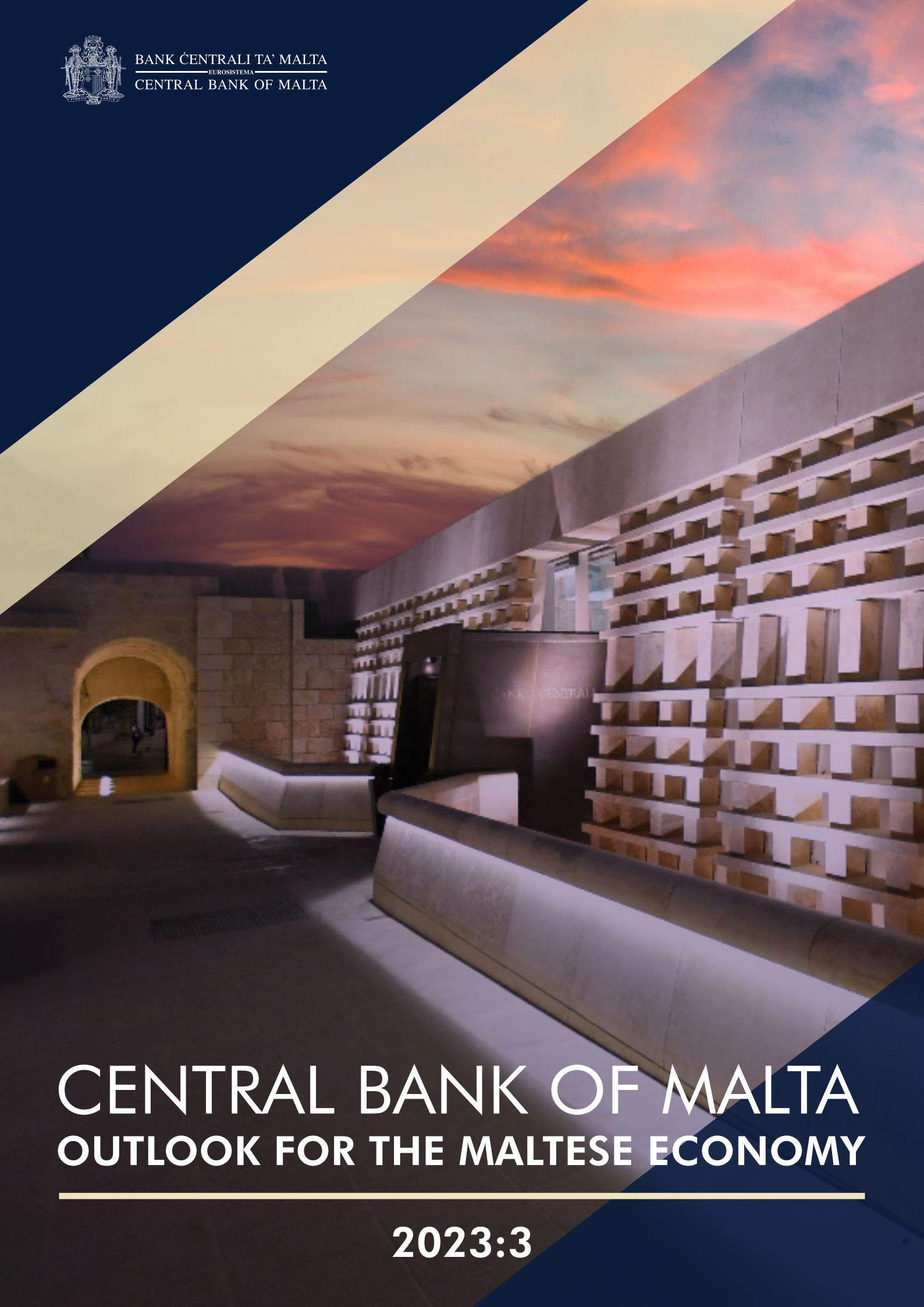




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CENTRAL BANK OF MALTA OUTLOOK FOR THE MALTESE ECONOMY

2023:3

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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 2023-2025

Overview^{1,2}

Incoming information suggests that economic activity in Malta remained broadly resilient despite the weaknesses exhibited in the international economy. In particular, the recovery in tourism remains faster than expected, while domestic demand has been generally robust. However, provisional national accounts data for the first quarter of this year signal higher-than-anticipated weakness in exports, and in construction investment.

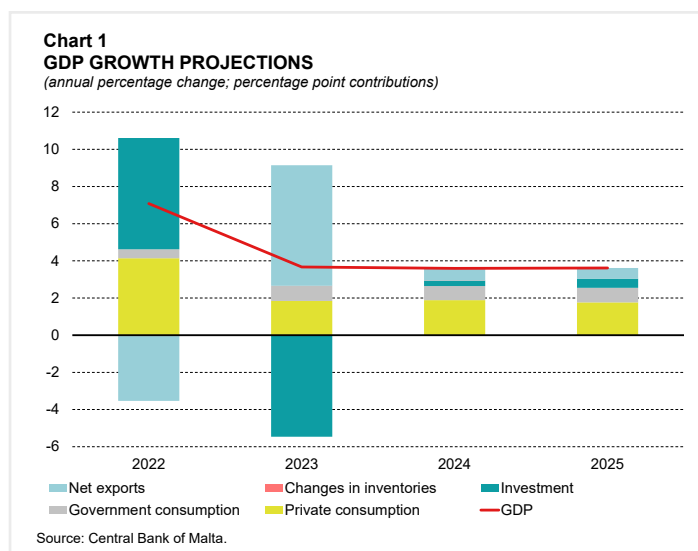
At the same time, price pressures remain highly persistent (see Box 1), and inflation is thus expected to remain elevated during most of the forecast horizon. In the short term this is likely to lead to slower growth in private consumption. Furthermore, wage pressures are expected to remain high and adversely affect firms' profitability in the medium term (see Box 2).

