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CENTRAL BANK OF MALTA

Economic projections

2017 - 2019

June 2017

Outlook for the Maltese economy

Economic projections

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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 4.4% for 2017. It is then expected to decelerate to 4.0% in 2018, and 3.5% in 2019.

As a result, the labour market is projected to remain tight, with the unemployment rate falling further to 4.5% in 2017, before picking up slightly to 5.1% by 2019.

Consumer price inflation is expected to pick up this year as the contribution of energy prices is envisaged to turn positive. Annual inflation, based on the Harmonised Index of Consumer Prices (HICP), should rise from 0.9% in 2016 to 1.4% in 2017. It is then projected to trend up to 1.8% by 2019, reflecting a pick-up in international commodity prices and domestic cost pressures.

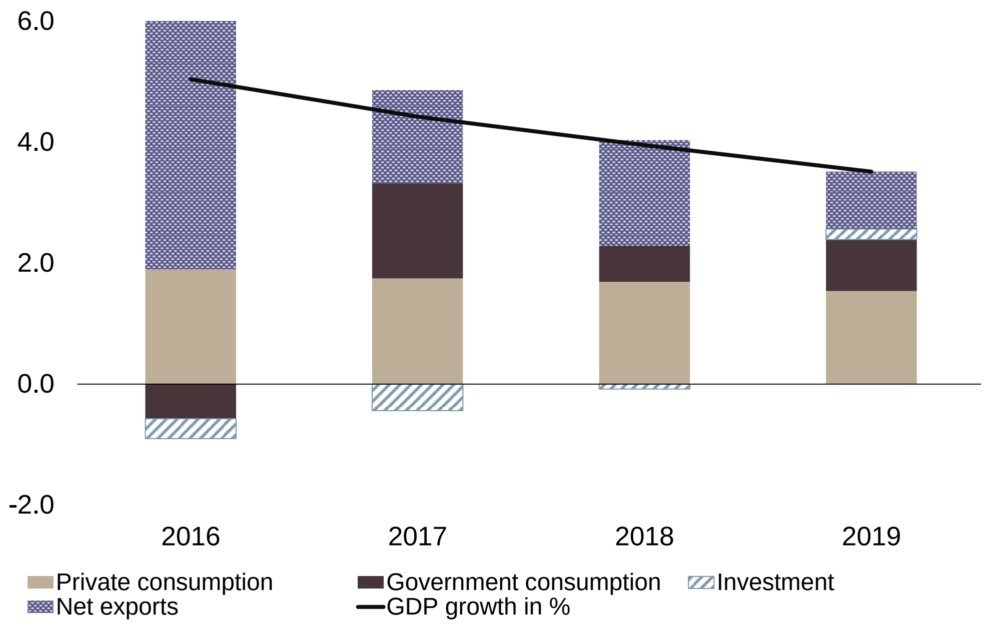
In terms of public finances, the general government balance is expected to remain in surplus between 2017 and 2019, while the debt-to-GDP ratio is projected to fall below 50%.

1 Economic outlook [1]

GDP growth in 2016 eased when compared with the very strong rates recorded in the previous two years, but remained significant at 5.0%, supported primarily by growth in services exports and private consumption. In the next three years the economic expansion should continue moderating to rates closer to potential output growth. GDP growth this year is projected to be 4.4%, easing further to 4.0% in 2018, and to 3.5% in 2019 (see Table 1).

Over the projection horizon as a whole, domestic demand will remain the main driver of economic growth, although net exports are also set to contribute positively (see Chart 1). The path of domestic demand is influenced by a strong base effect in government consumption, which contracted in 2016 and is expected to recover in 2017. The completion of projects in the energy and aviation sectors in turn condition heavily the profile of investment which is set to decline slightly during the first two years of the projection horizon. In contrast, private consumption is set to grow at a steady but decelerating pace throughout the forecast horizon. The contribution of net exports is also projected to remain positive, due to continued buoyancy in services exports and a decline in import shares.

