BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

# CENTRAL BANK OF MALTA
## OUTLOOK FOR THE MALTESE ECONOMY

**2023:2**

© **Central Bank of Malta, 2023**

**Address**
Pjazza Kastilja
Valletta VLT 1060
Malta

**Telephone**
(+356) 2550 0000

**Fax**
(+356) 2550 2500

**Website**
www.centralbankmalta.org

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

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

*The cut-off date for information in this publication is 27 May 2023. Figures in tables may not add up due to rounding.*

ISSN 2789-2190 (online)

# OUTLOOK FOR THE MALTESE ECONOMY 2022-2025

## Overview[1,2]

Latest short-term indicators suggest that economic activity remained strong in recent months. In particular, the tourism sector has rebounded much more strongly than expected. However, significant underlying headwinds from the international economic environment remain. In particular, a tighter monetary policy in the euro area is expected to adversely affect foreign demand, even though the interest-rate pass through to lending rates charged by banks in Malta has been low so far (see Box 1). At the same time, price pressures remain persistent, and inflation is thus expected to remain elevated during most of the forecast horizon.

Given these factors, economic growth in 2023 is expected to moderate significantly. Moreover, international developments, including the impact of monetary policy, are expected to continue to adversely affect growth throughout the projection horizon.

Meanwhile, price-mitigating fiscal measures continue to provide support to economic activity, as energy prices in Malta remain fixed (see Box 2).

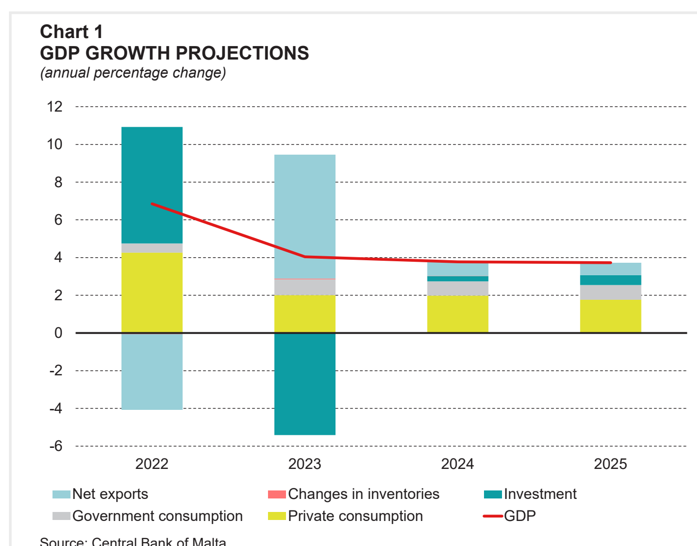
## Economic outlook

According to the Bank's latest forecasts, Malta's GDP growth is projected to slow down from 6.9% in 2022 to 4.0% in 2023. Growth is set to ease slightly further to 3.8% and 3.7% in 2024 and 2025, respectively (see Table 1). When compared to the previous projections, the Bank's latest forecast for GDP is revised upwards throughout the projection horizon. Indeed, GDP growth was revised up by 0.3 percentage points in 2023, and 0.2 percentage points in 2024 and 2025.

In 2022, domestic demand contributed significantly to GDP growth, driven by both private consumption and investment (see Chart 1). Net exports had a negative contribution, in part reflecting extraordinary imports in the aviation sector.

In 2023, net exports are expected to be the main contributor to growth. This reflects the expected sharp slowdown in imports (goods imports specifically are set to contract after being boosted by extraordinary imports of investment equipment in 2022), as well as robust growth in exports. Meanwhile, domestic demand is expected to lower growth, as investment is projected to contribute negatively, owing to base effects related to the aforementioned extraordinary outlays in 2022,

**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 27 May 2023. The GDP release for the first quarter of 2023, published on 30 May, has not been taken into account. Technical assumptions were transmitted by the ECB.

[2] See Central Bank of Malta Outlook for the Maltese Economy 2023:1.

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

| | 2022[2] | 2023 | 2024 | 2025 |
|---|---|---|---|---|
| **Real economic activity (% change)** | | | | |
| GDP | 6.9 | 4.0 | 3.8 | 3.7 |
| Private consumption expenditure | 10.1 | 4.6 | 4.5 | 4.0 |
| Government consumption expenditure | 2.4 | 4.4 | 4.0 | 4.1 |
| Gross fixed capital formation | 30.4 | -21.5 | 1.5 | 2.8 |
| Exports of goods and services | 6.4 | 4.1 | 3.3 | 3.1 |
| Imports of goods and services | 9.7 | 0.2 | 3.2 | 3.0 |
| **Contribution to real GDP growth (in percentage pts)** | | | | |
| Final domestic demand | 10.9 | -2.5 | 3.0 | 3.1 |
| Net exports | -4.0 | 6.6 | 0.7 | 0.7 |
| Changes in inventories | -0.1 | 0.0 | 0.0 | 0.0 |
| **Balance of payments (% of GDP)** | | | | |
| Goods and services balance | 8.6 | 14.2 | 14.3 | 14.7 |
| Current account balance | -5.8 | 0.8 | 0.8 | 0.9 |
| **Labour market (% change)**[3] | | | | |
| Total employment | 6.0 | 3.6 | 2.7 | 2.4 |
| Unemployment rate (% of labour supply) | 3.0 | 3.0 | 3.1 | 3.1 |
| **Real disposable income**[4] | 2.4 | 1.8 | 3.2 | 3.7 |
| **Household saving ratio**[4] | 28.6 | 26.6 | 25.7 | 25.5 |
| **Prices and costs (% change)** | | | | |
| GDP Deflator | 5.2 | 4.3 | 2.7 | 2.6 |
| RPI | 6.2 | 5.0 | 2.7 | 2.2 |
| Overall HICP | 6.1 | 5.3 | 2.9 | 2.3 |
| HICP excluding energy | 6.6 | 4.9 | 2.5 | 2.0 |
| Compensation per employee | 2.8 | 5.5 | 4.9 | 3.9 |
| ULC | 2.1 | 5.0 | 3.8 | 2.6 |
| **Business Cycle** | | | | |
| Potential output (% change) | 5.3 | 5.4 | 4.3 | 3.4 |
| Output gap (% of GDP) | 1.6 | 0.2 | -0.3 | 0.1 |
| **Technical Assumptions** | | | | |
| EUR/USD exchange rate | 1.05 | 1.08 | 1.09 | 1.09 |
| Oil Price (USD per barrel) | 103.7 | 78.0 | 72.6 | 70.4 |

