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Economic Projections for 2015 - 2017

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7. ECONOMIC PROJECTIONS FOR 2015 - 2017

Outlook for the Maltese economy[1]

The Bank's latest macroeconomic projections indicate that, following the strong expansion in 2014, gross domestic product (GDP) growth is expected to pick up further this year, before easing in 2016 and 2017. Thus, real GDP growth is set to accelerate to 4.1% in 2015 from 3.5% in 2014. However, it is forecast to ease back to 3.4% in 2016 and to 3.2% in 2017 (see Table 7.1).

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

	2014[(1)]	2015[(2)]	2016[(2)]	2017[(2)]
Real economic activity (% change)				
GDP	3.5	4.1	3.4	3.2
Private consumption expenditure	2.9	3.3	3.3	2.9
Government consumption expenditure	7.5	0.8	3.6	5.5
Gross fixed capital formation	9.1	13.1	3.5	-2.8
Exports of goods and services	-0.3	0.1	2.8	3.2
Imports of goods and services	0.6	0.4	2.8	2.5
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	4.7	4.4	3.2	2.0
Net exports	-1.3	-0.4	0.2	1.1
Changes in inventories	0.1	0.0	0.0	0.0
Real disposable household income[(3)]	2.6	3.3	3.1	2.4
Household saving ratio[(3)]	9.7	9.7	9.5	9.0
Balance of payments (% of GDP)				
Goods and services balance	6.4	5.4	5.7	6.4
Current account balance	2.4	1.4	1.8	2.4
Labour market (% change)				
Total employment	4.5	2.6	2.6	2.5
Unemployment rate (% of labour force)	5.7	5.3	5.4	5.4
Prices and costs (% change)				
RPI	0.3	1.2	1.3	1.8
Overall HICP	0.8	1.2	1.6	1.9
HICP excluding energy	1.5	1.9	1.9	1.9
Compensation per employee	0.3	1.1	2.0	2.1
ULC	1.2	-0.3	1.1	1.5
Public finances (% of GDP)				
General government balance	-2.1	-1.6	-1.2	-1.1
General government debt	68.3	66.6	65.2	63.7
Technical assumptions				
EUR/USD exchange rate	1.33	1.11	1.09	1.09
Oil price (USD per barrel)	98.9	53.8	52.2	57.5

(1) Data on GDP were sourced from NSO *News Release* 163/2015 published on 4 September 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 19 November 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 0.5 percentage point in 2015 and by 0.4 percentage point in 2016.[2]

These revisions are mainly motivated by developments during the first half of 2015, when GDP increased by an average of 5.1% in year-on-year terms, significantly faster than the 3.6% growth forecast in the previous exercise.

Domestic demand expected to remain the main driver of economic growth

The Bank expects economic growth to be driven principally by domestic demand. In contrast, net exports are set to contribute negatively to GDP growth in 2015, with their contribution turning positive in 2016 and increasing further in 2017. Changes in inventories are set to remain broadly constant over the forecast horizon.

Private consumption is projected to maintain a robust pace of expansion. Following a 2.9% increase last year, it is set to grow by 3.3% in both 2015 and 2016. Private consumption is expected to be supported by continued growth in real disposable income, which is set to benefit from a reduction in effective personal income tax rates in both years. In 2017 private consumption growth is projected to moderate to 2.9%, reflecting an expected easing in real disposable income growth. Over the projection period, the saving ratio should gradually fall from the relatively high level reached in 2014.

After rising by 7.5% in 2014, government consumption is projected to increase by a more moderate 0.8% in 2015. Growth in government consumption is then set to pick up to 3.6% in 2016 and to 5.5% in 2017. Underlying government consumption is expected to go up relatively fast throughout the projection horizon, partly because government employment is expected to continue rising, especially in the health and education sectors. Intermediate consumption growth is also projected to remain strong. Nonetheless, following the strong increases recorded last year, these two elements of government expenditure are set to grow at a more modest pace over the forecast horizon as, in line with announced policy, Government is expected to pursue a degree of expenditure restraint. The outlook for government consumption is heavily influenced by inflows from the Individual Investor Programme (IIP). These inflows, which are netted against consumption expenditure, are set to increase significantly in 2015 and to rise slightly further in 2016. This explains the relatively subdued growth rate of government consumption in both years. With inflows under the IIP projected to decline in 2017, government consumption is set to increase more strongly.

Following a rise of 9.1% in 2014, investment is expected to expand at an even faster pace of 13.1% this year, before it slows down to 3.5% in 2016. In 2017 investment is set to contract. This profile is heavily influenced by expected movements in private investment. The latter is expected to grow by 15.2% in 2015, before it decelerates to 8.2% in 2016. In 2017 private investment is projected to decline by 4.5%. The projected profile for private investment largely mirrors investment in machinery, which, in turn, is influenced to a large extent by spending on the new gas power plant and the conversion of the existing oil-fired power plant to gas, which is set to peak this year. With the power plant coming on stream in 2016, private investment in machinery is set to drop markedly in 2017.