Given these factors, economic growth in 2023 is expected to moderate sufficiently to close the output gap. Moreover, international developments, and the lagged transmission of monetary policy tightening, are expected to contribute to a further moderation in growth in 2024 and 2025.

Economic outlook

According to the Bank's latest forecasts, Malta's gross domestic product (GDP) growth is projected to slow down from 7.1% in 2022 to 3.7% in 2023. Growth is set to ease slightly further to 3.6% in both 2024 and 2025 (see Table 1). When compared to the previous projections, the Bank's latest forecast for GDP is revised marginally downwards throughout the projection horizon. Indeed, GDP growth was revised down by 0.3 percentage point in 2023, 0.2 percentage point in 2024, and 0.1 percentage point in 2025.

In 2023, net exports are expected to be the main contributor to growth (see Chart 1). This reflects the expected decrease in imports (goods imports specifically are set to contract significantly after being boosted by extraordinary imports of investment equipment in 2022), as well as 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 extraordinary outlays in 2022, as well as a projected fall in construction investment. This offsets positive contributions from government and private consumption.



¹ The Bank's projections for the Maltese economy are based on information available up to 14 August 2023.

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	7.1	3.7	3.6	3.6
Private consumption expenditure	9.8	4.3	4.3	4.0
Government consumption expenditure	2.4	4.2	4.0	4.1
Gross fixed capital formation	29.5	-21.9	1.5	2.7
Exports of goods and services	6.3	3.1	3.3	3.0
Imports of goods and services	9.2	-0.9	3.3	3.0
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	10.6	-2.8	2.9	3.0
Net exports	-3.5	6.5	0.6	0.6
Changes in inventories	0.0	0.0	0.0	0.0
Balance of payments (% of GDP)				
Goods and services balance	11.4	17.0	17.1	17.2
Current account balance	-3.0	3.3	3.3	3.4
Labour market (% change)⁽³⁾				
Total employment	6.3	3.8	2.6	2.5
Unemployment rate (% of labour supply)	3.0	3.0	3.1	3.1
Real disposable income⁽⁴⁾	2.5	1.4	3.6	3.7
Household saving ratio⁽⁴⁾	28.8	26.8	26.3	26.1
Prices and costs (% change)				
GDP Deflator	5.3	4.8	2.9	2.6
RPI	6.2	5.6	2.8	2.2
Overall HICP	6.1	5.9	3.1	2.3
HICP excluding energy	6.6	5.8	2.7	2.0
Compensation per employee	2.7	5.5	5.7	3.9
ULC	2.0	5.7	4.7	2.8
Business Cycle				
Potential output (% change)	6.3	5.5	3.8	3.1
Output gap (% of GDP)	1.8	0.0	-0.2	0.3
Technical Assumptions				
EUR/USD exchange rate	1.05	1.09	1.10	1.10
Oil Price (USD per barrel)	103.7	82.9	82.0	77.7

Sources: NSO; Central Bank of Malta.

⁽¹⁾ Data on GDP were sourced from NSO *News Release* 095/2023 published on 30 May 2023, while RPI and HICP data were sourced, respectively, from NSO *News Releases* 130/2023 and 126/2023 (published on 24 July 2023 and 19 July 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.

From 2024, domestic demand is expected to be the main driver of growth, led by private consumption. Net exports are also projected to contribute positively in 2024 and 2025, mainly due to robust services exports.

Private consumption growth is set to decelerate from 9.8% in 2022 to 4.3% in 2023. The slowdown reflects the normalisation of consumer demand following the strong recovery as a result of the post-COVID re-opening effects in the last two years, as well as slower growth in real disposable income. Despite the strong rise in inflation, pandemic-related savings remain a positive impulse to private consumption, though these are gradually being eroded by high inflation. In 2024 and 2025, growth in private consumption is expected to stand at 4.3% and 4.0%, respectively, outpacing the Bank's estimate of real disposable income growth. The saving ratio is thus envisaged to retreat from recent peaks and broadly return to its 2019 level this year, before edging down further in 2024 and 2025.

After increasing by 2.4% in 2022, government consumption is set to rise by 4.2% in 2023, 4.0% in 2024 and 4.1% in 2025. This profile is driven by higher 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 21.9% this year, reversing a significant part of the increase recorded in 2022. This is then forecast to grow by 1.5% in 2024, and 2.7% in 2025.

Private investment is expected to contract by around 26.0% in 2023, mostly reflecting the extraordinary outlays in the aviation sector a year earlier. Also, both residential and non-residential construction are projected to contract this year as hard data for the first half of the year indicates a decline and the sentiment in this sector is weak. Growth in private investment is then projected to stand at 3.5% and 3.1% for 2024 and 2025, respectively.

After falling by around 8.5% last year, government investment is set to grow by 4.3% in 2023, decline by 7.2% in 2024 and to grow again by 0.8% 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 slow down markedly from 6.3% in 2022 to 3.1%. This reflects a normalisation of growth following the pandemic recovery, as well as weaker growth in foreign demand. However, exports remain supported by the solid performance of the tourism industry. Growth in goods exports is expected to be very weak this year, reflecting developments in international demand. Growth in exports is then expected to hover just above 3% in the following two years, broadly in line with foreign demand.

Imports are expected to contract this year in line with the profile of equipment investment and slower growth in aggregate demand. As the latter picks up, imports are set to recover in the following two years.

The current account in the balance of payments is expected to turn to a surplus in 2023 of 3.3% of GDP, following a deficit of 3.0% registered in 2022. This primarily reflects base effects related to investment on the trade balance. The surplus on the current account is then projected to stand at 3.3% in 2024 and 3.4% of GDP in the outer year.