Sources: NSO; Central Bank of Malta.

[1] Data on GDP were sourced from NSO *News Release* 036/2023 published on 23 February 2023, while RPI and HICP data were sourced, respectively, from NSO *News Releases* 090/2023 and 086/2023 (published on 23 May 2023 and 17 May 2023).

[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.

offsetting positive contributions from government and private consumption. From 2024, domestic demand is expected to be the main driver of growth, as private consumption growth should remain relatively robust despite relatively high inflation. Net exports are also projected to contribute positively in 2024, and 2025 due to robust services exports.

Private consumption growth is set to decelerate from 10.1% in 2022, to 4.6% in 2023. The slowdown reflects the normalisation of consumer demand following the strong recovery in the last

two years, as well as slower growth in disposable income. Nevertheless, private consumption growth is still expected to be relatively strong, as consumers should continue to draw on their pandemic-related savings to sustain their consumption in a high-inflationary period. In 2024 and 2025, growth in private consumption is set to moderate somewhat further but should outpace the Bank's estimate of real disposable income growth. The saving ratio is thus envisaged to retreat from recent peaks and fall below 2019 levels this year.

After increasing by 2.4% in 2022, government consumption is set to rise by 4.4% in 2023, 4.0% in 2024 and 4.1% in 2025. This profile is driven by growth in outlays on compensation of employees and intermediate consumption. Growth in these items is expected to be particularly strong in 2023, mainly reflecting outlays on allowances and intermediate consumption by extra budgetary units.

Investment is projected to decline by 21.6% this year, reflecting a negative base effect in equipment investment. Investment is then forecast to grow by 1.5% in 2024, and 2.8% in 2025.

Private investment is expected to contract by around 25% in 2023, mostly reflecting the above-mentioned outlays in the aviation sector in 2022. Growth in overall investment is then projected to 3.4% for 2024, and 2025. Residential construction is set to grow moderately over the projection horizon, as levels in this sector are high from a historical perspective. Furthermore, sentiment in this sector is weak, and labour shortages are judged to be binding. Similarly, non-residential construction is expected to exhibit some weakness, and is hence projected to grow only slowly in the projection horizon.

After falling by around 8.3% last year, government investment is set to grow by 4.8% in 2023, and to decline by 7.7% in 2024 and by 0.3% in 2025. This profile is partly driven by the expected take up of EU funds, notably the full absorption of funds from the 2014-2020 financing framework by 2023, and the increased take up of RRF grants in 2023 and 2024. It also reflects the profile of domestically funded investment, which is set to be lower than the level reached in 2022.

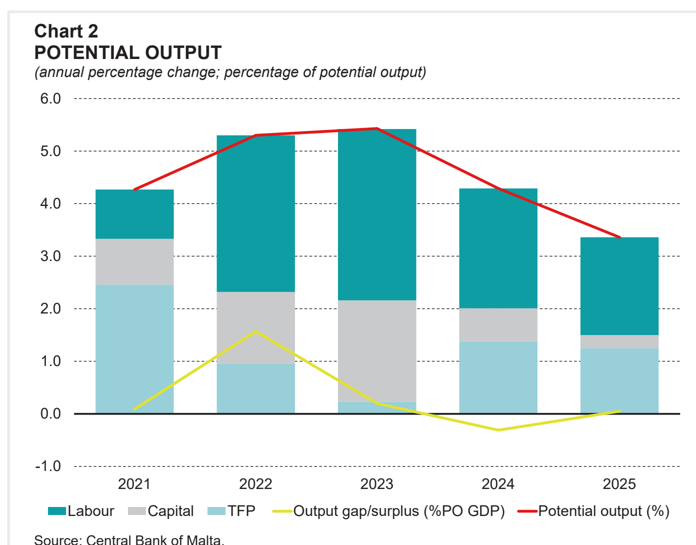
In 2023, export growth is expected to remain robust in line with the solid performance of tourism and non-business services exports. Indeed, at 4.1%, export growth is envisaged to exceed growth in foreign demand, mainly as tourism exports have rebounded faster than expected and are exceeding pre pandemic levels. Meanwhile, non-tourism services exports are also expected to remain robust this year, as they have continued to show resilience despite weaker international demand. Conversely, growth in goods exports is expected be weak this year reflecting developments in international demand. Growth in exports is then expected to moderate to just around 3% in the following two years and grow broadly in line with foreign demand.

