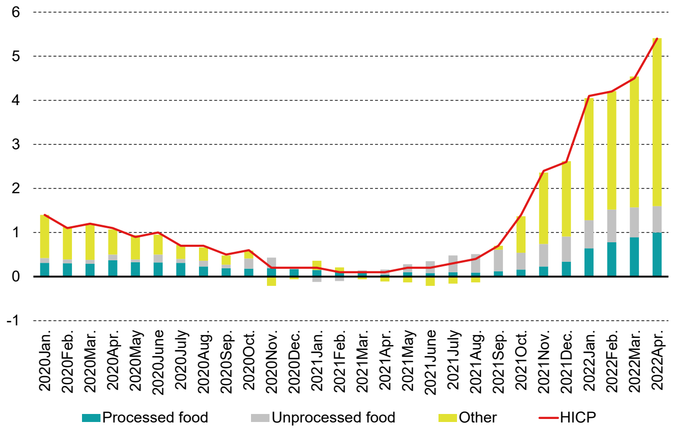
Introduction

Food, including alcohol and tobacco, accounts for 21.8% of Malta's consumption basket and is thus an important driver of Malta's headline HICP inflation (see Chart 1). The contribution of food prices to overall HICP inflation rose from 0.2 percentage point in April 2021 to 1.6 percentage points a year later. Both processed and unprocessed food inflation contributed to this increase, with the larger change registered in the former.

Food inflation in Malta has exceeded that of the euro area from April 2021 onwards (see Chart 2). By April 2022, food inflation in Malta stood 1.2 percentage points higher than that in the euro area.

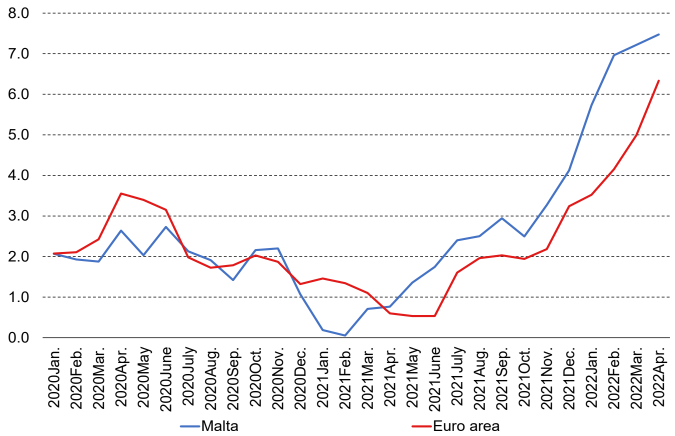
Malta imports around 70% of its food products and is therefore particularly susceptible to developments in international food prices, other commodity prices that affect food production as well as transport costs. The next section outlines the

Chart 1
HICP INFLATION AND ITS MAIN COMPONENTS
(annual percentage change; percentage point)



Source: SDW.

Chart 2
FOOD INCLUDING ALCOHOL AND TOBACCO
(annual percentage changes)



Source: Eurostat.

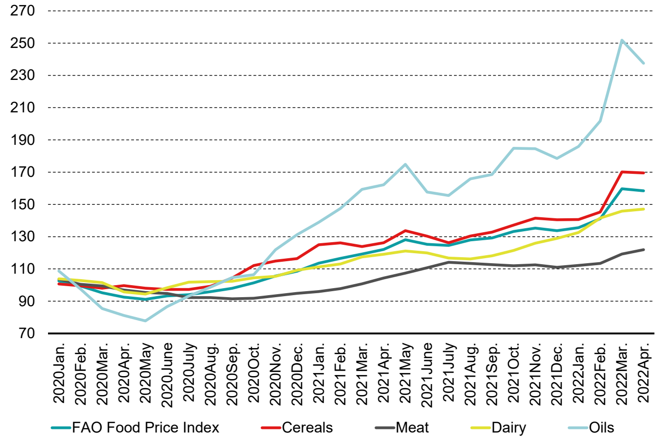
[4] Prepared by Abigail Marie Rapa, a senior economist within the Economic Analysis Department of the Central Bank of Malta.

recent developments in international food prices.

International food prices

In April 2022, 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 up by 29.8% from a year earlier, indicating significant international food price pressures (see Chart 3).[5] The increase in this index was driven by all subcomponents, with the oils subcomponent increasing the most, rising by an annual rate of 46.5%. This was followed closely by cereal prices, which increased by 34.3%.

