BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

ECONOMIC PROJECTIONS FOR 2016 - 2018

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Outlook for the Maltese economy[1]

Economic growth is expected to ease

Following three years of strong expansion, the Bank's latest macroeconomic projections point to continued robust growth in real gross domestic product (GDP) between 2016 and 2018. However, growth is expected to decelerate from a record-high 6.3% in 2015 to 4.9% in 2016 and to moderate further during the following years, standing at 4.2% and 3.6% in 2017 and 2018, respectively (see Table 1).

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

	2015	2016[(2)]	2017[(2)]	2018[(2)]
Real economic activity (% change)				
GDP	6.3	4.9	4.2	3.6
Private consumption expenditure	4.9	4.6	3.6	3.2
Government consumption expenditure	4.8	4.4	6.2	3.6
Gross fixed capital formation	21.4	2.7	6.1	0.4
Exports of goods and services	2.4	2.8	3.0	3.8
Imports of goods and services	3.0	2.2	3.3	3.0
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	7.5	3.9	4.4	2.4
Net exports	-0.6	1.0	-0.1	1.2
Changes in inventories	-0.5	0.0	0.0	0.0
Real disposable household income[(3)]	4.0	3.2	3.1	3.2
Household saving ratio[(3)]	13.1	11.9	11.5	11.5
Balance of payments (% of GDP)				
Goods and services balance	6.9	7.8	7.6	8.7
Current account balance	9.9	5.8	5.6	6.7
Labour market (% change)[(4)]				
Total employment	3.5	3.4	2.9	2.9
Unemployment rate (% of labour supply)	5.4	5.3	5.3	5.5
Prices and costs (% change)				
GDP deflator	2.3	1.9	2.1	2.3
RPI	1.1	0.7	1.5	1.7
Overall HICP	1.2	1.1	1.7	1.8
HICP excluding energy	1.8	1.5	1.8	1.9
Compensation per employee	1.5	1.9	2.6	2.8
ULC	-1.2	0.5	1.3	2.1
Public finances (% of GDP)				
General government balance	-1.5	-0.9	-0.8	-0.3
General government debt	63.9	61.9	59.9	56.8
Technical assumptions				
EUR/USD exchange rate	1.11	1.13	1.14	1.14
Oil price (USD per barrel)	52.4	43.4	49.1	51.3

(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 2015 are Central Bank of Malta estimates.

(4) Data on the number of employed are consistent with national accounts data. The unemployment rate is based on the number of unemployed and employed persons as reported in the Labour Force Survey.

1 The Bank's outlook for the Maltese economy is based on information available up to 18 May 2016 and is conditional on the technical assumptions shown in Table 1, which are sourced from the European Central Bank.

Compared with the Bank's previous projections, published in its latest Annual Report, GDP growth has been revised down by 0.4 percentage points in 2016. It has been left unchanged in 2017.[2]

The downward revision in 2016 was motivated by a number of factors. A less favourable external outlook led to a downward revision in exports. Moreover, the latest Update of the Stability Programme shows that the Government intends to step up its fiscal consolidation efforts, leading to a downward re-assessment of government investment and consumption in the Bank's projections.[3] Finally, new information suggests that part of the investment outlays related to the conversion of the existing oil-fired power plant to gas will be shifted from 2016 to 2017. This changes the growth rates of investment in both 2016 and 2017 but is mostly neutral on GDP growth, as imports were revised accordingly.