With regard to imports, growth is expected to slow down sharply this year, in line with the profile of equipment investment. Imports are then projected to grow in line with aggregate demand in the following two years.

The current account in the balance of payments is expected to turn to a small surplus in 2023 of 0.8% of GDP, following a deficit of 5.8% registered in 2022. This primarily reflects the foreseen normalisation in the trade balance due to base effects related to investment. The current account balance is then projected to stand at 0.8%, and 0.9% of GDP in the following two years.

## Potential output

Potential output growth is estimated to have picked up to 5.3% in 2022, from 4.3% in 2021 (see Chart 2). In 2023, growth in potential output is set to increase slightly to 5.4%, which reflects higher contributions from capital and labour. The labour contribution is expected to increase due to higher net migration flows while the contribution from capital is also envisaged to increase due to the high investment levels in the previous year.




Potential output growth is set to moderate to 3.4% by 2025, reflecting lower contributions from labour and capital, partly compensated by stronger total factor productivity. The latter partly reflects the lagged impact of productivity-enhancing investment from the Recovery and Resilience Facility (RRF).

The output gap is expected to narrow to 0.1% during the projection horizon, largely in view of the sharp slowdown in GDP growth in 2023.

## BOX 1: THE RECENT INTEREST-RATE PASS-THROUGH FROM MONETARY POLICY RATES TO MALTA'S RETAIL LENDING RATES, AND THE IMPACT ON GDP GROWTH AND INFLATION[1]

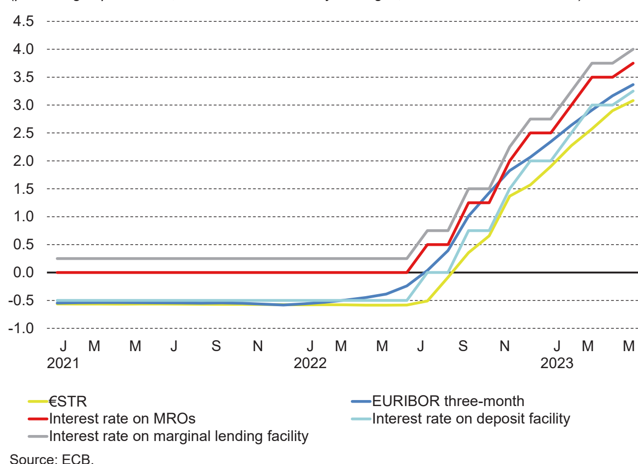
### Introduction

During the last decade, inflationary pressures in the euro area were low despite the very accommodative monetary policy stance. Indeed, the Deposit Facility Rate (DFR) was negative, from June 2014, until mid-2022, when the ECB began to raise its policy rates. In addition, several non-standard monetary policy measures were implemented to inject liquidity in the economy and safeguard the monetary transmission mechanism. However, inflationary pressures in the euro area and across the world have recently increased sharply, which has prompted central banks to embark on an unprecedented pace of monetary tightening. In this context, the ECB's Governing Council increased the DFR from -0.5% to 0.0% in July 2022. A rapid succession of policy rate increases since then brought the DFR to 3.25% in May 2023 (see Chart 1). Meanwhile, non-standard monetary measures also started to be gradually withdrawn. As a result, the Euro Short-term Rate (€STR) rose from -0.56% in December 2021 to 3.06% in May 2023, while the three-month EURIBOR rate increased from -0.58% to 3.37%.

[1] Prepared by Ian Borg and Martina Cassar, Manager and Economist, respectively, within the Economic Projections and Conjunctural Analysis office.

In view of the substantial increase in monetary policy rates, this box presents a partial and preliminary assessment of the degree to which Maltese commercial banks have passed on these increases to mortgage rates and lending rates for non-financial corporations (NFCs), compared to the other euro area countries. Moreover, the pass-through rate from the change in monetary policy rate to retail lending rates for the period December 2021 and March 2023 is estimated for Malta and the other euro area countries. These estimates are then utilised to estimate the impact of the bank lending channel on GDP growth and inflation in the projection horizon.

**Chart 1**
**KEY MONEY MARKET INTEREST RATES**
*(percentages per annum; market rates – monthly averages; ECB rates – end of month)*



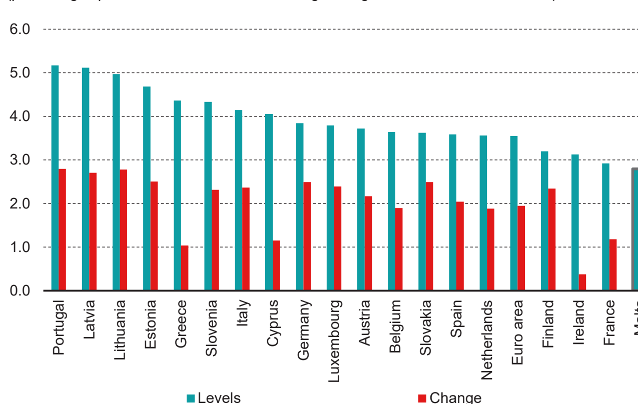

Source: ECB.