Chart 3
FAO FOOD PRICE INDEX
(Index, 2014-2016=100)



Source: FAO.

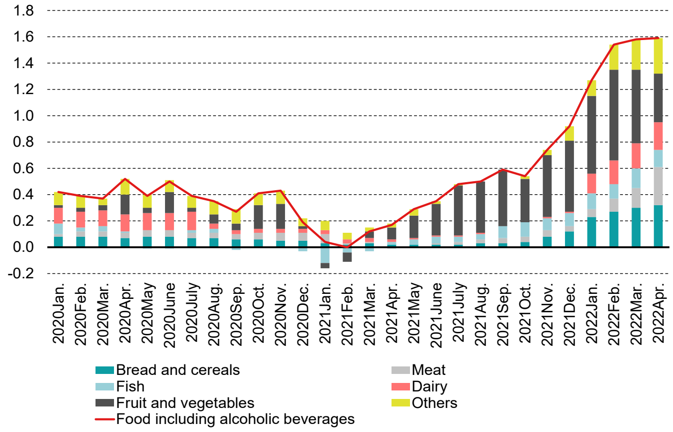
The latest data on EU trade, split by standard international trade classification (SITC), show that in February 2022, prices per 100 kilos of Malta's imports of food and live animals increased by 25.5% in annual terms. Similar to the FAO's food price index, the prices of cereals and feed for animals have increased by 29.4% and 22.2% respectively, putting upward pressures on prices of cereals and meat in Malta. Inflation in Malta's meat subcomponent was also affected by higher prices of imported meat. These have increased by an annual rate of 15.5% in February 2022.

Main drivers of food inflation in Malta

The acceleration in food inflation since the first quarter of 2021 reflects developments in all subcomponents, although in recent months growth was largely driven by bread and cereals, fruit and vegetables as well as meat (see Chart 4).

Bread and cereals prices rose by an average annual rate of 9.0%

Chart 4
CONTRIBUTION OF FOOD INFLATION AND ITS MAIN COMPONENTS
(percentage point)



Source: SDW.

[5] When compared to April 2019, the FAO Food Price Index stood 71.3% higher.

during the first four months of this year. This mainly reflects a price hike in January 2022, which will continue to affect annual price changes until the end of the year. The increase in bread and cereal prices partly reflects the international cereal prices, which rose significantly in recent months, due to both supply bottlenecks as well as the Russia-Ukraine war. As Malta is a small and open economy, local producers depend on foreign markets and are thus sensitive to changes in prices of food commodities as well as animal feed.

Similarly, meat prices rose by an average annual rate of 5.0% in the January-April 2022 period and have contributed by an average of 0.2 percentage point to overall HICP inflation, with the contribution in April standing at 0.3 percentage point. Import price pressures are also likely to be the main factor contributing to such increase. As mentioned earlier, the price of imported meat increased by an annual rate of 15.5% in February, while the price of animal feed has increased by 22.2%.

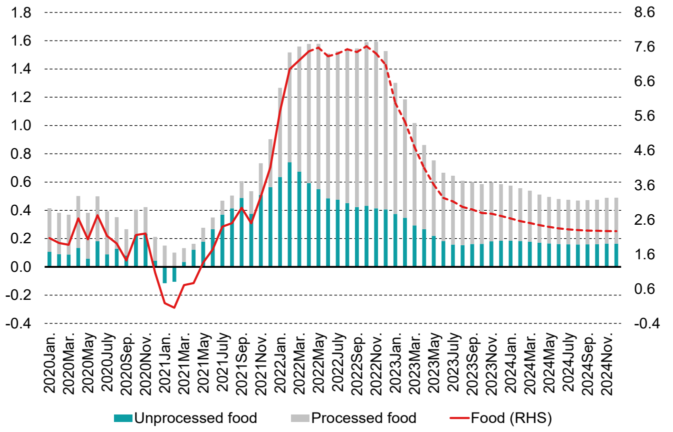
Fruit and vegetables prices rose by an average annual rate of 13.3% and 19.0% respectively during January-April 2022 and have together contributed 0.6 percentage point to overall HICP inflation. While this largely reflects local developments (such as weather conditions), the recent sharp increase in transport costs as well as other input costs (such as plastics and fertilisers) also contributed. Trade data show that the price of imported vegetables has increased by an annual rate of 4.7% in February, which is lower than the increases in the prices of the vegetables subcomponent of the HICP inflation.