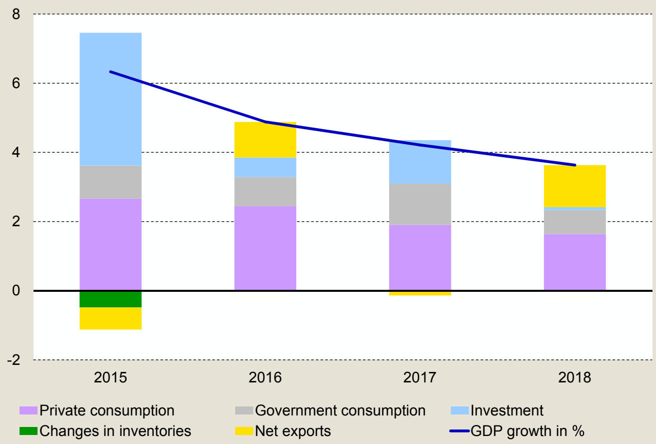
Domestic demand drives GDP growth

The Bank expects domestic demand to be the principal contributor of economic growth throughout the projection horizon, supported mainly by private consumption. Moreover, the contribution of net exports is expected to turn positive this year. It will turn marginally negative in 2017 due to the relatively high import content of a number of investment projects. In 2018, the contribution of net exports is envisaged to turn positive again, but remain smaller than 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 4.6% in 2016, 3.6% in 2017 and 3.2% in 2018. In turn, this mirrors developments in real disposable income, which is expected to decelerate from 4.0% in 2015 to 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 slow down in 2016 and grow by 4.4%. Subsequently, government consumption is envisaged to accelerate to 6.2% in 2017, and decelerate again to 3.6% in 2018. The profile of government consumption depends heavily on the inflows related to the Individual Investor Programme (IIP). These inflows, which are netted against consumption expenditure, rose significantly in 2015. They are expected to increase at a slower pace in

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



Sources: NSO; Central Bank of Malta calculations.

[2] See *Annual Report* 2015, Central Bank of Malta, pp. 72-77.
[3] See Medium-Term Fiscal Strategy for Malta: Update of Stability Programme 2016 – 2019. http://ec.europa.eu/europe2020/pdf/csr2016/sp2016_malta_en.pdf

2016. This has a positive impact on growth in government consumption, partly offsetting slower growth of intermediate consumption and compensation of employees. In 2017, inflows related to the IIP are projected to decline, pushing up growth in government consumption and outweighing the continued deceleration in the other expenditure components. In 2018, government consumption eases again, while inflows from IIP are expected to remain similar to those in 2017.

Following an increase of 21.4% in 2015, investment is expected to slow down sharply to 2.7% in 2016, before picking up to 6.1% in 2017. In 2018, a marginal increase is projected. Private investment is envisaged to slow down consistently throughout the projection horizon, whereas government investment is expected to fall in 2016, recover in 2017 and contract again in 2018.

Following double-digit growth in 2015, private investment is forecast to grow by 8.4%, 6.5%, and 0.7% in the following three years. This profile is heavily influenced by expected developments in the energy sector, notably 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 gas power plant is assessed to have taken place in 2015. As work on the gas power plant is expected to finish this year and the conversion of the existing oil-fired power plant to gas should be completed next year, investment in machinery is forecast to slow down sharply in 2016 and 2017, and drop in 2018.

After a strong rebound in 2015, growth in dwelling investment is expected to moderate in 2016 and decelerate further to around 6% in 2018. The growth foreseen over the projection period follows a protracted period of decline in dwelling investment. Investment in dwellings is set to continue to benefit from the Eurosystem's accommodative monetary policy stance, fiscal incentives targeting first-time buyers and demand from non-residents.

On the other hand, non-residential construction is set to accelerate markedly during the projection horizon, following a strong contraction in 2015. The projected strong pick-up 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 the following two years.

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 moderate. It is then expected to rise by 4.1% in 2017, as projects partly financed under this Framework gather pace. Taking into account the latest information on the Government's spending plans, real government investment is envisaged to contract by 1.1% in 2018.

Net exports contribute moderately to economic expansion

Following a rise of 2.4% in 2015, export growth is set to accelerate steadily over the projection period, to 3.8% in 2018. 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 as a result of offsetting movements across various components. In 2017 and 2018, export growth is forecast to gain momentum in line with an expected recovery in foreign demand.

Largely mirroring the deceleration in investment growth in 2016, imports are projected to grow less rapidly, rising by 2.2%, as against 3.0% in 2015. Due to the projected outlays on the conversion of the existing oil-fired power plant to gas, the bulk of which are now expected to take place in 2017, import growth in that year is expected to rise to 3.3%. Subsequently, as domestic demand is envisaged to decelerate in 2018, import growth decelerates again to 3.0%. Moreover, efficiency gains owing to new energy projects are expected to reduce imports of fuel for domestic use throughout the projection horizon.

On balance, net exports are foreseen to contribute positively to GDP growth in 2016, negatively in 2017, and positively again in 2018, reflecting primarily the impact of investment outlays on imports.