Potential output

Potential output growth is estimated to decrease to 5.5% in 2023, from 6.3% in 2022 (see Chart 2). This slowdown reflects a significantly lower contribution from total factor productivity and a

slightly lower contribution from labour. The labour contribution is expected to decrease due to slower growth in the working age population as inward migration flows are expected to diminish though remaining relatively strong, while the contribution from total factor productivity is envisaged to be weak in view of expected muted developments in labour productivity.

Growth in potential output is set to moderate to 3.1% by 2025, due to a lower contribution from capital and a lower contribution from labour, partly compensated by a recovery in total factor productivity. The latter partly reflects some expected recovery in labour productivity, though its contribution is envisaged to remain weak when seen from a historical perspective.

The output gap is expected to hover around 0% over the projection horizon, as the slowdown in potential output growth is matched by the envisaged normalisation in GDP growth.

Labour market

Employment growth is set to moderate to 3.8% in 2023 from 6.3% in 2022, which partly reflects the moderation in economic activity. Over the rest of the projection horizon, employment is set to slow down further, expanding by 2.6% and 2.5% in 2024 and 2025, respectively.

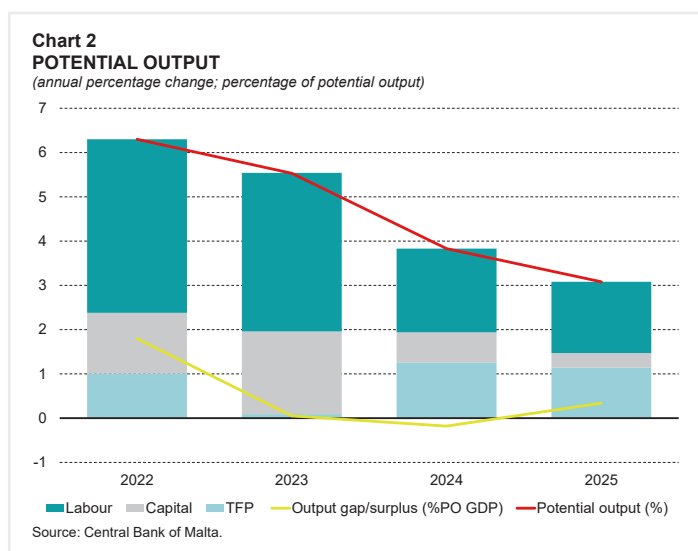
The unemployment rate is expected to stand at 3.0% in 2023, unchanged when compared to 2022, and to remain at a relatively low level of 3.1% in 2024 and 2025. Despite this marginal increase, the unemployment gap is expected to remain negative, as the NAIRU is projected to stand at 3.5% in 2025.

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, 5.7% in 2024, and 3.9% in 2025. Indeed, this will outpace consumer price inflation during the last two years of the projection horizon as consumer price passthrough to wages is projected to occur with a lag.

A persistently negative employment gap 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 dampen upward pressure on wages by 2025.

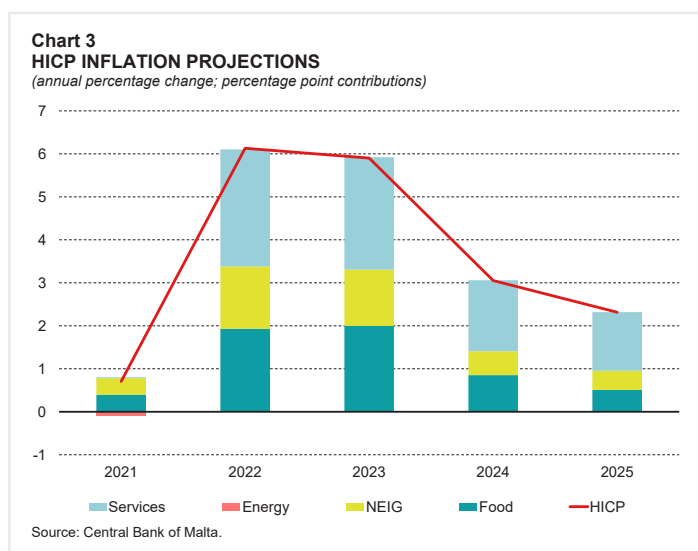
Prices

Annual HICP inflation is projected to remain persistently high this year, reflecting lingering indirect effects through the response of wages to past increases in input costs and higher profit margins. It is thus set to decline only marginally, from 6.1% in 2022 to 5.9% in 2023. As the impact from



recent shocks gradually fades, HICP is then set to gradually moderate in the following years (see Chart 3). Overall HICP inflation is set to stand at 3.1% and 2.3% in 2024 and 2025, respectively. HICP excluding food and energy is set to moderate as well over the projection horizon, going from 5.4% in 2023 to 2.5% by 2025.

Compared to the Bank's previous forecast publication, overall HICP inflation was revised upwards by 0.6 percentage point in 2023, and by 0.2 percentage point in 2024 following higher than expected outcomes in recent months. These data surprises have shown that price pressures are more persistent than previously assessed (see Box 1).



Services inflation is set to remain 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. Energy inflation is expected to have no effect on inflation over the NIPE horizon, reflecting the administered nature of this component and the Government's commitment to keep consumer prices for energy stable.

Services inflation is expected to ease from 6.0% in 2022, to 5.8% in 2023, and to 3.7% and 3.1% 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 as well as high wage pressures. The stronger rebound in tourism will also contribute to sustain prices of restaurant meals and tourism-related services.