Food price projections 2022-2024

Import price pressures are expected to remain elevated this year. Indeed, non-energy commodity prices in USD terms (which partly reflect projections for food commodity prices) are projected to grow by 14.4% this year. These should then decline by 4.9% in 2023 and 6.3% in 2024.

Overall, according to the Bank's projections, annual food price inflation is forecast to peak at 7.6% in May 2022 but should fall to 7.1% by the end of the year (see Chart 5). This is then expected to fall further and stabilise at 2.3% by the second half of 2024. While the contribution from processed food inflation is expected to continue to increase until the end of 2022, the contribution of unprocessed food inflation is expected to continue on the downward path evident in the last two months.

Chart 5
FOOD INFLATION FORECAST AND ITS CONTRIBUTION TO HICP
(annual percentage change; percentage point)



Source: Eurostat.

Public finance

The general government deficit-to-GDP ratio is set to amount to 5.6% in 2022, down from 8.0% in 2021 (see Table 2). It is projected to continue to narrow to 4.0% in 2023, and to 3.2% in 2024. This profile is driven by the unwinding of COVID-19 support measures in 2022, which more than offsets outlays on price mitigation measures.

Compared with the Bank's earlier projections, smaller deficits are projected throughout the forecast horizon. This reflects the better than expected turnout in 2021, which was primarily due to

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

	2021[1]	2022	2023	2024
Headline aggregates				
Total Revenue	37.5	37.1	37.4	37.0
Total Expenditure	45.5	42.7	41.3	40.3
General Government Balance	-8.0	-5.6	-4.0	-3.2
of which: Primary Balance	-6.8	-4.5	-2.8	-2.0
General Government Debt	57.0	58.4	58.5	58.7
Detailed breakdown				
Current Revenue	35.9	35.2	35.3	35.4
Current taxes on income and wealth	14.0	13.4	13.4	13.4
Taxes on production and imports	10.8	11.4	11.7	12.0
Social contributions	6.3	6.1	6.0	5.9
Other current revenue[2]	4.8	4.3	4.2	4.2
Current Expenditure	40.1	37.5	36.3	35.7
Compensation of employees	12.2	12.0	11.8	11.9
Social benefits	9.6	9.5	9.4	9.4
Intermediate consumption	9.4	9.0	8.7	8.8
Interest payments	1.2	1.2	1.2	1.2
Subsidies	4.7	2.9	2.5	1.9
Other current expenditure[3]	3.2	2.9	2.6	2.4
Gross Savings	-4.2	-2.3	-1.0	-0.3
Capital Revenue	1.6	1.9	2.0	1.6
Capital taxes	0.2	0.2	0.2	0.2
Other capital revenue[4]	1.4	1.7	1.8	1.4
Capital Expenditure	5.4	5.2	5.0	4.6
Gross fixed capital formation	4.2	4.2	4.1	3.8
Capital transfers	1.1	1.0	0.9	0.8
Other capital expenditure[5]	0.1	0.0	0.0	0.0
Capital Revenue net of Capital Expenditure	-3.8	-3.3	-3.0	-2.9
Underlying budgetary outcome				
Cyclical Component	-0.2	0.0	0.7	0.8
Temporary Government Measures	-0.4	0.0	0.0	0.0
Structural Balance	-7.4	-5.6	-4.7	-4.1

Sources: NSO; Central Bank of Malta.

(1) Actual data as per NSO *News Releases* 67/2022 (published on 22 April 2022) and 37/2022 (published on 1 March 2022).

(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.

higher than anticipated growth in tax revenue. However, following the introduction of measures to mitigate rising energy and other commodity prices in 2022, the deficit-to-GDP ratio is set to decline at a slower pace compared with the Bank's earlier projections.

In 2022, the share of current revenue in GDP is expected to be lower than 2021 levels but to increase slightly over the projection horizon. This is due to the profile of tax revenue, where only inflows from indirect taxes are set to grow at a stronger pace than nominal GDP. The latter reflects growth in VAT receipts, which is expected to be buoyed by the on-going recovery in tourism. Meanwhile, the share of other current revenue in GDP is set to decline in 2022 and to stabilise thereafter.