The balance of payments remains in surplus

The surplus on external trade in goods and services is expected to widen from 6.9% of GDP in 2015 to 7.8% in 2016. A slight narrowing is foreseen in 2017, largely mirroring developments in the goods balance and an expected decline in inflows under the IIP which affects services exports. The trade surplus is expected to widen again to 8.7% in 2018, as exports respond to the improvement in foreign demand. In addition, the foreseen slowdown in domestic demand is reflected in imports.[4]

In contrast to the trade balance, 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, consistent with historical patterns. Meanwhile, net inflows on the secondary income account are set to decline slightly as a share of GDP, reflecting an expected decrease in the use of EU funds. The current account surplus is expected to narrow slightly in 2017, before it widens again in 2018, mirroring expected developments in the trade balance.

The labour market continues to show resilience

Following a 3.5% increase in 2015, employment growth is set to ease slightly to 3.4% in 2016 and further to 2.9% in the following two years. The marginal slowdown in 2016 is driven by expected developments in the general government sector. In contrast, private sector employment growth is set to stabilise this year. In 2017 private sector employment is set to expand less rapidly on the back of slower growth in activity, while restraint in government employment continues. In 2018, employment growth is expected to stabilise, as real GDP growth slows down.

The unemployment rate is set to ease slightly from the low level of 5.4% recorded in 2015, standing at 5.3% this year and next. It begins to edge up again in 2018, when it is set to reach 5.5%.[5] The forecast takes into account a continued drop in the number of registered unemployed in the first three months of 2016. The pick-up in the unemployment rate in 2018 takes place against a backdrop of a slowing economy and an increase in the labour supply as a result of the rise in the retirement age.

Compensation per employee is set to pick up over the forecast horizon. This is set to accelerate from 1.5% in 2015 to 2.8% by 2018, largely mirroring the expected development of consumer

[4] Data on the trade balance in this commentary are consistent with NSO *News Release* 41/2016 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* 47/2016.

[5] In the Bank's projection exercise, employment growth is based on the number of employed persons in the national accounts. As from this projection exercise, the unemployment rate is based on the LFS measure of the labour force and the number of unemployed.

prices, as the growth in real compensation per employee is expected to be more moderate. Growth in the latter is set to increase from 0.4% in 2015 to around 0.7% over the forecast horizon. A continued supply of foreign workers, as well as subdued international price and cost pressures, are seen as restraining wage growth over the forecast horizon as well.

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 significantly outpaced compensation per employee. Between 2016 and 2018 ULCs are set to return to an increasing path, as growth in compensation per employee accelerates while productivity growth moderates.[6]

The fiscal deficit narrows

The general government deficit-to-GDP ratio fell from 2.0% of GDP in 2014 to 1.5% in 2015 as revenue increased strongly, benefiting from favourable economic conditions, inflows under the IIP and indirect tax measures. This offset the impact of reduced income tax rates for households and rapid expenditure growth.

The deficit ratio is set to narrow further over the forecast horizon, standing at 0.9% in 2016 and 0.8% in 2017. By 2018, it is expected to have narrowed to 0.3%.

The narrowing of the deficit in 2016 largely reflects the expectation that capital transfers to the national airline cease. Inflows under the IIP, moreover, are set to increase, while Government is expected to exercise an element of restraint in relation to employee compensation and, particularly, intermediate consumption. These factors, along with additional indirect taxes announced in the Budget 2016 are expected to offset a widening of the tax-free income bracket and increases in certain categories of pensions.[7]

In 2017 the fiscal deficit is expected to narrow marginally. Although a degree of restraint in recurrent expenditure is foreseen to prevail also that year, this would be dampened by slower revenue growth, largely reflecting a decline in inflows under the IIP. The further narrowing in the fiscal deficit in 2018 reflects the Bank's expectation of continued expenditure restraint, particularly as regards the wage bill. At the same time, the increase in the retirement age is set to dampen growth in social payments.

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

The general government debt-to-GDP ratio is estimated to fall from 63.9% in 2015 to 56.8% by 2018, supported by the expected improvement in the fiscal balance and rising nominal GDP.