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



Source: Central Bank of Malta

The robust growth on the demand side will be supported by the supply side of the economy. Potential output growth is expected to outpace GDP growth in the projection horizon, and as a result, the output

[1] The Bank's outlook for the Maltese economy is based on information available up to 23 May 2017 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]

	2016	2017[2]	2018[2]	2019[2]
Real economic activity (% change)				
GDP	5.0	4.4	4.0	3.5
Private consumption expenditure	3.8	3.6	3.5	3.2
Government consumption expenditure	-3.1	9.4	3.4	4.9
Gross fixed capital formation	-1.3	-1.9	-0.4	0.8
Exports of goods and services	4.0	4.3	4.2	3.6
Imports of goods and services	1.1	3.5	3.2	3.3
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	1.0	2.9	2.2	2.6
Net exports	4.2	1.5	1.7	0.9
Changes in inventories	-0.2	0.0	0.0	0.0
Real disposable household income[3]	3.0	2.9	2.8	2.8
Household saving ratio[3]	15.2	14.6	14.1	13.8
Balance of payments (% of GDP)				
Goods and services balance	11.9	13.0	14.0	14.5
Current account balance	7.9	8.4	8.6	8.9
Labour market (% change)[4]				
Total employment	3.7	3.0	2.8	2.7
Unemployment rate (% of labour supply)	4.7	4.5	4.8	5.1
Prices and costs (% change)				
GDP deflator	1.6	1.9	2.0	2.0
RPI	0.6	1.5	1.6	1.8
Overall HICP	0.9	1.4	1.6	1.8
HICP excluding energy	1.3	1.4	1.7	1.9
Compensation per employee	2.4	3.0	2.7	2.7
ULC	1.1	1.6	1.6	1.9
Business cycle				
Potential output (% change)	5.8	5.1	4.4	3.9
Output gap (% of GDP)	1.4	0.8	0.4	0.0
Technical assumptions				
EUR/USD exchange rate	1.11	1.08	1.09	1.09
Oil price (USD per barrel)	44.0	51.6	51.4	51.5

[1] Data on GDP were sourced from NSO News Release 041/2017 published on 7 March 2017.
[2] Central Bank of Malta projections.
[3] Data for 2016 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.

gap will return to zero by 2019.

The expected slowdown in private consumption growth mirrors a gradual projected easing in real disposable income. However, as private consumption is expected to outpace disposable income, this should still result in a gradual decline of the saving ratio. This reflects the historically low unemployment rate, above average consumer sentiment and a low interest rate environment.

With regard to real government consumption, its profile is influenced heavily by inflows related to the Individual Investment Programme (IIP), which are netted against consumption expenditure. More details on projected developments in public consumption can be found in section 5 of this report.

Investment growth is projected to fall marginally in 2017 and 2018, and pick up in 2019. This profile is strongly influenced by the interplay of expected developments in specific sectors that have a bearing on private investment, as well as the expectation of increased absorption of EU funds, which conditions the profile of government investment. In more detail, the small contraction in 2017 reflects significant declines in the private sector, which outweigh the expected recovery in government investment (for more details see section 5 of this report). The decline in private investment is due to a base effect arising from the strong expansion of the aviation sector in the previous two years. In 2018, private investment is projected to fall further but at a slower pace, as the completion of energy-related projects is partly offset by the commencement of major construction projects in education and health. Investment growth is expected to turn positive in 2019.

With regard to external trade, exports are expected to continue growing faster than foreign demand on the back of continued gains in market share by the services sector. Goods exports are forecast to recover but in line with recent performance they are expected to underperform foreign demand. After accelerating in 2017, growth in total exports is projected to ease in the following two years. Mainly mirroring investment and exports, import growth is expected to accelerate in 2017. Import growth is then envisaged to decelerate by 2019, reflecting the path of domestic demand and exports. Over the projection horizon the recent decline in import shares will persist, but to a much lower extent than that experienced in the last few years. As a result, the net export contribution to GDP growth, while positive, is expected to moderate over the forecast horizon.

As a result of the projected positive net export contribution, the trade surplus is expected to widen during the period 2017 and 2019. The current account balance should also rise slightly over the projection horizon, but by less, on account of expected higher primary income outflows due to larger assumed repatriated profits by foreign owned companies.

Compared with the Bank's earlier projections, GDP growth is being revised upwards due to carry over effects from the positive surprise in GDP growth in 2016. The upward revision is mainly driven by a more upbeat assessment of export growth due to stronger than expected growth rates in services exports in 2016 and upward revisions in 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 forecast to decelerate slightly, though remaining above its historical average. This notwithstanding, unemployment is expected to continue falling in 2017, reflecting developments in the first months of the year. Conversely, as employment growth and economic activity slow down further in 2018 and 2019, the unemployment rate is foreseen to rise slowly.

