BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

Economic projections

2016 - 2019

December 2016

Outlook for the Maltese economy

Economic projections

2016 - 2019

Economic activity in Malta is expected to remain robust over the projection horizon, supported by both demand and supply factors. In particular, the energy reforms that have taken place in recent years, new investment projects, increased labour market participation and robust services exports are the primary drivers supporting the economic expansion. Real GDP growth is projected at 4.3% for 2016. It is then expected to decelerate to 4.1% in 2017, 3.7% in 2018, and 3.3% in 2019.

As a result, the labour market is projected to remain tight, with the unemployment rate falling further to 4.9% in 2016, before picking up slightly to 5.3% by 2019.

Downward international price pressures are expected to contribute towards a further easing of consumer price inflation this year. Annual inflation, based on the Harmonised Index of Consumer Prices (HICP), should ease from 1.2% in 2015 to 0.9% in 2016. It is then projected to trend up to 1.9% by 2019, reflecting a pick-up in international commodity prices and domestic cost pressures.

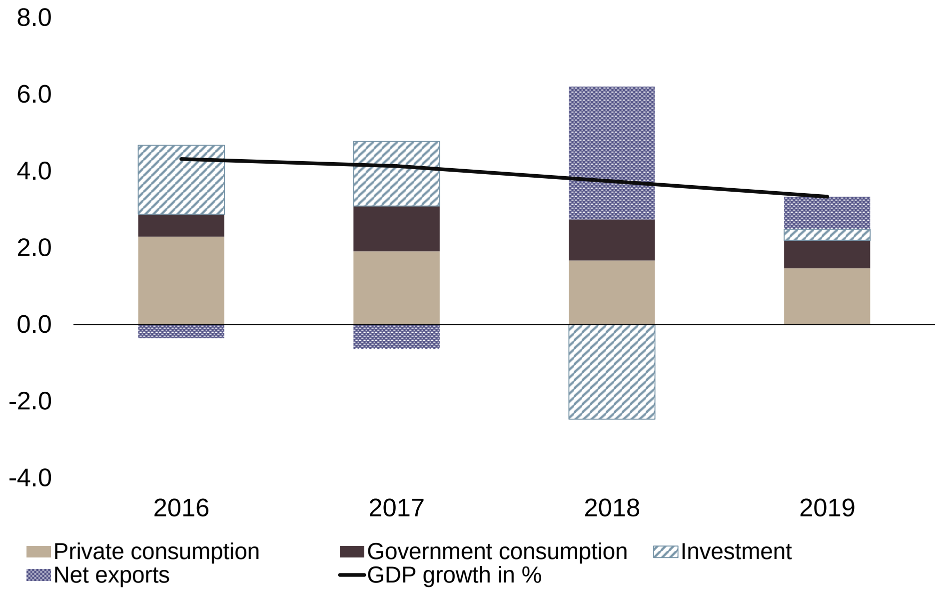
In terms of public finances, restraint in key expenditure variables is expected to contribute towards a decline in the general government deficit, with the government budget set to become broadly in balance by 2019.

1 Economic outlook[1]

Data for 2016 suggest that after three years of very strong growth, economic activity is likely to slow down this year. Consequently, real Gross Domestic Product (GDP) growth is projected to ease from 6.2% in 2015, to 4.3% in 2016. It is set to decelerate further in the following years, to reach 3.3% by 2019 (see Table 1).

Over the projection horizon as a whole, GDP growth is expected to be driven mainly by domestic demand. The contributions of domestic demand and net exports are heavily influenced by the path of investment, which is set to expand in 2016 and 2017, contract in 2018, and recover in the outer year. As a result, while domestic demand is expected to drive economic growth in the first two years of the projection horizon, its contribution is set to be marginal in 2018, before rising again in 2019. In contrast, net exports are forecast to contribute negatively in the first two years, but positively in 2018 and, to a lesser extent in 2019 (see Chart 1).