Food prices are projected to remain elevated in the near term, rising by 9.3% in 2023, marginally higher than the 9.1% observed in 2022, partly reflecting persistently high imported inflation. Indeed, this increase stems from processed food inflation which is expected to rise to 9.7%, from 8.2% in 2022. Unprocessed food inflation is set to ease to 8.0%, from 12.1% the previous year. Food inflation is set to moderate gradually to 2.4% in 2025, in line with expected developments in international commodity prices.

NEIG inflation is expected to remain rather persistent and decline only slightly, from 5.3% in 2022 to 4.7% in 2023. This slow-down arises because of the easing of international 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.

BOX 1: ARE PRICES STICKIER THAN USUAL? AN UPDATE OF INFLATION PERSISTENCE ESTIMATES AND FORECAST IMPLICATIONS.¹

During the recent period of extraordinarily high inflation, forecasting inflation has become very challenging. Indeed, overall HICP inflation forecasting errors have far exceeded historical average errors. These errors could stem from many sources, such as higher-than-expected commodity prices, unexpected government announcements, profit-margin behaviour, as well as model uncertainty. Another source of forecasting errors could be driven by indirect spillovers from energy to food commodity prices, as well as indirect spillovers from different subcomponents of the consumption basket.²

However, there is a possibility that inflation persistence might have increased during this period of high inflation. This box updates the study by Ellul and Micallef (2020), which had last estimated inflation persistence for Malta.³ In this study, persistence is estimated as the sum of autoregressive coefficients.

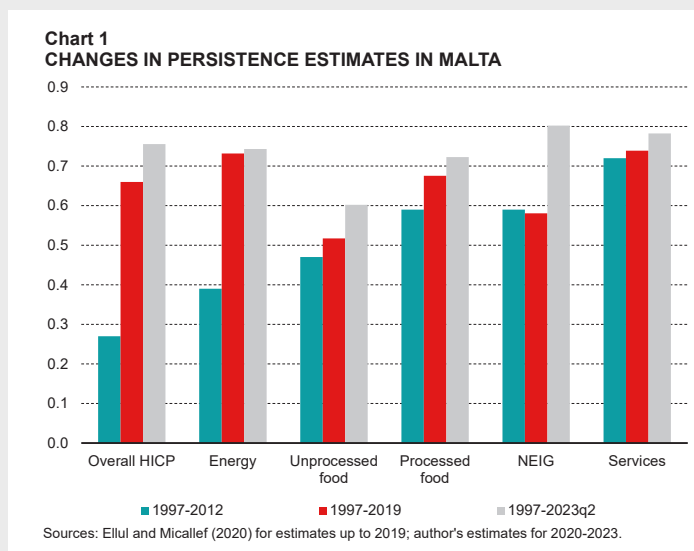
$$\pi_{i,t} = c_{i,t} + \sum_{k=1}^{K^*} \beta_{i,k} \pi_{i,t-k} + \varepsilon_{i,t} \text{ with } \rho_i = \sum_{k=1}^{K^*} \beta_{i,k} \quad (1)$$

where $\pi_{i,t}$ is the year-on-year inflation rate for a calendar quarter for index i , while the persistence parameter, ρ_i , refers to the sum of autoregressive coefficients. The optimal lag length K^* is identified by the Akaike information criterion.

This box extends Ellul and Micallef (2020) with rolling-window estimates of persistence, and then looks at the implications of this factor for the HICP projections.

Latest developments in inflation persistence

Chart 1 shows an update to the estimate of inflation persistence, considering the horizon 1997-2023. This is compared to estimates derived by Ellul and Micallef (2020) for the periods 1997-2012, and 1997-2019. Inflation persistence has increased considerably for overall HICP, as well



¹ Prepared by Ian Borg, Manager within the Economic Projections and Conjunctural Analysis office.

² See for example: Rapa (2022) "The indirect impact of high food inflation on the development and outlook of catering services prices" Article published in the *Outlook for the Maltese Economy* 2022:3, pp. 11-14 <https://www.centralbankmalta.org/site/Reports-Articles/2022/Box2-2022-3.pdf>.

³ Ellul and Micallef (2020) "How Do Estimates of Inflation Persistence in Malta Compare with Other EU Countries?", *International Journal of Economics and Finance*, Vol. 12, No. 7 <https://ideas.repec.org/a/ibn/ijefaa/v12y2020i7p31.html>.

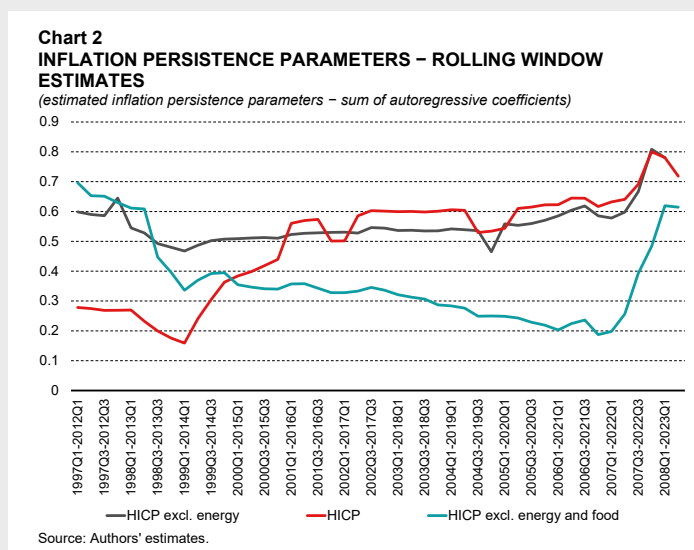
as most of its main subcomponents. The inflation persistence parameter for overall HICP has increased, from 0.66 for the period 1997-2019 to 0.76 for the period 1997-2023 Q2. This would suggest that the speed with which a process returns to its mean is longer than the 1997-2019 period.