The box relies on harmonised MFI interest rate statistics (MIR) on new business volumes with residents of the euro area published by the ECB.[2] Croatia is excluded from the analysis due to data limitations.

### Interest-rate pass-through since December 2021 to March 2023

Chart 2 depicts the three-month moving average of the mortgage lending rate in March 2023, as well as the change in the lending rate since December 2021 to March 2023. The mortgage lending rate in Malta stood at 2.8% in March 2023, which was the lowest when compared to other euro area countries. Since December 2021, the three-month average mortgage lending rate rose by just 28 basis points, while the euro area average rose by 195 basis points. Both the level of the lending

**Chart 2**
**LENDING RATES FOR MORTGAGES**
*(percentages per annum – three-month moving average of new business – APRC*)*



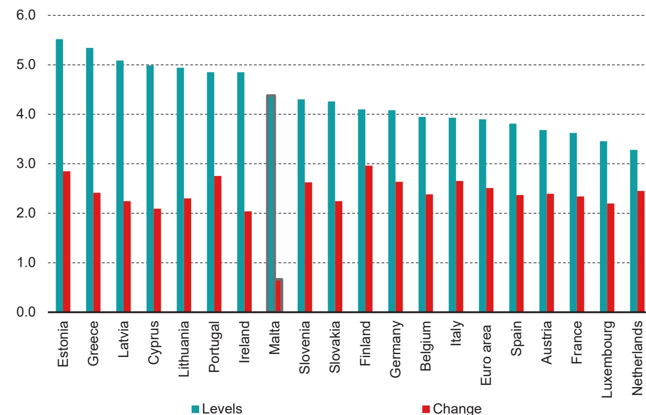

Source: ECB.
Last observation: March 2023.
*APRC covers the total cost of a loan, comprising the interest rate component and other (related) charges.

[2] These data may thus differ from MIR data covering transactions with residents of Malta cited in other Bank publications.

rate and its rise since December 2021 were the lowest in Malta when compared to other euro area countries.

With regard to loans to NFCs, Malta's lending rate stood at 4.4% in March 2023, above that in the euro area, which stood at 3.7% (see Chart 3).[3] The level of the lending rate was 8th highest in the euro area. The change in the three-month average NFC lending rate in Malta stood at 66 basis points, and hence these have been more responsive than mortgage lending rates. However, this change was much lower than the 251 basis points rise in the euro area, and was the lowest across all euro area countries, where increases of at least 200 basis points were recorded.

**Chart 3**
**LENDING RATES FOR NFCs**
*(percentages per annum – three-month moving average of new business)*




Source: ECB.
Last observation: March 2023.

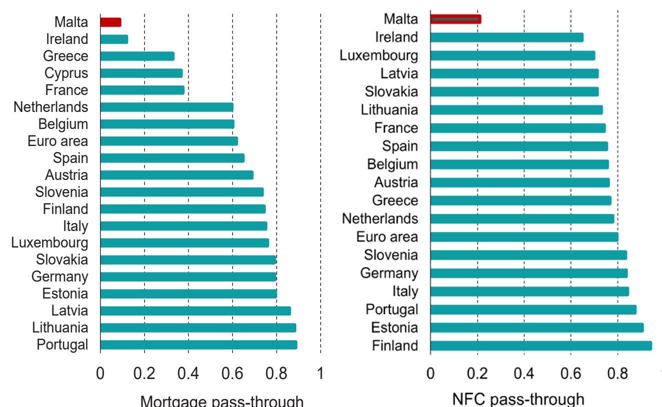
This suggests that, although we observe some increase in lending rates in Malta in response to the increase in monetary policy rates, the pass-through to retail rates has been low. To estimate the pass-through rate over the period December 2021 to March 2023, we calculate the following simple equation:

$$PT = \frac{\Delta rr_i}{\Delta pr}$$

where $\Delta rr_i$ is the change in the retail lending rate of country i between December 2021 and March 2023, while $\Delta pr$ is the change in the €STR during the same period.

Chart 4 shows that there has been very high heterogeneity in the pass-through of monetary policy to lending rates across euro area countries. The pass-through has been

**Chart 4**
**PASS-THROUGH RATES**
*(ratio of change in lending rate to the change in €STR)*




Sources: ECB; own workings.

[3] The three-month moving average of lending rates to NFCs for residents of Malta only stood at 4.9% in March 2023, around 98 basis points higher than those prevailing in December 2021. Such change would still be the lowest across all euro area countries.

incomplete in all countries, i.e., retail lending rates rose by less than the short-term rate. Both with regard to mortgages and NFCs, Malta has experienced the lowest pass-through. Indeed, the pass-through to the mortgage lending rate stood at just 0.09, while that for rates on lending to NFCs stood at 0.2.

