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CENTRAL BANK OF MALTA

ECONOMIC PROJECTIONS FOR 2016 AND 2017

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BOX 5: ECONOMIC PROJECTIONS FOR 2016 AND 2017

Outlook for the Maltese economy[1]

Following three years of strong expansion, the Bank's latest macroeconomic projections point to continued robust growth in real GDP in 2016 and 2017. However, growth is expected to decelerate from 6.3% in 2015 to 5.3% in 2016 and 4.2% in 2017 (see Table 1).

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA(1)

	2014	2015	2016(2)	2017(2)
Real economic activity (percentage change)				
GDP	3.7	6.3	5.3	4.2
Private consumption expenditure	2.4	4.9	4.4	3.6
Government consumption expenditure	7.2	4.8	5.0	6.3
Gross fixed capital formation	7.3	21.4	6.9	0.6
Exports of goods and services	0.1	2.4	2.9	3.2
Imports of goods and services	-0.2	3.0	2.7	2.6
Contribution to real GDP growth (in percentage points)				
Final domestic demand	4.0	7.5	4.7	3.2
Net exports	0.4	-0.6	0.5	1.0
Changes in inventories	-0.6	-0.5	0.0	0.0
Real disposable household income (percentage change)(3)	4.4	3.6	3.5	3.2
Household saving ratio(3)	12.7	11.6	10.8	10.4
Balance of payments (per cent of GDP)				
Goods and services balance	7.7	6.9	7.4	8.1
Current account balance	3.4	9.9	8.6	8.9
Labour market (percentage change)				
Total employment	5.1	3.5	3.7	3.3
Unemployment rate (per cent of labour force)(4)	5.6	5.2	5.1	5.2
Prices and costs (percentage change)				
GDP deflator	1.9	2.3	2.1	2.0
RPI	0.3	1.1	0.8	1.6
Overall HICP	0.8	1.2	1.2	1.8
HICP excluding energy	1.5	1.8	1.5	1.8
Compensation per employee	0.9	1.5	1.7	2.4
ULC	2.2	-1.2	0.2	1.5
Public finances (per cent of GDP)(4)				
General government balance	-2.1	-1.6	-1.1	-0.9
General government debt	67.1	63.6	61.0	58.6
Technical assumptions				
EUR/USD exchange rate	1.33	1.11	1.11	1.12
Oil price (USD per barrel)	98.9	52.5	34.9	41.2

(1) Data on GDP were sourced from NSO *News Release* 041/2016 published on 8 March 2016. Data on the current account balance were sourced from NSO *News Release* 047/2016.

(2) Central Bank of Malta projections.

(3) Data for 2014 and 2015 are Central Bank of Malta estimates.

(4) Data for 2015 are Central Bank of Malta estimates.

1 The Bank's outlook for the Maltese economy is based on information available up to 11 March 2016 and is conditional on the technical assumptions shown in Table 1, which are sourced from the European Central Bank. These projections were prepared by the Central Bank of Malta and do not represent the views of the Eurosystem.

Compared with the Bank's previous projections, GDP growth has been revised up by 1.8 percentage points in 2016 and by 1.0 point in 2017.[2] These revisions are motivated by stronger than expected growth in 2015, when GDP grew by 6.3%, significantly faster than the 4.1% growth projected in the previous exercise.

Domestic demand

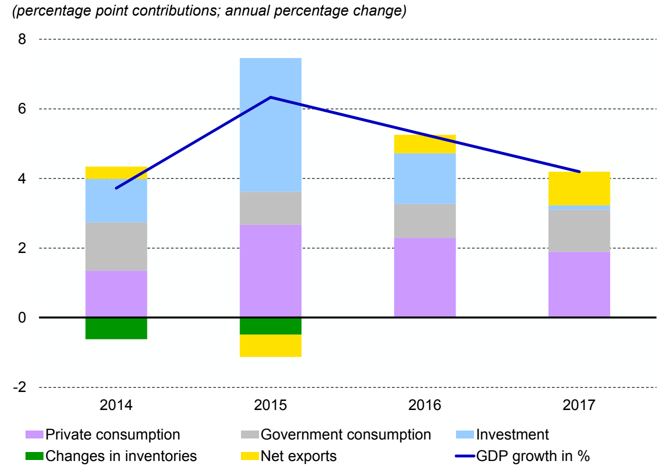
The Bank expects domestic demand to remain the primary driver of economic growth in 2016 and 2017. Moreover, the contribution of net exports is forecast to turn positive in 2016 and to increase in the following year. However, the contribution of net exports to growth will remain smaller when compared with that of domestic demand (see Chart 1).