Chart 1: GDP growth over the projection horizon
(percentage point contributions; annual percentage change)



Source: Central Bank of Malta

Private consumption is expected to remain one of the main drivers of economic growth going forward. This is set to benefit from favourable labour market conditions, a low interest rate environment and a number of measures introduced in the Budget 2017 to support low-income earners. At the same time, real disposable income is expected to decelerate in line with the projected easing in economic activity. Hence, private consumption is projected to decelerate throughout the projection horizon. As the latter

[1] The Bank's outlook for the Maltese economy is based on information available up to 23 November 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.

Table 1: Projections for the main macroeconomic aggregates for Malta[1]

	2015	2016[2]	2017[2]	2018[2]	2019[2]
Real economic activity (% change)					
GDP	6.2	4.3	4.1	3.7	3.3
Private consumption expenditure	5.5	4.3	3.6	3.2	2.8
Government consumption expenditure	4.6	3.1	6.2	5.6	3.7
Gross fixed capital formation	43.1	7.1	6.2	-9.2	0.9
Exports of goods and services	2.1	1.9	2.9	3.2	3.4
Imports of goods and services	5.6	2.2	3.5	0.6	2.9
Contribution to real GDP growth (in percentage pts)					
Final domestic demand	11.8	4.7	4.8	0.3	2.5
Net exports	-4.7	-0.4	-0.6	3.5	0.8
Changes in inventories	-0.9	0.0	0.0	0.0	0.0
Real disposable household income[3]	4.0	3.9	3.8	2.8	2.5
Household saving ratio[3]	12.0	11.6	11.6	11.3	11.2
Balance of payments (% of GDP)					
Goods and services balance	2.9	3.1	2.4	5.7	6.4
Current account balance	2.9	2.2	1.6	5.0	5.7
Labour market (% change)[4]					
Total employment	3.4	3.1	2.9	2.8	2.7
Unemployment rate (% of labour supply)	5.4	4.9	5.0	5.2	5.3
Prices and costs (% change)					
GDP deflator	2.3	1.9	2.0	2.1	2.1
RPI	1.1	0.6	1.4	1.6	1.8
Overall HICP	1.2	0.9	1.4	1.7	1.9
HICP excluding energy	1.8	1.3	1.6	1.7	2.0
Compensation per employee	2.7	3.3	3.3	2.8	2.4
ULC	0.0	2.2	2.0	1.9	1.8
Public finances (% of GDP)					
General government balance	-1.4	-0.8	-0.6	-0.4	-0.1
General government debt	64.0	62.6	60.8	57.4	54.8
Technical assumptions					
EUR/USD exchange rate	1.11	1.11	1.09	1.09	1.09
Oil price (USD per barrel)	52.4	43.1	49.3	52.6	54.6

[1] Data on GDP were sourced from NSO News Release 142/2016 published on 6 September 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 as reported in the Labour Force Survey.

is set to grow faster than real disposable income, the saving ratio is expected to decline.

With regard to real government consumption its profile is influenced heavily by the inflows related to the Individual Investor Programme (IIP). These inflows, which are netted against consumption expenditure, rose significantly in 2015 and are expected to peak in 2016. They are set to slow down in 2017 and more than halve in 2018. In 2019 they are expected to keep the same level. The forecast increase in government consumption in 2016 and 2017 also reflects spending related to Malta's Presidency of the Council of the European Union.

The outlook for investment growth is strongly influenced by expected developments in specific sectors, notably in energy and aviation, as well as the take-up of EU funds. Following the strong growth in 2015, overall investment growth is projected to slow down sharply this year. The deceleration in 2016 partly reflects a contraction in government investment, consistent with the low take-up of funds under the EU 2014-2020 Financing Framework. Additionally, private investment, which had been boosted by developments in the aviation sector in 2015, is expected to grow at a slower rate. In 2017, investment growth is expected to moderate further, as underlying investment responds to the slowing pace of economic activity and capital outlays in the aviation sector level off. These factors more than offset an expected recovery in government investment and support from major construction projects in health and education. In 2018, investment is projected to contract sharply, as major spending programmes in energy and aviation are expected to be finalised by 2017. Investment growth in 2019 is then projected to pick up again.