In terms of subcomponents, we can observe a broad-based increase in inflation persistence, except for energy inflation. Energy prices are administered and thus already exhibit high persistence, particularly in view of the recent freezing in all energy prices since mid-2021. The largest increase in inflation persistence can be observed in NEIG, whose inflation persistence parameter went up from 0.58 to 0.80. Given that this component has a high import content, one factor behind this increase could be more persistent imported inflation.

To check whether we can observe a change in inflation persistence during the recent period of high inflation, we run the same exercise on smaller rolling windows. The first estimate is for the period 1997Q1-2012Q1, which is similar to that estimated by Ellul and Micallef (2020) for the same period and reproduced in Chart 1 above. Then the estimation window is rolled over by one quarter for both the start date and end date (for example, the second estimate window is 1997Q2-2012Q2, and so on).

Chart 2 shows the evolution of estimated inflation persistence parameters. Firstly, we can observe that inflation persistence for overall HICP increased markedly between the period 2014 to 2016 and remained stable for most of the period thereafter. However, a sharp increase in inflation persistence can be detected since the incorporation of 2021Q4 in the estimation window, which is consistent with the period in which inflation exceeded the long-term average inflation rate of 2.3%. Since the beginning of 2023, overall persistence has declined, though this remains elevated. We can observe a similar development in HICP excluding energy, in which persistence has declined slightly since the beginning of 2023 but remains rather elevated.

Moreover, Chart 2 shows that inflation persistence in HICP excluding



energy and food was on a downward trend during the period 2014-2021. However, inflation persistence rose sharply since 2022, from just 0.19 in the 2006Q4-2021Q4 estimated window, to 0.62 in the 2008Q1-2023Q2 window. In addition, persistence seems to have peaked since the start of 2023 at very high levels, though we do not observe a decline as we do in the case of overall inflation.

Chart 3 elaborates further on the subcomponents of HICP. There was a substantial decline in the persistence of services inflation after 2018, reflecting much lower inflation persistence in services related to recreation. However, since the end of 2021, inflation persistence in services inflation has picked up markedly. This has peaked since the beginning of 2023.

With regard to NEIG, inflation persistence was rather stable over time until just before the pandemic. However, since the end of 2021, it has shot up sharply and has reached almost unity by 2023Q1. The latter is consistent with a unit root process in the data, which would mean that inflation can remain high for an infinite period, though this result is likely to be temporary and affected by the rolling-window sample period chosen for this exercise. One should expect some return to lower inflation persistence in the near term.

Chart 3
INFLATION PERSISTENCE PARAMETERS – SUBCOMPONENTS

(estimated inflation persistence parameters – sum of autoregressive coefficients)



Source: Authors' estimates.

We can also observe a very sharp increase in persistence of food inflation since the end of 2021. Similar to goods inflation, inflation persistence in food was rather stable prior to the recent period, except for some increase in the period 2016-2019. Yet, since end 2021, it has exhibited very high persistence, second only to NEIG, which also indicates that the sharp rise in inflation persistence observed until the first half of 2023 was mostly driven by persistently high imported inflation. We can also observe some slight decline since the beginning of 2023.

Persistence in energy inflation had increased sharply since 2014, which, as Ellul and Micallef (2020) had indicated, reflected the impact from energy reforms introduced since 2013. These reforms introduced a prolonged period of price stability in energy prices due to long-term bilateral contracts for electricity prices, as well as other hedging agreements for fuel and gas. Persistence in energy inflation remained stable during the recent period despite the sharp rise in international commodity prices. This reflects the government's policy to maintain fixed energy prices throughout the recent period of large shocks in international commodity prices.

The sharp increase in the estimated inflation persistence in this box needs to be interpreted with caution. Firstly, this analysis relies on an autoregressive methodology, which could be strongly affected by structural breaks. Hence, inflation persistence parameters might spuriously be high.

Moreover, the lack of structural identification implies that this approach is unable to account for the reasons behind the sharp rise in price stickiness. Indeed, the observed increase in inflation persistence might be temporarily affected by very large successive shocks, which could be for the most part, imported. For example: inflation-inducing shocks such as the pandemic-related recovery, the ensuing global supply-chain disruptions, as well as the Russia-Ukraine war happened successively in a very short period of time, which might be keeping headline and underlying inflation high for a very long time. Meanwhile, these very high successive shocks might have been accompanied by higher profit margins (see Box 2). At the same time, wages typically respond with some lag due to long wage contracts. Thus, wage pressures have only recently picked up and are likely to affect inflation in the next few years, which may contribute to higher inflation persistence.

Therefore, these results cannot yet be interpreted as indicative of a fundamental change in behavior. Inflation persistence might decline to their historical average over time as the impact from these shocks gradually fades away.

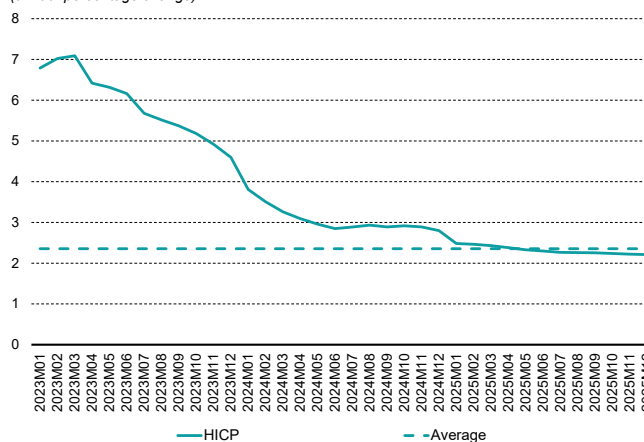
Implications for projections

In view of the recent increase in inflation persistence, HICP is projected to remain high from a historical perspective for a prolonged period. At the same time, we expect inflation persistence to decline over time and to slowly revert to their historical averages as the impacts from global supply chain disruptions and the Russia-Ukraine war slowly fade away. However, we expect that during the projection horizon, price stickiness will remain rather elevated in

view of the lagged effect from wages.