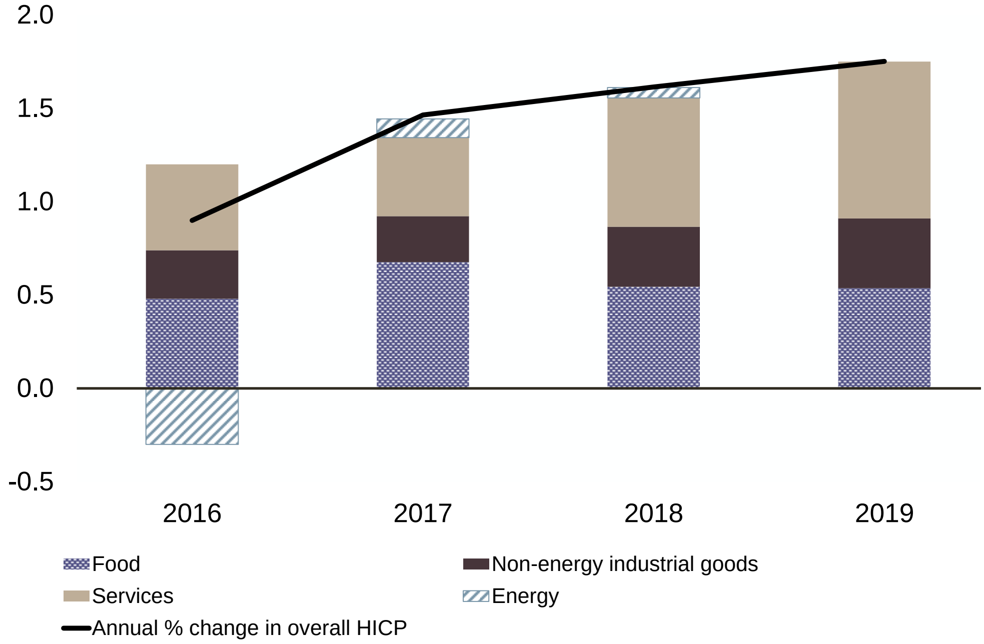
As regards wages, these slowed down in 2016. However, a national skills survey carried out last year and contacts with the industry continue to highlight labour market tightness and wage pressures to be gaining in importance. In this context, and reflecting also a pick-up in consumer prices, growth in nominal compensation per employee is expected to accelerate in 2017. Wage growth is then forecast to decelerate in 2018 and remain flat in 2019, as these factors are offset by slower growth in productivity.

3 Prices

The Bank's inflation projections are influenced by the technical assumptions shown in Table 1. The international price of oil in 2017 is expected to be higher than in the previous year but is set to remain broadly stable in the following two years. Against this background, but also taking into account developments up to April 2017 and the expected evolution of domestic cost pressures, HICP inflation in Malta is set to pick up from 0.9% in 2016 to 1.4% in 2017. It is projected to continue accelerating to 1.8% in 2019 (see Chart 2).

The pick-up in HICP in 2017 is primarily driven by energy inflation, which is set to turn positive as fuel and gas prices begin to respond to the recovery in international oil prices. Energy inflation is set to decelerate after 2017, in line with the profile of the technical assumptions. In more detail, fuel and gas prices are projected to move in line with these assumptions through a lagged and impartial pass-through,

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



Source: Central Bank of Malta

while electricity prices are expected to remain unchanged as per government policy.

HICP excluding energy is also projected to pick-up in line with upward demand and wage pressures. The acceleration in HICP excluding energy is foreseen to be primarily driven by faster inflation in services prices, and to a limited extent, non-energy industrial goods. Faster growth in food prices will also contribute in 2017.

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 and energy components.

4 Public finance

The profile of public finance projections for the period 2017-2019 is significantly affected by developments in 2016, when the general government balance reached a surplus of 1.0% of GDP from a deficit of 1.3% in the previous year. The turnout in 2016 exceeded the expectations of the Central Bank as well as the Government, which were forecasting a deficit of 0.8% of GDP and 0.7% of GDP, respectively. This was due to stronger than expected growth in tax revenue and inflows from the IIP, as well as lower than expected growth in social payments, current transfers and capital expenditure.