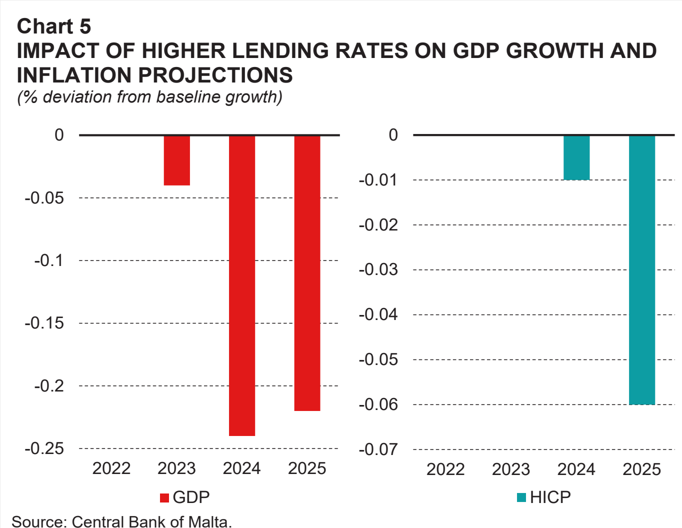
The low interest rate pass-through in Malta is not a new phenomenon. Previous estimates have put the short-term pass-through of mortgage lending rates in Malta at 0.26 and that for NFCs at 0.21.[4] However, the pass-through rates in Malta during the current tightening phase are even smaller than these estimates, especially for mortgages.

## The impact of the bank lending channel on GDP growth and inflation in the projection horizon

In order to estimate the impact of the rise in interest rates on economic activity and inflation in the projection horizon, we proceed in two steps. As a first step, we utilise the estimated impact of monetary policy on the short-term lending rate published by the ECB in its May 2023 economic bulletin.[5] In the latter exercise, the ECB estimated the upward impact of monetary policy tightening on short-term lending rates to be 91bps, 373bps, 336bps, and 277bps between 2022 and 2025, respectively. We then impose these estimated impacts as interest rate shocks in the Bank's main macro econometric model – STREAM – to assess the impact on GDP growth and inflation. For the purposes of this exercise, we calibrate down the short-term pass-through from the policy rate to lending rates in view of the lower pass-through reported in the previous section.

Monetary policy tightening is expected to raise lending rates for NFCs and mortgages in Malta by around 150bps and 140bps, respectively, over the full projection horizon.[6] This exerts some downward pressure on Maltese real activity and inflation. In particular, the rise in interest rates is estimated to reduce GDP growth by 0.04% in 2023, 0.24% in 2024, and 0.22% in 2025 (see Chart 5). Meanwhile, the impact on HICP is even more muted, with an estimated peak decline of 0.06% in 2025. The estimated

**Chart 5**
**IMPACT OF HIGHER LENDING RATES ON GDP GROWTH AND INFLATION PROJECTIONS**
*(% deviation from baseline growth)*




Source: Central Bank of Malta.

[4] See Micallef and Gauci (2014), "Interest-rate pass-through in Malta", Article published in the Quarterly Review 2014:1.
[5] See A model-based assessment of the macroeconomic impact of the ECB's monetary policy tightening since December 2021.
[6] Although the short-term pass-through rate is calibrated down in view of the observed low pass-through, the long-term pass-through is estimated at a longer horizon, and stands at around 50%.

downward pressure on real activity and inflation is primarily driven by lower private consumption and investment.

These estimated impacts account only for the interest rate channel of monetary policy, i.e., the extent to which higher lending rates lead to lower credit to households and firms, and as a result lower consumption and investment. There are other channels that are not accounted for in the above simulation, such as tighter credit standards, the exchange rate channel, spill overs from downward pressure in euro area real activity, and inflation, as well as higher long-term rates. Hence, monetary policy tightening is likely to have a more marked impact on Maltese real activity and inflation than shown above. In view of Malta's trade openness, indirect impact which stems from trade spill overs and the exchange rate channel could make the impact of monetary policy substantial despite the low domestic pass-through of retail lending rates.

## Labour Market

Employment growth is set to moderate to 3.6% in 2023 from 6.0% in 2022, which partly reflects the envisaged slowdown in economic activity towards potential growth. Over the rest of the projection horizon, employment is set to moderate further, expanding by 2.7% and 2.4%.

The unemployment rate is expected to stand at 3.0% in 2023, unchanged when compared to 2022, and to remain at a relatively low level of 3.1% in 2024 and 2025. Despite this marginal increase, the unemployment gap is expected to remain negative, as the NAIRU is projected to stand at 3.5% in 2025.

In view of the current high inflationary pressures, as well as tight labour market conditions, nominal wage growth is projected to be relatively strong from a historical perspective. Compensation per employee is thus set to grow by 5.5% in 2023, 4.9% in 2024, and 3.9% in 2025, outpacing consumer price inflation during the later period of the projection horizon.

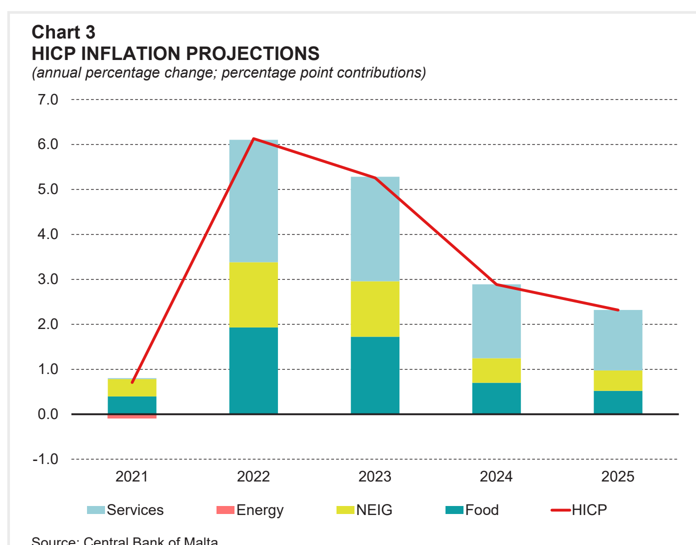
Slower growth in economic activity during the projection horizon is expected to reduce the tightness in labour market conditions. Nevertheless, the unemployment gap is still foreseen to remain marginally negative by 2025 (at around -0.4 percentage point), which implies that labour market tightness will remain a factor that could limit economic growth going forward, albeit less than before. This easing of labour market tightness should also ease upward pressure on nominal wages by 2025.