Chart 4 shows that inflation is projected to remain above its long-term average until the first quarter of 2025. We then expect overall HICP to undershoot slightly the long-term average in the last six months of 2025 as we foresee some reduction in inflation persistence.

Chart 4
MONTHLY INFLATION PROJECTIONS
(annual percentage change)



Source: Central Bank of Malta.

BOX 2: RECENT DEVELOPMENTS IN PROFITS AND FORECAST IMPLICATIONS¹

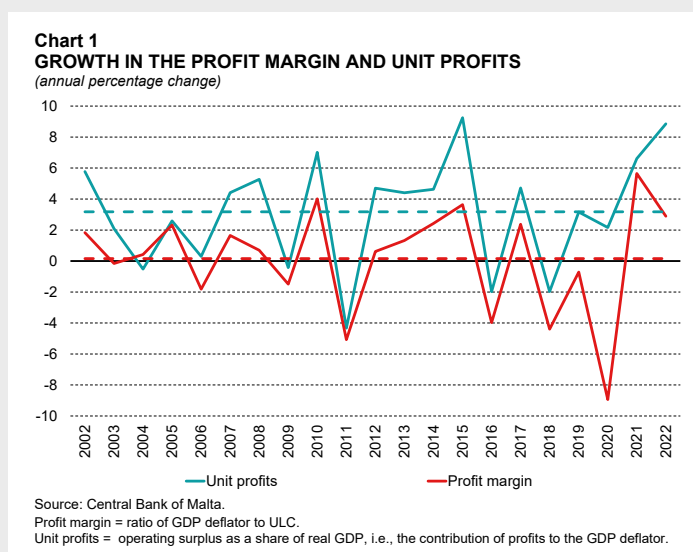
The steep increase in underlying inflation in Malta was in large part driven by very high import price pressures, although re-opening effects after the pandemic may also have contributed. Since Malta is a small, open economy, these high import price pressures are a major cost to Maltese businesses. Businesses may either absorb such costs, compressing profit margins, or may pass them on to consumers. The pass-through to consumer price inflation depends on firms' ability to pass on higher costs to retail prices – which would be reflected in profit margins.

There are two main indicators of profits that emerge from the national accounts: unit profits and profit margins. Unit profits measure domestic price pressures and are defined as gross operating surplus and mixed income per unit of real GDP. The second indicator is profit margins which is defined as the ratio of the GDP deflator to unit labour costs (ULCs).² The latter shows the degree to which profits grow with respect to the change in labour costs.³

This box outlines recent developments in both indicators and expands on profit growth projections.

Recent developments in unit profits and profit margins

Chart 1 plots the growth in profit margins and unit profits since 2002 and compares them to their historical average (dashed line). On average, unit profits have grown at an annual rate of around 3.2% since 2001, while the profit margin historical growth rate stands at around 0.2%. Both indicators have picked up strongly since 2021 and have markedly exceeded their historical averages. This



¹ Prepared by Ian Borg, Manager within the Economic Projections and Conjunctural Analysis office.

² See https://www.ecb.europa.eu/pub/economic-bulletin/focus/2023/html/ecb.ebbox202304_03~705befadac.en.html#:~:text=Overall%2C%20unit%20profits%20have%20grown,through%20of%20increased%20labour%20costs for an extensive treatment of such measures.

³ These measures must be interpreted with cautions in view of measurement difficulties in deflators as well as the evolution of hours worked on unit labour costs. Another measure of profits is the profit markup, which is expressed as profit as a percentage to total costs. See <https://maltabusinessweekly.com/insight-averting-a-wage-price-spiral/23594/> for the latter.

suggests that firms have generally been able to pass on recent increases in costs to consumer prices.

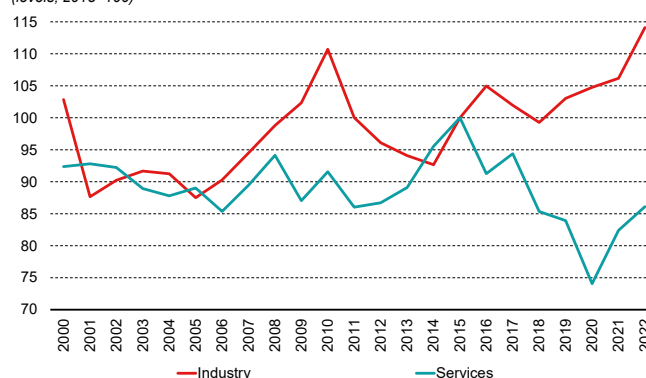
Developments in profits need to be interpreted with caution, however, especially in view of the statistical impact of the pandemic on these measures. Firstly, while unit profit growth slowed down slightly in 2020, it remained quite robust (and close to its historical average). This reflects the statistical impact of the wage supplement scheme on unit taxes and unit labour costs. The wage supplement scheme was generally very successful at avoiding layoffs through subsidies to firms. By contrast, profit margins declined sharply in 2020 in view of the sharp increase in ULCs, though this was partly financed by the wage supplement scheme.

The strong increase in unit profits and profit margins in 2021 and 2022 can thus partly be interpreted as a normalisation from the pandemic. Indeed, profit margins rose sharply in 2021 and 2022 in view of the strong decline in unit labour costs, which was in turn driven by a sharp improvement in productivity as activity levels rebounded. Meanwhile, unit profits continued to accelerate in 2022, as the positive contribution of unit taxes decreased.