The headline budget balance is expected to remain in surplus throughout the forecast horizon, sustained by large positive primary balances (see Table 2). In 2017 the general government surplus is expected to

Table 2: Projections for main fiscal items (% of GDP) [1]

	2016	2017[2]	2018[2]	2019[2]
Headline Aggregates				
Total revenue	39.1	38.8	39.0	39.2
Total expenditure	38.1	38.3	38.3	38.4
General Government Balance	1.0	0.5	0.7	0.8
of which: Primary Balance	3.2	2.5	2.6	2.5
General Government Debt	58.3	55.7	52.0	49.2
Detailed Breakdown				
Current Revenue	38.5	37.9	37.7	37.6
Current taxes on income and wealth	13.9	14.0	14.1	14.2
Taxes on production and imports	12.8	12.8	12.7	12.7
Social contributions	6.5	6.4	6.3	6.2
Other current revenue[3]	5.3	4.8	4.6	4.5
Current Expenditure	34.8	34.7	34.2	34.2
Compensation of Employees	12.0	11.9	11.9	12.0
Intermediate Consumption	6.4	6.7	6.4	6.5
Social benefits	10.9	10.8	10.7	10.7
Interest payments	2.2	2.0	1.9	1.8
Subsidies	1.3	1.3	1.3	1.3
Other current expenditure[4]	2.0	2.0	2.0	2.0
Gross savings	3.7	3.2	3.5	3.4
Capital Revenue	0.6	0.9	1.3	1.6
Capital taxes	0.2	0.2	0.2	0.2
Other capital revenue[5]	0.5	0.7	1.1	1.4
Capital Expenditure	3.3	3.6	4.1	4.2
Investment	2.5	2.8	3.2	3.2
Capital transfers	0.8	0.8	1.0	1.0
Other capital expenditure[6]	0.0	-0.1	-0.1	-0.1
Capital Revenue Net of Capital Expenditure	-2.6	-2.7	-2.8	-2.6
Underlying Budgetary Position				
Cyclical component	0.7	0.6	0.5	0.3
Temporary government measures	0.0	0.0	0.0	0.0
Structural balance	0.3	-0.1	0.2	0.5

[1] CBM calculations based on NSO News Release 041/2017 (published on 8 March 2017) and News Release 068/2017 (published on 24 April 2017).
[2] Central Bank of Malta projections.
[3] Mainly includes revenue from dividends, rents and sales.
[4] Mainly includes spending on education and contributions to the EU budget.
[5] Mainly includes grants from EU Programmes.
[6] Mainly reflects the value of changes in inventories and in the net acquisition of valuables and other assets.

decline to 0.5% of GDP from 1.0% in the previous year, before increasing to 0.7% in 2018 and 0.8% by 2019. The profile for 2017 and 2018 is largely driven by expected developments in gross savings, or the balance between current revenue and current expenditure. Meanwhile, the improvement in the headline balance in 2019 is determined by a lower shortfall in the balance between capital revenue and capital expenditure.

Overall, the share of tax revenue items in GDP is expected to remain in line with the 2016 outcome, reflecting expected strong growth in the economy. The share of current taxes on income and wealth in GDP is expected to increase slightly, driven by higher income tax revenue from corporations. However, revenue from social contributions is expected to increase at a smaller pace than GDP, reflecting the presence of contribution limits.[2] Inflows from taxes on production and imports are expected to grow broadly in line with GDP.

Meanwhile, the share of other current revenue in GDP is set to decline over time. This is due to the forecast profile of income from the IIP, which are not expected to be as high as in 2016.

Overall, the main current spending items are projected to grow in line with economic activity. The share of compensation of employees in GDP is set to remain broadly stable, in line with the 2016 outcome. Owing to forecast positive economic developments and recent initiatives to encourage labour market activity, the share of social payments in GDP is expected to decline slightly. Forecast pension expenditure is also affected by the impact of an increase in the retirement age in 2018. Meanwhile, the share of intermediate consumption in GDP is set to increase in 2017 before declining in 2018 and remain stable thereafter. This is partly due to higher expected operational costs related to the 2017 Presidency of the EU Council. On the other hand, interest payments are forecast to grow at a smaller pace than GDP, owing to lower projected financing needs.