## Prices

Annual HICP inflation is projected to moderate to 5.3% in 2023, as international supply bottlenecks are expected to ease further (see Chart 3). However, lingering indirect effects from recent increases in input costs are set to keep inflation high from a historical perspective. HICP inflation is set to ease steadily in the following years. Thus, overall HICP inflation is set to stand at 2.9%

When compared with the Bank's previous forecast publication, overall HICP inflation was revised up throughout the projection horizon, following higher than expected outcomes in recent months,

and indications that price pressures are more persistent than previously assessed.




The projected fall in inflation in 2023 reflects a broad-based decrease across all sub-components of HICP, except for energy inflation, which is expected to remain unchanged in view of government support measures. Services is envisaged to be the main contributor to HICP inflation, but food and non-energy industrial goods (NEIG) are also projected to contribute strongly to annual HICP inflation in 2023.

Services inflation is expected to ease from 6.0% in 2022, to 5.2% in 2023, and to 3.7% and 3.0% in 2024 and 2025, respectively. The projected higher than average inflation is expected to be driven by restaurants and housing services which are assumed to remain affected by indirect spillovers from inflation of other subcomponents, such as food and NEIG, wage pressures, as well as high inflation persistence. The stronger rebound in tourism will also contribute to sustain prices of restaurant meals and tourism-related services.

Food price inflation is projected to remain elevated this year. Food prices are projected to rise by 8.0% in 2023, slightly less than the 9.1% observed in 2022. This easing is driven by unprocessed food inflation, which is expected to decline to 7.4%, from 12.1% in 2022. Processed food inflation is expected to remain relatively elevated at 8.2%, unchanged from 2022, which partly reflects higher diary product prices as from June 2023. Food inflation is set to moderate gradually to 2.4% in 2025, in line with expected developments in international commodity prices. Furthermore, the impact on the annual rate of inflation stemming from increases in certain dairy products as from 1 June 2023 should fade away in the corresponding month of 2024.

NEIG inflation is expected to remain rather persistent and decline only slightly from 5.3% in 2022 to 4.4% in 2023. This slow-down reflects an easing of supply-chain disruptions and hence a moderation in imported inflation. However, this component is exhibiting a high degree of persistence, which is expected to keep inflation rates above historical outcomes in the projection horizon. NEIG inflation is expected to moderate over the rest of the projection horizon, standing at 1.6% in 2025.

With regard to energy prices, these are expected to remain unchanged during the whole projection horizon, in line with the Government's commitment to keep energy prices stable.

## Public finance

In 2023, the general government deficit-to-GDP ratio is set to decline to 4.9% of GDP, from 5.8% in 2022 (see Table 2). It is set to continue declining over the rest of the forecast horizon, reaching

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

| | 2022[1] | 2023 | 2024 | 2025 |
|---|---|---|---|---|
| **Headline aggregates** | | | | |
| Total Revenue | 35.1 | 35.0 | 34.8 | 34.7 |
| Total Expenditure | 40.9 | 40.0 | 38.4 | 38.1 |
| General Government Balance | -5.8 | -4.9 | -3.6 | -3.4 |
| of which: Primary Balance | -4.8 | -3.6 | -2.2 | -2.0 |
| General Government Debt | 53.4 | 54.4 | 55.0 | 55.3 |
| **Detailed Breakdown** | | | | |
| Current Revenue | 34.0 | 33.7 | 33.9 | 33.8 |
| Current taxes on income and wealth | 13.6 | 13.4 | 13.4 | 13.5 |
| Taxes on production and imports | 10.5 | 10.6 | 10.9 | 10.9 |
| Social contributions | 5.9 | 5.8 | 5.8 | 5.7 |
| Other current revenue[2] | 4.0 | 3.9 | 3.8 | 3.7 |
| Current Expenditure | 36.6 | 35.4 | 34.4 | 34.2 |
| Compensation of employees | 10.8 | 10.7 | 10.6 | 10.5 |
| Social benefits | 8.8 | 8.8 | 8.9 | 8.8 |
| Intermediate consumption | 8.1 | 8.2 | 8.1 | 8.1 |
| Interest payments | 1.0 | 1.3 | 1.4 | 1.4 |
| Subsidies | 5.0 | 3.7 | 2.6 | 2.5 |
| Other current expenditure[3] | 2.8 | 2.7 | 2.8 | 2.9 |
| Gross Savings | -2.6 | -1.7 | -0.5 | -0.4 |
| Capital Revenue | 1.0 | 1.3 | 0.9 | 0.9 |
| Capital taxes | 0.2 | 0.2 | 0.2 | 0.2 |
| Other capital revenue[4] | 0.8 | 1.1 | 0.7 | 0.7 |
| Capital Expenditure | 4.3 | 4.5 | 4.0 | 3.9 |
| Gross fixed capital formation | 3.3 | 3.4 | 3.0 | 2.9 |
| Capital transfers | 0.9 | 1.2 | 1.0 | 1.0 |
| Other capital expenditure[5] | 0.0 | 0.0 | 0.0 | 0.0 |
| Capital Revenue net of Capital Expenditure | -3.2 | -3.3 | -3.1 | -3.0 |
| **Underlying budgetary outcome** | | | | |
| Cyclical Component | 0.4 | 0.2 | 0.0 | 0.0 |
| Temporary Government Measures | 0.0 | 0.0 | 0.0 | 0.0 |
| Structural Balance | -6.2 | -5.1 | -3.5 | -3.4 |