Chart 2 shows the evolution of profit margins in the industrial and services sectors, excluding the public administration, education, and health. Profit margins have improved in both the industrial and services sectors in 2021 and 2022.⁴ Profit margins in the industrial sector have reached historical highs, which suggests that, the manufacturing industry was able to pass on higher non-energy input costs to customers. In part, though, this might also reflect the fact that Maltese businesses have generally been shielded from higher energy costs due to the government's freezing of energy prices, which thus limited the increase in their overall production costs. This enabled local firms to increase their profit margins without compromising competitiveness.

In the services sector, the increase in profit margins in 2021 and 2022 may reflect a normalisation in profit margins following the sharp declines experienced in 2020 as a result of the COVID-19 pandemic. However, profit margins in this sector exceeded those in 2019. We observe a broad improvement in profit margins across all sub-sectors of the services sector, which

Chart 2
SECTORAL PROFIT MARGINS OF INDUSTRY AND SERVICES
(levels; 2015=100)



Source: Central Bank of Malta.

Profit margin = ratio of GVA deflator to ULC; industry is composed of manufacturing and construction; Services is composed of wholesale, retail, and transport, information and communication, real estate, professional and administration, and arts and entertainment.

⁴ The industrial sector is composed of manufacturing and construction. Services is composed of the wholesale, retail and transport, information and communication, real estate, professional and administration, and arts and entertainment.

reverses the trend decline in profit margins that occurred between 2015 and 2019. In particular, sectors that are more domestically-oriented – such as the wholesale, retail, and transport sector – have regained their 2019 profit margins after the strong decline experienced in 2020. Meanwhile, export-oriented sectors such as the professional and administration sector, as well as the arts and entertainment sectors, have increased their profit margins beyond those in 2019.

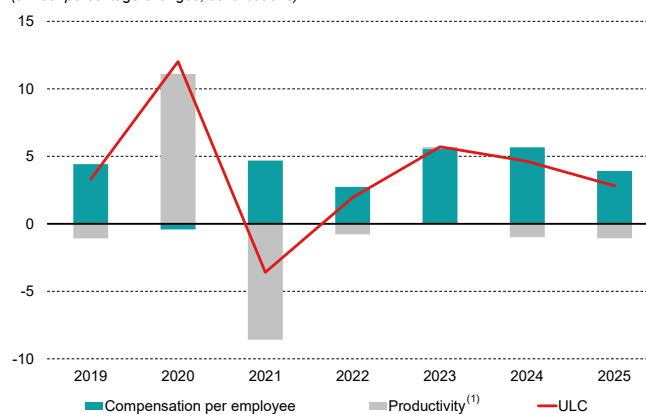
Profitability is expected to moderate significantly in the projection horizon

The latest CBM business dialogue⁵ suggests that firms this year are increasingly worried about their ability to maintain strong profitability levels. In part this reflects very high wage pressures due to inflation compensation and high labour market tightness.

During the projection horizon, we expect unit labour costs to increase markedly, and exceed their historical growth (see Chart 3). This is projected to be driven by a sharp rise in nominal wage growth, which reflects the prevailing high wage pressures. Meanwhile, productivity growth is expected to remain subdued over the projection horizon, as demand for employees is still expected to remain strong.

As regards prices, we expect that growth in the GDP deflator will remain persistently high in 2023. It is projected to grow by 4.8% in 2023, slightly down from 5.3% in 2022 (see Chart 4). This reflects our projection that consumption prices will remain quite high this year in view of very high inflation persistence (see Box 1). Meanwhile,

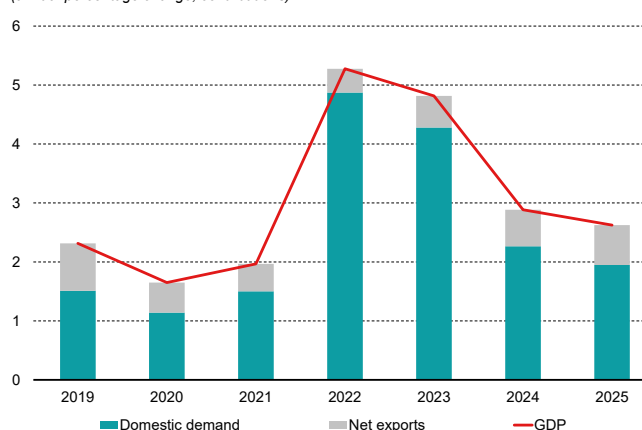
Chart 3
UNIT LABOUR COSTS PROJECTIONS
(annual percentage changes; contributions)



Source: Central Bank of Malta.

⁽¹⁾ A rise (drop) in productivity contributes negatively (positively) to ULC growth.

Chart 4
GDP DEFLATOR PROJECTIONS
(annual percentage change; contributions)



Source: Central Bank of Malta.

⁵ See [Business Dialogue Vol. 3 No. 3](#).

investment prices are expected to moderate somewhat this year in view of lower import price pressures. On the other hand, the terms of trade are projected to contribute positively to the growth in the GDP deflator as import price pressures normalise. Over the period 2024 and 2025, we expect growth in the GDP deflator to ease considerably. This is driven almost entirely by the envisaged slowdown in consumer prices.

In view of the expected sharp increase in labour costs over the projection horizon, as well as the projected moderation in price pressures, we expect profitability to be weak (see Chart 5). This implies that over the projection horizon, the rise in costs will be distributed between both labour and businesses. In particular, profit margins are projected to decline throughout the projection horizon. Meanwhile, growth in unit profits is expected to remain slightly positive this year, supported in part by energy-related subsidies, before they decline in 2024 and increase again in 2025.