With regard to external trade, exports are expected to decelerate in 2016, reflecting a slowdown in foreign demand, and a contraction in goods exports. Exports are then expected to accelerate in the projection horizon, supported by a recovery over the manufacturing sector and continued robust services export growth. Nevertheless, the weakness in goods exports is envisaged to persist, and hence, total exports are foreseen to grow less rapidly than foreign demand.

The profile of import growth mainly mirrors that of investment and exports. In 2016, imports are expected to decelerate due to the sharp slowdown in capital-intensive investment and a moderation of export growth. In 2017 they are then projected to accelerate, due to the envisaged recovery in exports. In 2018, imports grow only marginally, as the contraction in capital imports that year partially offsets the impact of growth in the other domestic demand components and exports. In 2019, imports begin to pick up again, in line with the foreseen recovery in investment and continued expansion in exports.

Although on the real side import growth is expected to exceed export growth this year, the decline in international commodity prices is projected to affect import prices more than export prices, in line with developments in the first half of the year. As a result, the trade surplus is expected to widen. However, the surplus on the current account should narrow due to a decline EU funds absorption. In 2017, the trade surplus is foreseen to narrow, mirroring the rise in investment of a capital-intensive nature and the Bank's expectation that import prices would grow broadly in line with export prices. It is then set to widen in 2018 and 2019, reflecting the projected recovery in net exports. The current account balance in the last three years of the projection horizon broadly follows the trade balance.

Compared to the Bank's previous projections, GDP growth is being revised downward, with the most significant revision arising in 2016. The downward revision is mainly driven by the less upbeat assessment for exports, taking into account the negative surprise in goods exports in the first half of the year and a less optimistic outlook for foreign demand.

2 Labour market

The persistence of robust GDP growth over the projection horizon, alongside the extension of active labour market policies, is expected to support continued growth in employment. Nevertheless, the foreseen restraint in public sector employment and the expected slowdown in economic activity from its historical highs should limit the rate of hiring in the next few years. As a result, employment growth is forecasted to decelerate throughout the projection horizon, mirroring an easing in both the public and private sector.

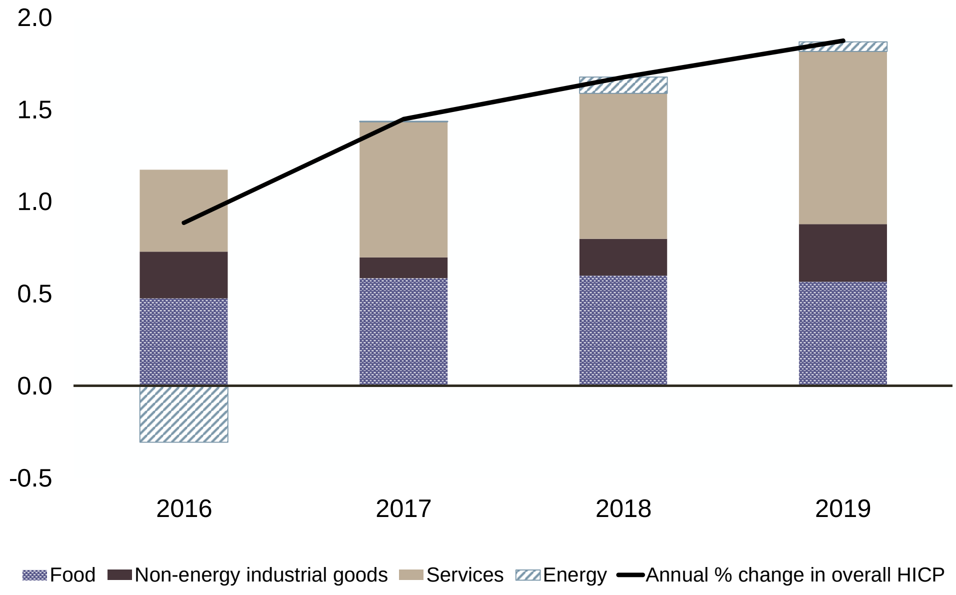
This notwithstanding, unemployment this year is expected to continue falling, reflecting developments in the first half of the year. Conversely, as employment growth and economic activity slow down further in the period 2017 and 2019, the unemployment rate is foreseen to rise slowly.