Sources: NSO; Central Bank of Malta.

[1] Actual data as per NSO *News Releases* 66/2023 (published on 21 April 2023) and 36/2023 (published on 28 February 2023).

[2] Mainly includes revenue from dividends, rents and sales.

[3] Mainly includes spending on education and contributions to the EU budget.

[4] Mainly includes grants from EU Programmes.

[5] Mainly reflects the value of changes in inventories and in the net acquisition of valuables and other assets.

3.4% of GDP by 2025. This improvement is driven by a declining share of expenditure in GDP, mainly due to the profile of inflation-mitigation measures.

Compared with the Bank's earlier projection, the deficit for 2023 remains unchanged. However, the latest projections envisage a smaller deficit in 2024 (by around 0.2 percentage points), but a larger deficit in 2025 (by around 0.5 percentage points). This is mostly due to revisions in the profile of tax revenue and in outlays on support measures.

The share of current revenue in GDP is expected to fall slightly over the forecast horizon. Tax revenue as a share in GDP is set to remain broadly stable, as a decline in the ratios of current taxes on income and wealth and in social contributions is set to be offset by an increase in the ratio of taxes on production and imports. Non-tax current revenue is also set to increase by less than nominal GDP.

The share of capital revenue in GDP is set to peak in 2023, before declining and stabilising in 2024 and 2025. This is due to the expected profile of EU grants, which part-finance capital expenditure.

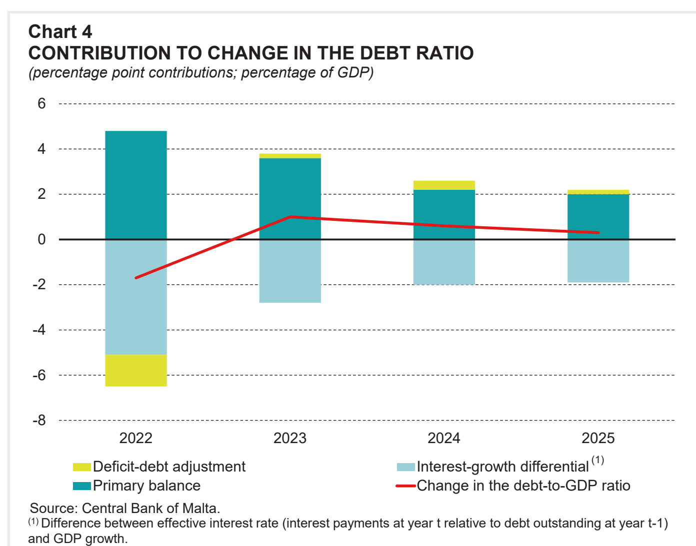
The share of current expenditure in GDP should decline throughout the forecast horizon, mainly due to a projected decline in subsidies. This reflects the profile of inflation-mitigation measures, which is set to decrease in line with forecast energy prices. The share of compensation of employees is also set to decline as outlays are not set to grow as much as nominal GDP. Meanwhile, spending on intermediate consumption and social benefits are set to grow broadly in line with GDP from 2023 onwards. Other current expenditure is set to grow by more than nominal GDP, mainly due to the profile of interest payments.

The share of capital expenditure in GDP is projected to increase in 2023, and to decline thereafter. On the one hand, the share of domestically funded projects in GDP is set to decline throughout the projection horizon. However, outlays on EU funded investment projects are set to increase by more than GDP in 2023, and to grow in line with GDP in 2024 and 2025. This reflects the expected full absorption of funds from the 2014-2020 EU financing framework, and the projected pick-up in spending on projects financed through the RRF.

The structural deficit is projected to narrow over the projection horizon, reaching 3.4% of GDP by 2025, from 6.2% in 2022.[3] This profile is driven by outlays on inflation support measures, which are not treated as one-off outlays, and thus affect the underlying structural position.

The general government debt ratio is set to increase throughout the forecast horizon, and to reach 55.3% by 2025. This is driven by the expected level of primary deficits, which offset the debt-decreasing impact of the 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.

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

## BOX 2: THE COMPOSITION OF GOVERNMENT SUBSIDIES[1]

Historically, subsidies made up a relatively small share of government expenditure. Between 2000 and 2019, they amounted to around 3.2% of total spending, and averaged around 1.3% of GDP.

