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ECONOMIC PROJECTIONS FOR 2014 AND 2015

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ECONOMIC PROJECTIONS FOR 2014 AND 2015

Outlook for the Maltese economy[1]

The Bank's latest projections indicate that the economic recovery seen in 2013 is expected to be sustained in 2014 and 2015. Compared with the Bank's previous projections, which were concluded in March 2014, the latest exercise foresees higher growth in 2015.[2] Thus, real gross domestic product (GDP) growth is set to ease marginally from 2.4% in 2013 to 2.3% in 2014, but should rise again to 2.6% by 2015 (see Table 7.1).

The Bank's projection for GDP growth in 2014 is similar to that of the previous exercise, as a downward revision in investment was counterbalanced by an upward revision in net exports. With regard to net exports, although both exports and imports have been revised downwards compared with the previous exercise, the revision to exports was smaller in view of new data showing that the tourism sector remained buoyant in the early months of 2014 and in light of announcements about new airline routes. This offsets a slight downward revision to the expected growth of exports of manufactured goods.

The upward revision to GDP growth in 2015 is mainly prompted by the inclusion in the latest exercise of the expected reduction in commercial utility tariffs from March of next year. It is assumed that this reduction will be partly reflected in lower export and consumer prices. The resulting improvement in external competitiveness and in households' spending power is expected to have an upward impact on exports and private consumption, which, in turn, would also boost private investment.

Domestic demand

The Bank expects growth in 2014 and 2015 to be driven by domestic demand, particularly private consumption and investment, as government consumption is projected to grow at a modest rate over the forecast horizon. To a lesser extent, net exports are also set to support growth over the projection period. Changes in inventories, which include the statistical discrepancy, are assumed to remain broadly constant as a proportion of GDP.

Private consumption growth is expected to rise from 1.8% in 2013 to 2.2% in 2014 and stabilise at that level in 2015, supported by continued, if moderating, growth in real disposable income. The household saving ratio is projected to rise over the forecast horizon as households are expected to continue replenishing their savings.

Following a 0.2% drop in 2013, government consumption is set to increase by 1.3% this year and by 0.2% in 2015. These relatively modest growth rates reflect the Bank's expectation that the Government will restrain recurrent expenditure as it aims to reduce the deficit. Moreover, growth in this component, which is largely composed of intermediate consumption and salaries paid to government employees, is set to be partly offset by expected intakes from the Individual Investor Programme.[3]

[1] The Bank's outlook for the Maltese economy is based on information available up to 21 May 2014 and is conditional on the technical assumptions shown in Table 7.1.

[2] See *Annual Report 2013*, Central Bank of Malta, pp. 67-70.

[3] Intakes from the Individual Investor Programme are expected to be classified as receipts from sales of government output, which offset government consumption expenditure.

Table 7.1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA

	2012(1)	2013(1)	2014(2)	2015(2)
Real economic activity (% change)				
GDP	0.6	2.4	2.3	2.6
Private consumption expenditure	-0.2	1.8	2.2	2.2
Government consumption expenditure	5.4	-0.2	1.3	0.2
Gross fixed capital formation	-2.0	-3.8	3.3	7.4
Inventories (% of GDP)	-1.5	0.9	0.8	0.8
Exports of goods & services	8.6	-5.6	1.8	3.4
Imports of goods & services	6.2	-5.2	1.6	3.4
Contribution to real GDP growth (in percentage pts)(3)				
Final domestic demand	0.7	0.4	2.0	2.4
Net exports	2.6	-0.7	0.3	0.3
Changes in inventories	-2.6	2.6	0.0	-0.1
Real disposable household income(4)	1.6	3.2	3.1	2.7
Household saving ratio(4)	6.9	8.1	8.9	9.3
Balance of payments (% of GDP)				
Goods and services balance	6.0	5.6	5.6	5.6
Current account balance	2.0	1.4	1.4	1.4
Labour market (% change)				
Total employment	2.5	3.1	1.8	1.5
Unemployment rate (% of labour force)	6.4	6.5	6.4	6.4
Prices and costs (% change)				
RPI	2.4	1.4	1.0	1.5
Overall HICP	3.2	1.0	1.1	1.7
HICP excluding energy	3.1	1.1	1.9	2.1
Compensation per employee	2.1	0.6	1.0	2.0
ULC	4.0	1.3	0.5	0.9
Public finances (% of GDP)				
General government balance	-3.3	-2.8	-2.7	-2.7
General government debt	70.8	73.0	73.1	72.6
Technical assumptions				
EUR/USD exchange rate	1.29	1.33	1.38	1.38
Oil price (USD per barrel)	112.0	108.8	107.2	102.2