[2] See *Quarterly Review* 2015:1, Central Bank of Malta, pp. 81-85.

Dwelling investment is also expected to grow strongly over the forecast horizon, particularly in 2015, as it builds on the rebound seen during the first half of the year and the continued recovery in permits issued. In the following two years growth in dwelling investment is set to moderate, although it will still exceed recent years' outturns. Over the forecast horizon, dwelling investment is set to benefit from the Eurosystem's expanded asset purchase programme. Fiscal incentives targeting first-time buyers and property purchases in urban conservation areas are also expected to support investment in this area.

In contrast, expenditure on non-residential construction is set to decline this year following an exceptionally strong outturn related to one-off outlays in the energy sector in 2014. Non-residential construction is set to recover strongly in 2016 and maintain a high growth rate in 2017, partly reflecting the start of a number of projects in the health and education sectors, and the expected redevelopment of facilities previously occupied by the Malta Shipbuilding. Other investment, which includes spending on software, is also set to broadly accelerate over the forecast horizon, in line with the expectation that the services sector in Malta will continue to perform strongly over this period.

After having increased very strongly in 2014, government investment is set to rise by a further 4.9% this year, thereby maintaining a high level. The profile of government investment continues to reflect the Bank's expectation of further progress in relation to the absorption of funds under the 2007-2013 EU financing framework. In the following year, government investment is set to decline as the take-up of funds under the 2014-2020 framework is projected to be initially low. It is then set to rise by 7.0% in 2017, as projects partly financed under this Programme get under way.

Net exports begin to support GDP growth in 2016

After having dropped in 2013 and 2014, exports are set to increase marginally in 2015, before accelerating in 2016. A further acceleration, to 3.2%, is foreseen in 2017. The recovery in exports in 2015 is mainly attributable to an expected improvement in semiconductor exports and the stabilisation of fuel re-exports. In contrast, total service exports are projected to contract during 2015, despite increased receipts related to Malta's IIP and tourism, partly reflecting developments seen during the first half of the year. In 2016 and 2017, exports are expected to continue recovering in line with an expected recovery in foreign demand. They are also set to benefit from an improvement in price competitiveness following a decline in utility tariffs in April 2015.

Import growth largely mirrors expected developments in aggregate demand, notably exports and investment. Activity in the energy sector, in particular, explains the relatively fast growth in imports, compared with exports, in 2015. As projects in the energy sector near completion in 2016, import growth begins to mirror more closely exports growth, also standing at 2.8%. In 2017 import growth is set to moderate to 2.5%, reflecting lower capital spending. Additionally, investment in the energy sector is expected to lead to efficiency gains in power generation, somewhat lowering fuel imports.

On balance, net exports are foreseen to contribute negatively to GDP growth in 2015, but their contribution turns slightly positive in 2016 and increases further in 2017, as investment-related imports moderate and exports respond to the improvement in external demand.

The external balance is expected to remain in surplus

The surplus on external trade in goods and services is expected to narrow slightly to 5.4% in 2015 from 6.4% of GDP in 2014, before it increases to 5.7% in 2016 and to 6.4% in 2017.

The goods balance is expected to deteriorate in 2015 and, to some extent, also in 2016. Lower international oil prices should dampen fuel imports. However, these are more than offset by an increase in imports related to exports and investment.[3] A slight narrowing in the goods deficit is foreseen for 2017 as capital imports slow down, following the completion of the aforementioned projects and as a result of efficiency gains in power generation. At the same time, goods exports should respond to the expected strengthening in foreign demand.

In contrast, the services balance is set to improve in both 2015 and 2016, aided by inflows under the IIP and a buoyant tourist sector, with the surplus remaining broadly stable as a share of GDP in 2017. In 2015 the deterioration in the goods balance is stronger than the improvement on the services account, leading to a narrower trade surplus overall. As investment-related imports normalise, the overall balance is set to improve in 2016. With the services balance broadly stable in 2017 and the goods deficit narrowing, the overall trade surplus is expected to widen further that year.

Broadly reflecting expected movements in the trade balance, the current account surplus is also set to narrow in 2015, before widening slightly again in the following two years, reaching 2.4% of GDP in 2017.

Employment growth is set to moderate

Following a 4.5% increase in 2014, annual employment growth is set to moderate to 2.6% in 2015, reflecting developments seen in the first half of the year. It is expected to fluctuate around 2.5% over the rest of the projection horizon. Employment growth is projected to moderate in both the private and public sectors. In the private sector, employment growth is set to slow down as firms adjust to recent declines in productivity. Following very strong intakes in both 2013 and 2014, government employment should also grow at more moderate rates during the forecast horizon.

After having stood at 5.7% in 2014, the unemployment rate is projected to fall to around 5.4% over the forecast horizon.[4] It is thus set to remain very low from a historical perspective.

Partly reflecting a tighter labour market, growth in nominal compensation per employee is expected to pick up over the forecast horizon, going from 0.3% in 2014 to 1.1% this year, and rising further to 2.0% in 2016 and to 2.1% in 2017. In particular, private sector employees are expected to respond to a period of relatively subdued growth in nominal wages, and a recovery in productivity and consumer inflation, by demanding higher wages.