Inflation picks up

The Bank's inflation projections are influenced by the technical assumptions shown in Table 1. In 2016, these entail a decline in the US dollar oil price and a marginal appreciation of the euro against the US dollar. In 2017 and 2018 the US dollar oil price is set to increase. As a result, the

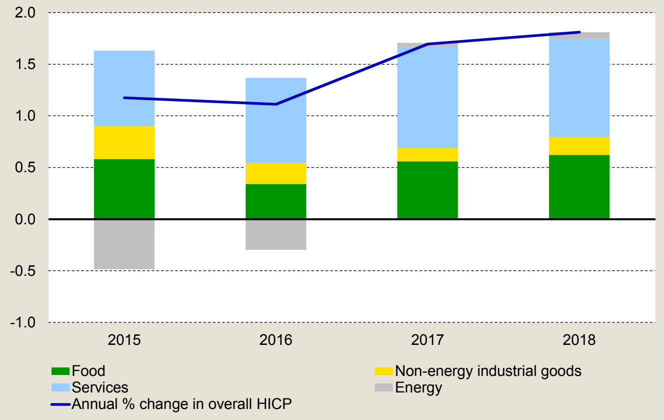
[6] The increase in Maltese ULCs seen in the past, and which resumes over the projection period, is heavily influenced by the shift to services, which are labour-intensive, in the composition of output. See Rapa, N. "Measuring International Competitiveness" in *Quarterly Review* 2016:1.

[7] 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. Moreover, the Bank's projections only take into account policy measures that are well specified and have passed the legislative process. Therefore, for 2017 and 2018 no additional fiscal policy measures are assumed.

oil price in euro terms is expected to significantly fall in 2016, before it recovers in 2017 and 2018.

HICP inflation is set to ease from 1.2% in 2015 to 1.1% in 2016, before picking up to 1.7% in 2017 and 1.8% in 2018 (see Chart 2).

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



Sources: Eurostat; Central Bank of Malta.

The marginal fall in inflation in 2016 is driven by HICP excluding energy and is influenced by the outcomes seen in the first quarter of the year. HICP excluding energy is set to ease from 1.8% in 2015 to 1.5%, largely on account of slower growth in prices of food and, to a lesser extent, of non-energy industrial goods. In contrast, energy inflation is set to be less negative this year, as the impact of electricity tariff reductions, which had lowered the energy component in the first part of 2015, fades away. On the other hand, as announced, domestic prices for gas and fuel transport respond with a lag to earlier declines in the international oil price.

In 2017 and 2018, both energy inflation and HICP excluding energy inflation are set to accelerate. In the absence of official announcements, the Bank's projections assume that energy inflation begins to respond to the recovery in Brent oil, turning positive in 2017 and edging up further in the following year. Although to a lesser extent, HICP excluding energy also accelerates in 2017 and 2018, largely reflecting developments in international food prices and, to a lesser extent, prices of services.

Compared with the Bank's earlier projections, the latest inflation outlook entails a slight downward revision for 2016 and 2017, reflecting a downward revision in energy inflation. Although the oil price in euro is higher compared with the previous exercise, the latest inflation projections incorporate the announced reductions in the domestic prices of gas and fuel for transport use. Additionally, the pass through from past reductions in the international oil price to domestic prices is set to be more gradual in this exercise. Consequently, the transmission of the increase in international oil prices takes longer than in the previous exercise.

Risks to the projections

Risks to the projections slightly on the downside

Risks to the GDP growth projections are slightly on the downside. Downside risks relate to the fragility of the external environment. In particular, a prolongation of weak activity in the euro area, a vote in the United Kingdom to leave the EU, or a more persistent slowdown in emerging economies would adversely affect exports. The latter could also surprise on the downside if the expected recovery in semiconductor exports is delayed. At the same time, the Government could also implement additional consolidation measures, beyond those included in the Bank's baseline, to meet its fiscal targets. On the other hand a weaker than expected euro would boost exports.

Imports could also be lower than expected, if efficiency gains in the energy sector are stronger than assumed in the forecasts. The forecasts also incorporate conservative estimates for a number of projects in the health and education sector. A frontloading of the related expenditure would have a positive impact on investment, although imports would also be higher. GDP growth could also be higher than expected if the saving ratio converges to its long-run average more rapidly than foreseen, implying faster growth in private consumption.

Risks to the inflation projections are slightly 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 gas and fuel 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.