Private consumption is expected to maintain a strong positive contribution towards economic growth during the projection horizon, supported by continued but moderating growth in real disposable income. Following an increase of 4.9% in 2015, private consumption growth is expected to moderate to 4.4% in 2016 and 3.6% in 2017. In turn, this mirrors developments in real disposable income, which is expected to decelerate slightly from 3.6% in 2015 to 3.5% and 3.2% during the projection horizon as inflation picks up. With private consumption expected to outpace real disposable income, the saving ratio is envisaged to decline.

Following a rise of 4.8% in 2015, real government consumption is expected to pick up in 2016 and grow by 5.0%. Growth in government consumption is projected to accelerate further to 6.3% in 2017. The profile of government consumption depends heavily on the inflows related to the IIP. These inflows, which are netted against consumption expenditure, rose significantly in 2015. They are expected to increase at a slower pace in 2016 and to decline in 2017. This reduces their negative impact on growth in real government consumption over the forecast horizon, pushing up the headline growth rate. This factor outweighs a slowdown in underlying government consumption over the forecast period. Employment growth and wages in the government sector are projected to remain strong but to decelerate throughout the projection horizon. Intermediate consumption, which increased sharply in 2015, is projected to moderate, as Government is expected to pursue a degree of expenditure restraint.

After having expanded strongly in 2015, investment is expected to slow down sharply. It is forecast to grow by 6.9% and 0.6% in 2016 and 2017, respectively, following an increase of 21.4% in 2015. This mirrors expected developments in both private and government investment. While the former is envisaged to slow down in both 2016 and 2017, government investment is expected to contract in 2016 and recover in 2017.

Chart 1
GDP GROWTH OVER THE FORECAST HORIZON
(percentage point contributions; annual percentage change)



Sources: NSO; Central Bank of Malta calculations.

[2] See *Quarterly Review* 2015:3, Central Bank of Malta, pp. 86-91.

Private investment is estimated to have grown by 20.5% in 2015, and is forecast to grow by 11.8% in 2016 and 0.3% in 2017. This profile is heavily influenced by expected movements in investment in machinery, which in turn mirrors the investment in the new gas power plant and the conversion of the existing oil-fired power plant to gas. The bulk of the spending on machinery related to the power plant is assessed to have taken place in 2015 and, hence, investment outlays on machinery are foreseen to decelerate sharply in 2016. Moreover, as work on the new gas power plant finishes this year, investment in machinery is forecast to drop in 2017.

Following a strong rebound in 2015, growth in dwelling investment is expected to moderate in 2016 and decelerate further to around 7% in 2017. The growth foreseen over the projection period follows a protracted period of decline in dwelling investment. Indeed, investment in dwellings is set to continue to benefit from the Eurosystem's accommodative monetary policy stance, fiscal incentives targeting first-time buyers and interest from non-residents in the context of the IIP.

On the other hand, non-residential construction is set to accelerate markedly in 2016 and 2017, following a strong contraction in 2015. The projected strong pick-up in 2016 and 2017 mirrors the start of new projects related to education, health and tourism, and buoyant economic growth that is expected throughout the projection horizon. Other investment, such as investment in software, is projected to rebound this year following a contraction in 2015, and grow less rapidly in 2017.

After two years of very strong growth, government investment is set to contract in 2016, as the take-up of funds under the EU 2014-2020 Financing Framework is projected to be low. It is then expected to rise by 1.9% in 2017, as projects partly financed under this Framework get under way.