Chart 5
PROJECTED GROWTH IN THE PROFIT MARGIN AND UNIT PROFITS
(annual percentage change)



Source: Central Bank of Malta.

Public finance

In 2023, the general government deficit-to-GDP ratio is set to decline to 4.8% of GDP, from 5.8% in 2022 (see Table 2). It is set to narrow further over the rest of the forecast horizon, reaching 3.3% 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.

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

	2022 ⁽¹⁾	2023	2024	2025
Headline aggregates				
Total Revenue	35.0	35.1	34.8	34.8
Total Expenditure	40.8	39.9	38.3	38.1
General Government Balance	-5.8	-4.8	-3.5	-3.3
of which: Primary Balance	-4.8	-3.5	-2.1	-2.0
General Government Debt	53.2	54.0	54.5	54.8
Detailed Breakdown				
Current Revenue	33.9	33.8	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	10.7	11.0	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	36.5	35.3	34.3	34.2
Compensation of employees	10.8	10.6	10.5	10.5
Social benefits	8.8	8.8	8.8	8.8
Intermediate consumption	8.1	8.1	8.1	8.1
Interest payments	1.0	1.3	1.3	1.4
Subsidies	5.0	3.7	2.7	2.6
Other current expenditure ⁽³⁾	2.8	2.7	2.8	2.9
Gross Savings	-2.6	-1.5	-0.4	-0.4
Capital Revenue	1.0	1.3	0.9	1.0
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	4.6	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	0.5	0.1	0.0	0.1
Temporary Government Measures	0.0	0.0	0.0	0.0
Structural Balance	-6.3	-4.9	-3.5	-3.5

Sources: NSO; Central Bank of Malta.

⁽¹⁾ Actual data as per NSO *News Releases* 095/2023 (published on 30 May 2023) and 116/2023 (published on 5 July 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.

Compared with the Bank's earlier projections, the deficit in the latest projections is lower throughout the projection horizon. These revisions reflect revised macro projections, particularly nominal private consumption and tourist expenditure, which lead to higher growth in tax revenue.

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 increase slightly until 2024, before returning to 2022 rates, mostly due to the profile of taxes on production and imports. Current taxes on income and wealth are set to retain a broadly stable ratio in GDP, while the ratio of social contributions is expected to decline over time. Non-tax current revenue is also set to increase by less than nominal GDP.

The share of capital revenue in GDP is set to 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.

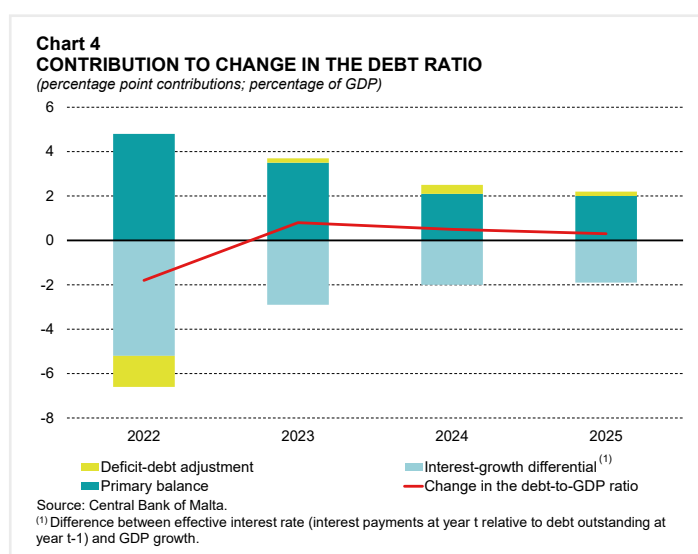
The share of current expenditure in GDP is forecast to decline throughout the forecast horizon, mainly due to a projected decline in subsidies. This reflects the profile of inflation-mitigation measures, which is set to decrease in line with forecast energy prices. While growth in compensation of employees is set to slightly exceed its long-run average, outlays are not envisaged to increase by more than nominal GDP. Meanwhile, spending on intermediate consumption and social benefits are set to grow broadly in line with GDP. Other current expenditure is set to grow by more than nominal GDP from 2023 onwards, 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. While remaining elevated in level terms from a historical perspective, 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 mostly in line with GDP in 2024 and 2025. This reflects the expected full absorption of funds from the 2014-2020 EU financing framework by 2023, and the projected pick-up in spending on projects financed through the Recovery and Resilience Facility in 2023 and 2024.

The structural deficit is projected to narrow over the projection horizon, reaching 3.5% of GDP by 2025, from 6.3% in 2022.³

This profile is driven by the above-mentioned 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 54.8% 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).



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

Risks

On balance, risks to economic activity are tilted to the downside for 2023 and are more balanced thereafter. The main downside risks relate to the possibility of stronger than envisaged weakness in the international economic environment, especially if financing conditions tighten more forcibly in response to tighter monetary policy than assumed in this projection round. This would lead to lower foreign demand and, hence, weaker exports.

Risks to inflation are balanced. Global inflationary pressures have started to ease considerably in recent months. Further monetary tightening or a stronger pass-through of such tightening to financial and real economic conditions could ease inflationary pressures in the medium-term. On the other hand, wage pressures could be stronger than envisaged in the baseline, which could delay the envisaged decline in inflation. However, the strong increase in profit margins in 2022 could provide a buffer to inflation in the projection horizon, especially as firms could seek to maintain competitiveness during a period of weak international economic activity. Meanwhile, upside risks to inflation also stem from extreme weather events and geopolitical related disruptions to trade in key food commodities.

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. The impact of higher-than-expected outlays on electricity distribution and compensation for the temporary interruption of services during peak temperatures in July is still being assessed and therefore is not fully accounted for in these projections. In contrast, additional deficit-decreasing risks in the outer years of the forecast horizon 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.