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Economic Projections for 2015 and 2016

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7. ECONOMIC PROJECTIONS FOR 2015 AND 2016

Outlook for the Maltese economy[1]

The Bank's latest macroeconomic projections indicate that, following the strong expansion of 2014, gross domestic product (GDP) growth will pick up slightly further in 2015, before easing in 2016. Thus, in 2015 real GDP growth is expected to edge up from 3.5% last year to 3.6%. It is set to moderate to 3.0% in 2016 (see Table 7.1).

Table 7.1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA[(1)]

	2014[(1)]	2015[(2)]	2016[(2)]
Real economic activity (% change)			
GDP	3.5	3.6	3.0
Private consumption expenditure	3.4	3.2	2.9
Government consumption expenditure	7.3	1.8	4.1
Gross fixed capital formation	14.0	12.3	3.5
Exports of goods & services	-0.2	3.0	3.5
Imports of goods & services	0.1	3.6	3.7
Contribution to real GDP growth (in percentage pts)[(3)]			
Final domestic demand	5.7	4.5	3.1
Net exports	-0.5	-0.6	-0.1
Changes in inventories	-1.7	-0.2	0.0
Real disposable household income[(3)]	3.5	3.5	2.6
Household saving ratio[(3)]	9.5	9.7	9.5
Balance of payments (% of GDP)			
Goods and services balance	6.0	5.9	5.4
Current account balance	2.4	2.2	1.8
Labour market (% change)			
Total employment	4.2	2.8	2.3
Unemployment rate (% of labour force)	5.7	5.9	5.8
Prices and costs (% change)			
RPI	0.3	1.1	1.3
Overall HICP	0.8	1.4	1.8
HICP excluding energy	1.5	1.9	1.8
Compensation per employee	0.9	1.5	2.0
ULC	1.5	0.7	1.4
Public finances (% of GDP)			
General government balance	-2.1	-1.8	-1.7
General government debt	68.0	66.9	66.1
Technical assumptions			
EUR/USD exchange rate	1.33	1.12	1.12
Oil price (USD per barrel)	98.9	63.8	71.0

(1) Data on GDP were sourced from NSO *News Release* 046/2015 published on 9 March 2015.
(2) Central Bank of Malta projections.
(3) Data for 2014 are Central Bank of Malta estimates.

1 The Bank's outlook for the Maltese economy is based on information available up to 20 May 2015 and is conditional on the technical assumptions shown in Table 7.1.

Compared with the Bank's previous projections, GDP growth has been revised up by 0.2 percentage point in 2015 and 2016.[2]

These revisions mainly reflect a more favourable outlook for investment, following a reassessment of capital expenditure in the private sector. Government consumption growth is also slightly higher in both years. Moreover, export growth has been revised upwards, reflecting the improved economic situation in Malta's trading partners and the recent weakening of the euro. However, given the high import content of investment and exports, import growth has also been revised upwards, particularly in 2015. As a result, the overall revision in GDP growth is small.

Domestic demand expected to drive economic growth

The Bank expects economic growth in 2015 and 2016 to be driven by domestic demand, particularly private consumption and private investment. Government consumption is also expected to support activity, though to a more limited extent.

Private consumption growth is projected to moderate to 3.2% in 2015 and to 2.9% in 2016. In 2015 private consumption is expected to be supported by robust disposable income growth, partly under the impact of a reduction in personal income tax rates. Given the structure of the tax cut, the saving ratio is expected to rise slightly. In 2016 private consumption is expected to decelerate, as growth in disposable income slows down.

After having expanded strongly in 2014, government consumption is expected to grow less rapidly over the forecast horizon, as growth in public employment and in intermediate consumption moderates.

Following an increase of 14.0% in 2014, investment is set to expand slightly less rapidly in 2015, adding 12.3%, before slowing down more significantly in 2016. Continued strong growth in investment in 2015 reflects developments in private investment, while developments in both government and private investment explain the slowdown in 2016.

After having increased very strongly in 2014, government investment is set to remain broadly stable at a high level in 2015, as projects under the 2007-2013 EU financing framework approach completion. In the following year, it is expected to fall as the take-up under the new EU financing programme would be initially moderate.