After declining in 2013 and 2014, productivity is set to recover in 2015, gaining 1.4%. In 2016 and 2017 productivity is projected to increase further, although with GDP growth moderating, the gains are set to be more modest, at 0.8% and 0.6%, respectively.

[3] Data on the trade balance and the current account in this Chapter are consistent with *News Release* 163/2015, NSO, and with projections for real exports and imports reported in Table 7.1. These may differ from the balance of payments data published in *News Release* 173/2015, NSO.

[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*.

Unit labour costs (ULC) are set to decline in 2015, as the recovery in compensation per employee is initially modest, with growth in average compensation levels falling short of the increase in productivity. Subsequently, as compensation per employee accelerates, while productivity growth moderates, ULC growth is expected to turn positive, reaching 1.5% in 2017.

The fiscal deficit is projected to narrow further[5]

The general government deficit-to-GDP ratio is set to narrow to 1.6% in 2015 from 2.1% in 2014, and further to 1.2% in 2016. In 2017 the fiscal deficit-to-GDP ratio is set to stand at 1.1%.

The narrowing in 2015 mainly reflects a rise in the intake under the IIP, and increases in direct and indirect tax revenues, in the context of a buoyant economy and higher excise duties announced in the Budget 2015. These factors offset the negative impact of lower tax rates, a one-time bonus for households and higher capital transfers to the national airline.

The further decline in 2016 largely reflects the expectation that capital transfers to the national airline cease as the airline returns to profitability. Inflows under the IIP, moreover, are set to maintain a high level, while Government is expected to exercise an element of expenditure restraint, particularly in relation to the wage bill. These factors, along with additional indirect taxes announced in the Budget 2016, are expected to offset the widening of the tax-free income bracket and increases in certain categories of pensions.

In 2017 the fiscal deficit is expected to narrow. Although a degree of restraint in recurrent expenditure is foreseen to prevail that year, this is almost entirely offset by an expected decline in revenue, reflecting the profile of inflows under the IIP. The Bank's projections for 2017 assume no new fiscal measures.

The general government debt-to-GDP ratio is set to fall from 68.3% in 2014 to 63.7% in 2017, supported by an improvement in the primary balance and a favourable interest rate environment.

Inflation is expected to accelerate

Inflation projections are influenced by the technical assumptions shown in Table 7.1, which entail a significant decline in the US dollar oil price in 2015, and a weakening of the euro against the US dollar. In 2016 a further drop in the US dollar oil price is set to be partly offset by the weakening of the euro that year. As a result, the oil price in euro terms is expected to fall significantly in 2015 and, to a lesser extent, in 2016. With the exchange rate assumed to be stable, the oil price in euro terms is set to increase in 2017, mirroring the movement in the dollar price of oil.

The annual rate of inflation, measured by the Harmonised Index of Consumer Prices (HICP), is expected to accelerate to 1.2% in 2015 from 0.8% in 2014. This acceleration largely reflects developments during the first ten months of the year, when overall HICP inflation averaged 1.1%. Developments during this period were characterised by a strong recovery in food price inflation and some pick-up in non-energy industrial goods inflation, the latter partly reflecting the impact of the weaker euro. In addition, the decline in energy prices eased. In contrast, service prices grew at a slightly slower annual rate.

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

In 2016 consumer prices are set to rise at a slightly faster pace of 1.6%. Although food price inflation is projected to remain broadly unchanged, energy prices are foreseen to decline at a weaker rate compared with 2015, largely in line with the oil price. Moreover, services price inflation is set to accelerate, supported by an expected pick-up in prices charged by restaurants and hotels in the context of a fast expanding tourist sector and the introduction of an environmental contribution on tourist nights following the Budget 2016.

In 2017 HICP inflation is set to pick up slightly further, to 1.9%, largely reflecting the higher international oil price.

Risks to the projections

Risks to the GDP growth projections are balanced. Downside risks relate to the fragility of the global economic recovery, particularly if the slowdown in emerging economies is more pronounced than assumed in the projections. The recovery in the euro area may also be slower than expected. These factors would weigh on Maltese exports. Exports could also surprise on the downside if the envisaged recovery in the semiconductors industry is delayed.

On the other hand, government consumption could surprise on the upside if the assumed restraint in expenditure does not materialise. In addition, the relatively high level of the saving ratio poses an upside risk to the projections for private consumption, should savings converge more rapidly to their estimated long-run average. Imports could also be lower than expected, if efficiency gains from electricity generated by the new power plants prove stronger than assumed in the projections.

Risks to inflation projections are balanced. Downside risks relate to the possibility of an extended period of weak inflation in Malta's trading partners, which would translate into lower import and consumer prices. Inflation would also be lower than expected if domestic fuel and gas prices were to fall further in response to earlier declines in the international oil price. On the other hand, the international oil price may rise above the levels implied by the technical assumptions.