(1) Data on GDP were sourced from NSO *News Release* 047/2014 published on 11 March 2014. Data on the current account balance were sourced from NSO *News Release* 053/2014.

(2) Central Bank of Malta projections.

(3) The contributions to GDP growth in this Table are estimated using GDP expenditure aggregates expressed in the previous year's prices. This approach yields different results from those reported elsewhere in this publication.

(4) Data for 2012 and 2013 are Central Bank of Malta estimates.

After contracting for the third consecutive year in 2013, private investment is set to expand by 2.6% in 2014 and by 8.8% in 2015. These projections continue to be conditioned by the Bank's expectations with regard to investment in the energy sector, particularly the new gas power plant. Investment in this area is expected to begin in 2014 and to reach a significantly higher level in 2015. As in the previous exercise, both the electricity interconnector between Malta and Sicily and the Valletta City Gate project should be completed in 2014. The remaining categories of private investment are set to return to positive growth this year and to accelerate more strongly next year, supported by non-residential construction, a pick-up in housing investment and by ongoing growth in investment in information technology. At the same time, underlying growth in equipment investment is set to recover slightly in 2014, and more steadily in 2015, as firms respond to increased demand. Additionally, the reduction in commercial utility tariffs should spur capital investment, partly in response to increased sales resulting from the pass-through of the tariff reduction to consumers.

Government investment is set to expand by 6.3% in 2014, after the drop recorded in 2013, reflecting the Bank's assessment that some outlays that did not materialise last year will be carried forward, to be financed by EU funds available to Malta under the 2007-2013 EU Financial Programme. In 2015 government investment is set to grow at a slower rate of 1.9%, as the utilisation of funds under the 2014-2020 financial programme is foreseen to be low in the initial stage of the budgetary period.

Net exports

Net exports, which fell in 2013, are set to grow in 2014 and 2015 as exports outpace imports. In 2014 exports are set to partially recover from the previous year's decline. The increase is projected to be driven by service exports, notably tourism, and, to a lesser extent, by exports of semiconductors. Activity in the tourism industry is set to continue to expand, supported by the opening of new airline routes and by additional capacity in hotels. Semiconductor exports are expected to benefit from an improvement in the outlook for the industry.

In 2015 export growth is set to accelerate further. While semiconductor exports are set to contribute, faster export growth in 2015 also reflects a recovery in exports of other manufacturing goods. These are expected to benefit from an improvement in price competitiveness, as export-oriented sectors that operate in the manufacturing sector pass on the reduction in commercial tariffs to their clients abroad to attract foreign demand.

Imports are set to accelerate up to 2015, growing broadly in line with the foreseen recovery in private consumption, investment and exports.

The balance of payments

Over the forecast horizon, the surplus on the goods and services balance is expected to remain stable around its 2013 level of 5.6%, as a widening in the deficit on goods is set to be counterbalanced by an increase in the surplus on services.[4]

The current account balance is expected to remain in surplus over the projection period, with the ratio to GDP remaining at a similar level to that recorded in 2013.