Net exports

Following a rise of 2.4% in 2015, export growth is set to accelerate further in 2016 and 2017, to 2.9% and 3.2%, respectively. The acceleration in 2016 is expected to be primarily driven by foreign sales of goods. In turn, this stems from a recovery foreseen in the semiconductor industry and the assumption that fuel re-exports would stabilise following the decline seen in 2015. On the other hand, growth in service exports is expected to be broadly unchanged in 2016 as a result of offsetting movements across various components. In 2017 export growth is forecast to gain momentum in line with an expected recovery in foreign demand.

Largely mirroring the outlays on the gas power station and the consequent deceleration in investment growth in 2016 and 2017, imports are projected to grow less rapidly than in 2015. Import growth is expected to slow down from 3.0% in 2015, to 2.7% and 2.6% in the subsequent two years. Moreover, efficiency gains owing to new energy projects are expected to continue dampening imports of fuel for domestic use.

On balance, net exports are foreseen to contribute positively to GDP growth during the projection horizon, as the completion of major projects leads to more moderate import growth and exports respond to a recovery in foreign demand.

The balance of payments

As a result of these developments, the surplus on external trade in goods and services is expected to widen from 6.9% of GDP in 2015 to 7.4% in 2016 and further to 8.1% of GDP in 2017.[3]

In contrast, the current account surplus is expected to decline in 2016, as the net balance on the primary income account, which turned positive in 2015, is expected to revert to a negative position,

[3] Data on the trade balance in this Box are consistent with NSO *News Release* 041/2016 and with projections for real exports and imports reported in Table 1. These may differ from the balance of payments data published in NSO *News Release* 047/2016.

reflecting historical patterns. Meanwhile, net inflows on the secondary account, which also increased strongly in 2015, are set to decline slightly as a share of GDP, partly reflecting lower utilisation of EU funds. In 2017, however, the current account surplus is expected to widen, mirroring developments in the trade balance.

The labour market

Following a 5.1% increase in 2014, employment went up by 3.5% in 2015. In 2016 employment growth is expected to pick up slightly to 3.7%, before it decelerates to 3.3% in 2017. Although employment growth in the general government sector is set to moderate over the forecast horizon, in the private sector it is set to accelerate slightly in 2016. The profile of private sector employment is influenced by the Bank's view that, in the context of a buoyant services sector, part-time employment should begin to recover from the decline reported in 2015. As a result, overall headcount numbers are set to slightly accelerate in 2016. In 2017 private sector employment growth is set to decelerate on the back of slower growth in activity.

The unemployment rate is estimated to have reached a low of 5.2% in 2015 and to remain around this level in the subsequent two years.[4] The forecast takes into account LFS data up to the third quarter and a continued drop in the number of registered unemployed in the last quarter of 2015.

Notwithstanding the still robust employment growth in 2015, growth in overall compensation per employee was relatively subdued. This is attributed to a steady supply of foreign workers, as well as subdued cost pressures in Malta's main trading partners, which may have limited the scope of faster wage increases in the private sector. These factors are expected to continue restraining wage growth. At the same time, following a period of negative or very subdued growth, the real wage in the private sector is expected to recover over the forecast horizon, particularly in the context of a continued quick pace of economic activity and the significant recovery in productivity in 2015. Reflecting this view and the expectation of a pick-up in inflation, nominal compensation per employee is set to accelerate from 1.5% in 2015 to 2.4% by 2017.

With regard to unit labour costs (ULC), these declined by 1.2% in 2015, following a sequence of increases. The decrease in 2015 arose as productivity growth, at 2.7%, significantly outpaced growth of 1.5% in compensation per employee. In 2016 and 2017 ULCs are set to return to an increasing path, as growth in compensation per employee accelerates while productivity growth moderates.

Fiscal developments

The Bank estimates that the general government deficit-to-GDP ratio fell from 2.1% of GDP in 2014 to 1.6% in 2015. The narrower deficit partly reflects increased intakes under the IIP. At the same time, favourable economic conditions and indirect tax measures are estimated to have led to robust growth in underlying tax revenue, offsetting the impact of reduced income tax rates for households. Revenue is estimated to have grown at a faster rate than expenditure.

The deficit ratio is set to narrow further in 2016 and 2017 to 1.1% and 0.9%, respectively.