The forecast path of capital revenue and expenditure is primarily driven by the level of EU-funded projects under the 2014-2020 financing framework. These are expected to increase substantially from the low levels seen in 2016, as projects are identified and tenders are adjudicated. Consequently, capital revenue, capital transfers paid and, to a lesser extent, government investment are expected to grow at a faster pace than GDP between 2017 and 2019. The profile of investment is also affected by growth in domestically-funded projects, which is expected to grow at a stronger pace than GDP between 2017 and 2018, and to weaken somewhat in 2019.

The Central Bank of Malta also produces estimates for the structural government balance, which captures the underlying budgetary position corrected for the economic cycle and temporary government measures.

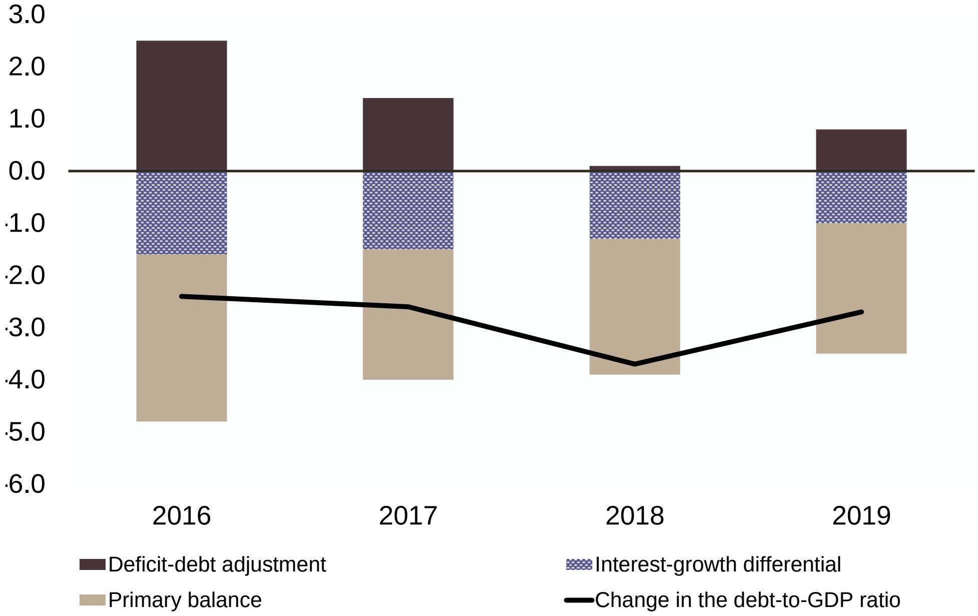
[2] According to the Social Security Act (tenth schedule), the weekly rate of contributions cannot exceed a specified ceiling.

This is computed using a methodology applied within the European System of Central Banks, [3]

In the absence of significant temporary measures, the profile of the structural balance is determined by the extent to which the headline balance is influenced by the economic cycle. The Bank expects a positive but declining cyclical component, indicating the diminishing contribution of the economic cycle, in line with the forecast closure of the positive output gap. Overall, the structural balance is set to swing from a surplus in 2016 to a small deficit in 2017, due to a decline in current revenue as explained above. The structural balance is then forecast to improve considerably in 2018 and 2019, due to a recovery in current revenue and restraint in expenditure growth.

The general government debt-to-GDP ratio is forecast to decline from 58.3% in 2016 to below 50% by 2019, driven by high primary balances and a favourable interest-growth differential (see Chart 3).

Chart 3: Contribution to change in the debt ratio
(percentage point contributions; percentage of GDP)



Source: Central Bank of Malta

Compared with the Bank's earlier projections, which forecast a deficit throughout the 2017-2019 period, the outlook for the government balance is much more favourable. However, public finances are now set to improve at a smaller pace over time.

[3] Projections by national central banks are used to generate bi-annual forecasts for the euro area GDP and budget balance. For further details, see `https://www.ecb.europa.eu/pub/projections/html/index.en.html`, which differs from the approach used by the Commission and the Maltese Government.

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, geopolitical uncertainties, 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 and if the savings ratio converges more rapidly towards its long-run equilibrium. Faster than expected continued growth in tourism also poses some upside risks to the GDP forecast.

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. 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 the inflation projections.

Risks to the public finances tilt on the upside, with contingency risks from public corporations more than offset by the possibility of higher than projected revenues from the IIP and growth in tax revenue.