Private investment is expected to accelerate strongly in 2015 and to revert to a less rapid rate of growth in 2016. This profile is heavily influenced by expenditure on the new gas power plant and the conversion of the existing oil-fired plant to gas. Outlays on these projects are set to pick up sharply in 2015, and then rise less rapidly in 2016, when they are expected to become operational.

In contrast, other private investment is expected to be broadly stable in 2015 and to accelerate in 2016, when underlying investment in machinery is expected to pick up. Over the projection period, dwelling investment is also expected to recover, partly because the Eurosystem's expanded asset purchase programme (EAPP) should have a positive effect on the domestic property market. Non-residential construction is expected to grow robustly in 2015 and to remain at a high level in 2016, supported by initiatives such as the increased height allowed in the case of eligible hotels.

[2] See *Annual Report* 2014, Central Bank of Malta, pp. 77-81.

Net exports expected to dampen GDP growth

After having declined in 2014, exports are set to grow by 3.0% in 2015, mainly due to an improvement in exports of semiconductors and services. The latter are boosted by receipts related to a buoyant tourism sector and underlying growth in other service exports. Export growth is set to accelerate further in 2016, in line with improving foreign demand conditions. Over the forecast horizon, exports are also set to benefit from an improvement in price competitiveness, partly as a result of the decline in utility tariffs for businesses in April 2015.

Largely mirroring developments in exports and investment, imports are also set to recover, growing by 3.6% in 2015 and by 3.7% in 2016. The recovery is particularly strong in 2015, as a result of a large increase in imports of machinery & equipment. In 2016 imports are projected to grow at a marginally higher rate. Although export growth is set to accelerate again that year, slower growth in private consumption and investment will dampen the overall rise in imports.

On balance, net exports are foreseen to provide a negative, though diminishing, contribution to economic growth in 2015 and 2016.

The surplus on external trade is set to narrow marginally

The surplus on external trade in goods and services is expected to narrow marginally to 5.9% of GDP in 2015 and to decline further to 5.4% next year. Over the projection horizon, a widening of the merchandise trade deficit should offset a larger surplus on services. The low oil price that is assumed to prevail over the projection period is expected to have a positive effect on the balance of trade in goods. However, it is expected to be offset by a substantial rise in import volumes related to investment and exports.[3]

Broadly reflecting expected movements in the trade balance, the current account surplus is also expected to decline as a share of GDP, ending at 1.8% in 2016.

Employment growth is expected to moderate

Following a 4.2% increase in 2013 and 2014, employment growth is set to moderate over the forecast horizon. Growth in private sector employment is expected to slow down as firms react to declining productivity by moderating their hiring. Recruitment in the public sector is also expected to be moderate in 2015 and 2016.

The unemployment rate is expected to rise slightly from a historically low level of 5.7% in 2014 to 5.9% on average over the forecast horizon.[4] This slight increase is in line with the expected slowdown in activity and employment growth.

Nominal compensation per employee rose by 0.9% in 2014, as a small drop in average wages in the private sector partly offset an increase in the general government sector. Growth in compensation per employee is set to reach 1.5% in 2015, and to accelerate further to 2.0% next year, largely reflecting an expected recovery in wages in the private sector.

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[3] Data on the trade balance and the current account in this Chapter are consistent with NSO *News Release* 046/2015 and with projections for real exports and imports reported in Table 7.1. These may differ from the balance of payments data published in NSO *News Release* 054/2015 that are referred to elsewhere in this *Review*.

[4] In the Bank's projection exercise, the unemployment rate is computed as the ratio of the number of unemployed reported in the Labour Force Survey(LFS) to a measure of the labour force based on the LFS and national accounts data. For this reason, references to the unemployment rate in this Chapter may differ from those mentioned elsewhere in this *Review*.

Following a period of negative wage growth and against a backdrop of rising productivity, tighter labour market conditions and a gradual pick-up in consumer price inflation, faster wage growth is expected in the private sector in 2015 and 2016. In contrast, average compensation growth in the public sector is set to be weaker than in 2014.

Productivity is set to recover after four consecutive years of negative or very low growth. This is expected to dampen growth in unit labour costs (ULC). As a result, ULC growth is set to decelerate from 1.5% in 2014 to 0.7% in 2015. ULC growth is projected to pick up again to 1.4% in 2016, however, as compensation per employee rises faster than productivity.