The 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 increase, while Government is expected to exercise an element of restraint in relation to wages and, particularly, intermediate consumption. These factors, along with additional indirect taxes announced in the Budget 2016

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

are expected to offset a widening of the tax-free income bracket and increases in certain categories of pensions.[5]

In 2017 the fiscal deficit is expected to narrow slightly further. Although a degree of restraint in recurrent expenditure is foreseen to prevail in that year, this would be partly 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.

Lower interest payments are also expected to contribute to the narrowing of the deficit ratio over the projection horizon.

The general government debt-to-GDP ratio is estimated to fall from 63.6% in 2015 to 58.6% by 2017, partly reflecting a favourable interest growth differential and the expected improvement in the primary fiscal balance.

Inflation

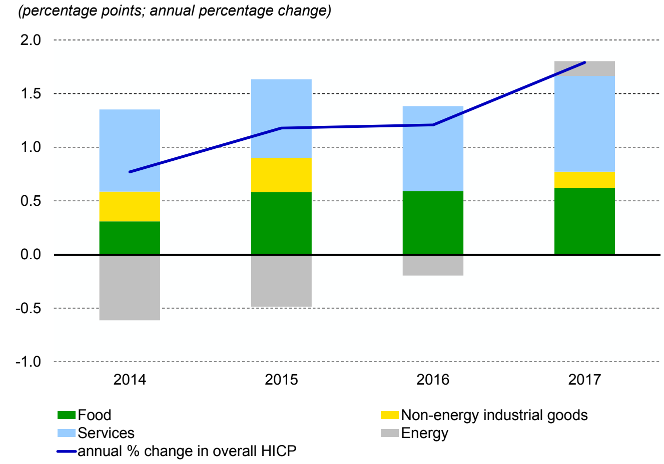
Inflation projections are influenced by the technical assumptions shown in Table 1, which entail a decline in the US dollar oil price in 2016 and a broadly stable exchange rate of the euro against the US dollar. In 2017 the US dollar oil price is set to increase, more than offsetting a marginal appreciation of the euro. As a result, the oil price in euro terms is expected to significantly fall in 2016, before it recovers in 2017.

The annual rate of inflation, measured by the HICP, is expected to remain unchanged at 1.2% in 2016, before it accelerates to 1.8% in 2017 (see Chart 2).

In 2016 services inflation is expected to accelerate slightly. Meanwhile, energy inflation is projected to turn less negative compared with a year earlier, in line with the technical assumptions, which foresee the oil price recovering in the course of the year. These elements outweigh a slowdown in NEIG inflation, partly reflecting the pass-through of earlier declines in international commodity prices.

The pick-up in overall HICP inflation in 2017 is largely driven by developments in the non-energy industrial goods and energy components. In both cases, their inflation rates are expected to turn positive that year, partly in response to the envisaged recovery of the oil price over the forecast horizon. At the same time, services inflation is also expected to accelerate, against a backdrop of rising cost pressures, while food inflation rises marginally.

Chart 2
HICP INFLATION OVER THE FORECAST HORIZON
(percentage points; annual percentage change)



Sources: Eurostat; Central Bank of Malta.

[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.

Compared with the Bank's earlier projections, the latest inflation outlook entails a slight downward revision for 2016 and 2017, reflecting a lower path for international oil prices and weaker than expected outcomes for inflation around the turn of the year.

Risks to the projections

Risks to the GDP growth projections are balanced. Downside risks relate to the fragility of the global economy. In particular, a prolongation of weak activity in the euro area or a more persistent slowdown in emerging economies would negatively impact export growth. The latter could also surprise on the downside if the expected recovery in semiconductor exports is delayed. On the other hand, a weaker than expected euro would have a positive impact on exports. Imports could also be lower than expected, if efficiency gains in the energy sector prove stronger than assumed in the projections. GDP growth could also surprise on the upside if the assumed restraint in government expenditure does not materialise.

Risks to the inflation projections are on the downside. A continuation of the current weak inflation environment in Malta's main trading partners would limit growth in import prices, which should in turn translate into weaker domestic inflationary pressures. Inflation would also be lower than expected if domestic fuel and gas prices were to fall further in response to earlier declines in international oil prices. On the other hand, a renewed weakening of the euro, or a sharper than expected rebound in international commodity prices, would have an upward impact on inflation in Malta.