In a context of a recovery in productivity, rapid economic growth and low unemployment levels, the labour market is tightening. Indeed data for the first half of the year and surveys suggest that wage pressures are becoming a salient feature of the Maltese economy. Hence, compensation per employee is forecast to accelerate in 2016. In the period 2017 and 2019, wage pressures are expected to ease slightly, as productivity growth slows down and tightness in the labour market dissipates.

3 Prices

The Bank's inflation projections are influenced by the technical assumptions shown in Table 1. The international price of oil in euro is expected to increase over the next three years. Against this external background, but also taking into account developments up to October 2016 and the expected evolution of domestic cost pressures, HICP inflation in Malta is set to ease from 1.2% in 2015 to 0.9% in 2016, before picking up to 1.9% by 2019 (see Chart 2).

Chart 2: HICP inflation over the projection horizon
(percentage point contributions; annual percentage change)



Source: Central Bank of Malta

The drop in overall HICP inflation in 2016 is driven by the relatively subdued outcome for HICP excluding energy during the first ten months of the year. In 2016 as a whole, the latter is set to ease, largely on account of slower growth in prices of unprocessed food, services, and, to a lesser extent, non-energy industrial goods. Over the following three years, HICP excluding energy inflation is expected to accelerate in response to demand and wage pressures.

In contrast, energy inflation is set to be less negative this year, as the impact of the 2014 electricity tariff reduction, which had lowered the energy component significantly in the first part of 2015, drops out from the annual inflation rate. In the following three years, energy inflation is expected to turn positive, as in the absence of official announcements domestic prices for gas and transport fuel are projected to gradually respond to the foreseen recovery in Brent oil prices, while electricity tariffs are expected to remain unchanged.

Compared with the Bank's earlier projections, the latest exercise entails a slight downward revision in the inflation projections, largely reflecting downward revisions to the services component.

4 Public finance

The general government deficit-to-GDP ratio is set to decline throughout the forecast horizon, from 1.4% in 2015 to 0.1% in 2019. The Bank expects a slower rate of consolidation compared with Government projections; according to the 2017 Budget estimates, a surplus of 0.1% of GDP is set to be achieved by 2019.[2]

The improving fiscal outlook over the forecast period is supported by strong tax revenue growth, but is mainly driven by the expectation of continued restrained in key recurrent expenditure items. In particular, the Bank's projections assume restrictions in public sector hiring, and declines in interest payments in line with lower financing needs and prevailing low interest rates. The relatively low spending growth profile is also due to certain special factors, such as the end of capital transfers to Air Malta from 2017 onwards, and the increase in the statutory retirement age in 2018. At the same time, inflows from the IIP are also expected to contribute to the narrowing of the deficit. However, this impact is concentrated in 2016 and 2017, when these inflows are expected to be at their highest.

The general government debt-to-GDP ratio is estimated to fall from 64.0% in 2015 to 54.8% by 2019, supported by the expected improvement in the primary fiscal balance and a favourable GDP growth-interest rate differential.

The outlook for the deficit ratio is broadly unchanged compared with the Bank's earlier projections, as higher than expected IIP inflows were partly offset by an upward revision in costs attributed to the EU Presidency and the Budget 2017 measures. The debt ratio has been revised slightly upwards, in view of new information on financing transactions.

5 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, uncertainties regarding Brexit, 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 manufacturing exports is delayed. On the other hand, there are upside risks to private consumption growth if wages pick up faster than assumed, for instance if the new collective agreement in the public sector is more generous than assumed here, and if the savings ratio converges more rapidly towards its long-run equilibrium.

[2] 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.

Risks to inflation are also broadly balanced. 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. The pass-through from the recent appreciation of the euro could also be delayed. Meanwhile, services inflation has recently surprised on the downside, which might point towards a lower path than that currently expected. On the other hand, if wage growth accelerates more strongly than expected, inflation would be higher than expected. Policy decisions regarding administered prices, particularly in the energy sector, could also affect inflation.