The fiscal deficit is projected to narrow further[5]

The general government deficit-to-GDP ratio narrowed to 2.1% in 2014. The Bank expects the deficit ratio to fall further in 2015 and 2016, to 1.8% and 1.7%, respectively.

The narrowing in 2015 mainly reflects the Bank's expectation that, following a strong increase last year, government consumption will moderate. The smaller deficit this year also reflects a rise in indirect tax revenue as a result of continued strong growth in private consumption and higher excise duties announced in the Budget 2015. These factors offset the impact of lower income tax rates for households and a one-time bonus.

The deficit is set to decrease marginally in 2016, reflecting the fact that the bonus granted in 2015 is not repeated and as a result of continued restraint in current expenditure in general. Additionally, as the national airline is expected to return to profitability in 2016, the related capital transfers are projected to decline.

The general government debt-to-GDP ratio is set to fall from 68.0% in 2014 to 66.1% by 2016.

Inflation is projected to accelerate

The inflation projections are influenced by the technical assumptions reported in Table 7.1, which entail a significant decline in the US dollar price of oil in 2015, and a simultaneous weakening of the euro against the US dollar. With the exchange rate assumed to remain broadly unchanged in 2016 and oil prices in dollar terms increasing, the oil price in euro terms is expected to rise that year.

Overall, the effect of the lower oil price in 2015 is exceeded by the impact of a weaker euro and other domestic factors that are expected to push up a number of price indices. Thus, the annual average rate of inflation, measured by the Harmonised Index of Consumer Prices (HICP), is expected to accelerate from 0.8% in 2014 to 1.4% in 2015. It is set to pick up further to 1.8% in 2016.

Various other factors are also behind the acceleration in HICP inflation in 2015. First, in the initial quarter of 2015, unprocessed food prices rose by 4.7% on a year earlier, after having declined in 2014. These prices are expected to continue to grow strongly in the rest of the year. Prices of various types of services are also set to accelerate slightly, largely reflecting projected developments in the prices charged by restaurants and hotels in the context of a buoyant tourism sector. The annual rate of change of energy prices is set to be less negative compared with 2014, as the effect of the cut in household electricity tariffs of April 2014 drops out of the annual inflation rate.

[5] The Bank's fiscal projections may differ from those of the Government owing to variances in the underlying macroeconomic projections and different assessments about the impact of fiscal measures.

A further pick-up in inflation is expected in 2016, mainly because prices of services accelerate further. Additionally, with oil prices increasing and electricity tariffs assumed to remain unchanged, the annual rate of change of energy prices is expected to turn positive.

Compared with the Bank's previous projections, the latest inflation outlook entails a small upward revision in 2015 and a slight downward adjustment in 2016. These revisions largely reflect the slightly higher than expected inflation readings in the first four months of 2015, which were largely driven by stronger than expected outcomes for food, accompanied by a higher oil price and a weaker euro. These factors offset additional reductions in domestic fuel and gas prices.

The downward revision for 2016 reflects negative adjustments to the forecasts for both energy and services inflation compared with the previous projection round.

Risks to the projections

Risks to the GDP growth projections are balanced. Downside risks relate to the fragility of the global economic recovery and the possibility that growth in the euro area would be weaker than expected. This would weigh on external demand. Exports could also surprise on the downside if the envisaged recovery in the semiconductor industry falls short of expectations. On the domestic front, private investment could also be weaker than expected if major projects are delayed. Stronger government current expenditure restraint could also pose a downside risk. Upside risks relate to the possibility that government capital expenditure increases, particularly in 2015. Moreover, the EAPP could have more favourable effects on activity than envisaged in the baseline.

Risks to the inflation projections are also balanced. On the one hand, a prolongation of the current weak inflation environment in Malta's main trading partners could translate into weaker import prices that may feed into lower consumer prices. Inflation would also be lower than expected if domestic fuel prices were to fall further in response to earlier declines in international oil prices. On the other hand, a further weakening of the euro, or a sharper than expected rebound in international commodity prices, would result in higher inflation in Malta. Upside risks also stem from the EAPP, if its effects on domestic activity are stronger than assumed in the projections.