The labour market

Following a strong increase in 2013, employment is projected to grow at slower rates over the two years to 2015. In 2014 private firms are expected to add jobs at a slower pace than in the previous year. Moreover, the number of employees in the general government sector, which is

[4] Data on the trade balance used in this report are consistent with NSO *News Release* 047/2014 and with projections for real exports and imports reported in Table 7.1. The current account projections are based on balance of payments data published in NSO *News Release* 053/2014.

estimated to have increased sharply in 2013, is assumed to fall slightly. Employment growth is set to moderate further in 2015.

In 2013 compensation per employee increased by a moderate 0.6%. Coupled with a drop in productivity that year, this pushed up unit labour costs (ULC) by 1.3%.

In 2014 productivity growth is set to turn positive following three consecutive annual declines. The favourable effect of increased productivity on ULCs, however, is partly offset by faster growth in average wages. Consequently, ULCs are set to increase by 0.5%, less than in the previous year. With GDP continuing to outpace employment, a further gain in productivity is foreseen in 2015. At the same time, however, compensation per employee is set to outpace productivity. As a result, ULCs are expected to increase by 0.9%.

Following a small rise in 2013, the unemployment rate is set to stabilise at 6.4% in 2014 and 2015.[5]

Fiscal developments

Recent data released since the previous exercise confirm that the general government deficit-to-GDP ratio fell below 3% in 2013. This improvement mainly reflected strong increases in direct taxes and receipts from sale of output on the revenue side. At the same time, on the expenditure side, a drop in intermediate consumption and the pension reform programme also helped limit outlays on social benefits.

The deficit ratio is expected to narrow slightly further to 2.7% in 2014, and remain at that level in 2015.

The narrowing in the deficit ratio in 2014 is largely driven by the Bank's expectation that employment in the government sector will be restrained following the exceptional increase recorded in 2013. At the same time, capital transfers to the national airline are set to be substantially lower. Increases in excise taxes announced in the Budget 2014 are also set to contribute to the narrowing of the deficit ratio this year.

In 2015 the impact of inflows from the Individual Investor Programme announced in the 2014 Budget is projected to be broadly offset by an expected increase in capital transfers to the national airline.

Inflation

Inflation is set to accelerate over the forecast horizon, while remaining moderate, at below 2.0% throughout.

The inflation projections are influenced by the technical assumptions reported in Table 7.1, which include a decline in the price of oil in dollars and a strong euro. During the forecast horizon, inflation in Malta is also expected to be dampened by a reduction in utility tariffs for consumers in 2014 and, to a lesser extent, the pass-through to domestic consumer prices of the announced reduction in commercial tariffs in 2015. Weak price pressures abroad also contribute.

[5] 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 report may differ from those mentioned elsewhere in this *Report*.

Thus, the average annual rate of inflation, as measured by the Harmonised Index of Consumer Prices (HICP), is projected to accelerate marginally from 1.0% in 2013 to 1.1% in 2014. This modest increase reflects offsetting developments in the main HICP components. Services inflation is expected to turn positive and non-energy industrial goods prices are set to pick up somewhat. However, food price inflation is expected to moderate substantially. Moreover, as in the previous exercise, energy prices are set to decline, reflecting the reduction in electricity tariffs introduced earlier this year.

HICP inflation is set to reach 1.7% by 2015, reflecting a further pick-up in services price inflation and in non-energy industrial goods prices.

Risks to the projections

Risks to the GDP growth projections are balanced. Downside risks relate to the fragility of the global economic recovery. In particular, a weaker than expected expansion in the euro area economy would weigh on external demand for Maltese exports. Investment could also be weaker than expected if major infrastructure projects under way are delayed and underlying private investment takes longer to recover than envisaged. Upside risks relate to the possibility that the pass-through of the reduction in commercial electricity rates to prices is stronger than embedded in the Bank's projections. This would have a positive effect on exports and, indirectly, on private consumption. Exports could also surprise on the upside, given that the Bank's export projections are more conservative than projections for external demand.

With regard to prices, risks are slightly on the downside. Such risks relate to the possibility of weaker than expected price pressures in Malta's trading partners and a stronger pass-through of the expected cut in commercial electricity rates to domestic prices.