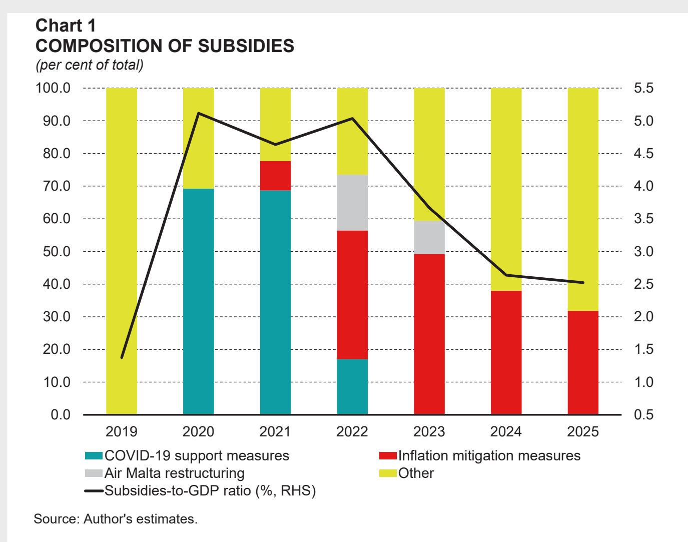
During this period, outlays were mostly in the form of recurring measures. These include spending on Public Service Obligation contracts, which are offered to public sector entities which deliver essential services (such as the Gozo ferry, the bus service and public broadcasting). The Maltese Government also covers interest payments on a debenture loan stock issued to Malta Freeport Corporation (which will mature in 2028). Through the route support scheme, it also subsidises landing fees for airlines which run underserved routes. Subsidies are also offered to the film industry, and for the provision of spare electricity capacity. Other subsidies affect residential utility tariffs (the eco-reduction benefit) and providers of electricity produced by solar photovoltaic systems (the feed-in tariff).

In recent years, outlays on subsidies surged and their share in GDP rose from 1.4% of GDP in 2019 to 5.0% by 2022 (see Chart 1). While outlays are forecast to decline in the coming years, their share in GDP is still expected to remain above 2019 levels by 2025. The share of subsidies in total expenditure is set to peak in 2023 at 12.3%, before declining to 6.6% by 2025.

This profile is driven by support measures, introduced between 2020 and 2022, to mitigate the impact of COVID-19 and of high inflation on the Maltese economy. The largest COVID-19 support measures classified as subsidies were the Wage Supplement Scheme, vouchers issued to households and subsidised interest payments on government guaranteed debt. Inflation mitigation measures include subsidies to public sector entities to maintain the retail prices of electricity, fuel and LPG fixed.

Additional support measures during 2022 were related to the restructuring exercise carried out by Air Malta. This included the launch of an early retirement scheme to employees.

**Chart 1**
**COMPOSITION OF SUBSIDIES**
*(per cent of total)*




Source: Author's estimates.

Overall, most outlays on subsidies between 2020 and 2022 were in the form of support measures related to COVID and the energy price shock. In these three

[1] Prepared by John Farrugia, Manager Fiscal Affairs and Reports Office.

years, such outlays averaged around 73% of total subsidies. Around 60% of the forecast level of spending on subsidies in 2023 is also due to such support measures. Outlays on recurring measures are forecast to once again make up the majority of subsidies in the outer years of the projection horizon. However, support measures are still set to amount to around 38% of subsidies in 2024, and around 32% in 2025.

COVID-related measures made up around 69% of total subsidies each year in 2020 and 2021. However, their share dropped to 17% in 2022, as these measures were unwound. During 2022 a significant increase in outlays related to inflation-mitigation measures, which started being implemented at end-2021. These measures made up around 9% of total subsidies in 2021, and around 39% in 2022. Although they are forecast to decline in level terms in 2023, their share in total subsidies is set to increase to around 49%. The share of these measures in total subsidies is then set to decline to around 38% in 2024, and around 32% in 2025, as energy prices are forecast to decline.

Meanwhile, support to Air Malta made up around 17% of total subsidies in 2022. The latest Stability Programme envisages the implementation of a second early retirement scheme in 2023. In the Bank's forecasts, this is set to account for around 10% of total subsidies.

## Risks

On balance, risks to economic activity are tilted to the downside for 2023 and 2024 and are more balanced thereafter. The main downside risks relate to the possibility of stronger than envisaged weakness in the international economic environment, which could lead to lower exports. Foreign demand may also be weaker than expected, especially if monetary policy in advanced economies tightens more forcibly than assumed in this projection round. GDP data for the first quarter of the year also implies some downside risks to domestic demand. On the other hand, private consumption could surprise on the upside if wage growth is higher than expected, particularly in the outer years.

Risks to inflation are to the upside for the entire projection horizon. Indeed, inflation could be more persistent than assumed in the baseline projections and could continue to be affected by indirect effects from past increases in commodity prices. Moreover, second round effects from higher wages and profit margins could also delay the decline in inflation to the Eurosystem's objective. Conversely, further monetary tightening and lower foreign demand could ease inflationary pressures in the medium-term.

On the fiscal side, risks are on the downside (deficit-increasing) particularly in 2023. These mainly reflect the likelihood of additional support measures related to Air Malta. There exist some deficit-decreasing risks in the outer years of the forecast horizon. These mainly relate to fiscal consolidation pressures as the general escape clause in the Stability and Growth Pact will be deactivated at the end of 2023.