The share of capital revenue in GDP is set to peak in 2023 before declining in 2024, due to the profile of EU grants, which part-finance capital expenditure.

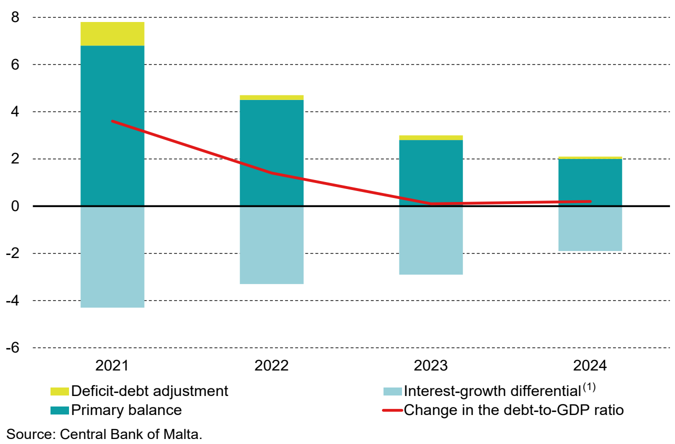
The share of current expenditure in GDP is expected to decline significantly over the forecast horizon, mainly due to lower outlays on subsidies. This reflects the aforementioned decline in COVID-related spending and the gradual unwinding of price-mitigating measures announced in 2022. Compensation of employees and intermediate consumption are set to increase at a slower pace than nominal GDP, as health-related outlays are set to grow by less compared with the period immediately following the onset of COVID-19. Social benefits are also set to grow by less than nominal GDP, owing to the profile of pension payments. On the other hand, the share of interest payments in GDP is set to end its declining trend and remain broadly stable over the forecast horizon.

The share of capital expenditure in GDP is projected to remain elevated throughout the forecast horizon, although it is set to decline over time. This profile reflects a declining share of domestically-funded projects and the completion of projects financed from the 2014-2020 EU financing framework. This is partly offset by the projected pick-up in spending on projects financed from grants by the Recovery and Resilience Fund.

The structural deficit is projected to narrow further over the projection horizon, reaching 4.1% of GDP by 2024. This is due to the unwinding of support measures, as these are not treated as one-off outlays and thus affect the underlying structural position.

The general government debt-to-GDP ratio is projected to increase from 57.0% in 2021 to 58.4% in 2022. It is then projected to increase further in the outer years of the projection horizon, albeit at a slower pace, reaching 58.7% by 2024. The increase in the debt ratio is driven by the expected primary deficits, which are partly offset by a negative interest-growth differential (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.

Risks

On balance, risks to economic activity are to the downside for 2022 and 2023, and on the upside for 2024. Downside risks relate to the possible prolongation of the Russia-Ukraine war, with potential production disruptions related to sanctions on Russian oil and gas. In such a case, economic activity might be adversely affected by higher import price pressures, weaker foreign demand and a rise in uncertainty. Moreover, if supply bottlenecks, as well as higher input and transport costs persist for a longer period, manufacturing activity could be weaker than anticipated in the baseline. Furthermore, the prolongation of supply bottlenecks could sustain inflationary pressures for longer and this could adversely impact private consumption and corporate investment. Foreign demand could also be weaker than expected if monetary policy in advanced economies tightens more forcibly than assumed in this projection round, which would dampen foreign demand.

These downside risks are mitigated somewhat by potentially more expansionary domestic fiscal policy (in particular, more support to cushion the impact of imported inflation). In addition, the savings ratio could fall faster than assumed in the baseline, stimulating higher consumption. A faster resolution of the war than that assumed in the baseline as well as the potential for a faster drawdown of domestic private savings underpin the small upside risks to activity in 2024.

Risks to inflation are on the upside during the entire projection horizon. Indeed, possible disruptions to Russian oil and gas supplies could increase commodity prices further, which would put further upward pressures on the prices of imported goods and transport costs. Such pressures could be amplified by China's zero-COVID policy, which would prolong supply disruptions globally. Finally, wage pressures could become stronger if high inflation persists for a longer period.

On the fiscal side, risks mainly relate to a larger deficit in 2022 and 2023. These mostly reflect the likelihood of additional Government support to mitigate rising commodity prices and the likelihood of state aid to Air Malta.