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CENTRAL BANK OF MALTA

ECONOMIC PROJECTIONS FOR 2013 AND 2014

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ECONOMIC PROJECTIONS FOR 2013 AND 2014

Outlook for the Maltese economy[1]

The Bank's latest economic projections indicate that activity is expected to accelerate in 2013 and again in 2014. Compared with the Bank's previous projection exercise, which was concluded in November 2012, the latest exercise foresees a stronger acceleration in 2013.[2]

Real GDP growth is expected to accelerate from 0.8% in 2012 to 1.4% in 2013 (see Table 1). The Bank projects GDP growth to reach 1.8% in 2014.

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA

	2011(1)	2012(1)	2013(2)	2014(2)
Real economic activity (% change)				
GDP	1.7	0.8	1.4	1.8
Private consumption expenditure	3.3	-0.6	1.0	1.8
Government consumption expenditure	3.8	5.5	1.8	1.7
Gross fixed capital formation	-14.1	-2.5	2.0	-0.3
Inventories (% of GDP)	-1.7	-2.2	-2.2	-2.0
Exports of goods & services	0.8	5.2	2.0	2.8
Imports of goods & services	-2.0	4.4	2.0	2.6
Contribution to real GDP growth (in percentage pts)(3)				
Final domestic demand	0.4	0.4	1.3	1.4
Net exports	2.6	1.0	0.1	0.3
Changes in inventories	-1.3	-0.6	0.0	0.1
Balance of payments (% of GDP)				
Goods and services balance	5.2	5.7	6.1	6.1
Current account balance	-0.1	0.4	0.7	0.6
Labour market (% change)				
Total employment	2.7	2.1	1.2	1.3
Unemployment rate (% of labour force)(4)	6.5	6.5	6.6	6.6
Prices and costs (% change)				
RPI	2.7	2.4	2.0	1.5
Overall HICP	2.5	3.2	2.2	1.7
HICP excluding energy	1.8	3.1	2.4	2.0
Compensation per employee	0.5	2.4	1.7	2.4
ULC	1.5	3.7	1.5	2.0
Public finances (% of GDP)(4)				
General government balance	-2.7	-2.7	-2.6	-2.6
General government debt	70.3	72.1	72.5	72.9
Technical assumptions				
EUR/USD exchange rate	1.392	1.286	1.346	1.348
Oil price (USD per barrel)	111.0	111.9	114.1	106.8

(1) Data on GDP were sourced from NSO *News Release 049/2013* published on 11 March 2013. Data on the current account balance were sourced from NSO *News Release 055/2013*.
(2) Central Bank of Malta projections.
(3) The contributions to GDP growth in this Table are estimated using GDP expenditure aggregates expressed in the previous year's prices. This approach yields different results from those reported elsewhere in this *Report*.
(4) Data for 2012 are Central Bank of Malta estimates.

1 The Bank's outlook for the Maltese economy is based on information available up to 15 March 2013 and is conditional on the technical assumptions included in Table 1.
2 See *Quarterly Review 2012:4*, pages 64-71.

The upward revisions to GDP growth in 2013 and 2014 are mainly prompted by the release of GDP and trade data covering the whole of 2012. These show that GDP growth in the second half of the year was better than in the first half, suggesting an incipient recovery going forward. More specifically, while the outcome for private consumption for the year as a whole was in line with previous expectations, private consumption growth picked up towards the end of the year. Furthermore, government consumption also increased more strongly than previously foreseen in 2012. This is expected to have a positive carry-over effect in the forecast horizon. At the same time, net exports are expected to contribute slightly more to the expansion in GDP compared with the previous exercise. Although both exports and imports are now projected to grow less rapidly than before, exports, which had been envisaged to grow slightly less than imports in 2013, are now expected to grow at broadly the same pace this year and at a slightly higher pace in 2014. The outlook for exports takes into account a slightly more positive assessment concerning the tourist sector in Malta, reflecting the solid performance recorded in 2012 and improved expectations concerning the semiconductors industry.

Final domestic demand expected to drive growth

In its latest exercise, the Bank expects growth in 2013 and 2014 to be driven by domestic demand, particularly private consumption, which should recover in the first year of the projection horizon and accelerate further in the second. Government consumption is also set to support the expansion over the forecast horizon, while investment is projected to boost activity in 2013. Net exports are foreseen to expand over the projection horizon, although at a more moderate pace compared with 2012.

After having dropped by 0.6% in 2012, private consumption is set to increase by 1.0% in 2013 and by 1.8% in 2014. The recovery is expected to be driven by a projected acceleration in real disposable income due to developments in taxes in 2013 and to stronger growth in employment income in 2014. Over the forecast horizon, private consumption should also benefit from a reduction in uncertainty about the orientation of domestic economic policies.

Government consumption is also expected to support the expansion in 2013 and 2014. However, its contribution is set to moderate relative to 2012 as expenditure restraint is assumed to continue in the context of the need, also under EU rules, for Malta to make progress towards the medium-term objective of a balanced budget. Moreover, the increase in government consumption in 2012 appears to be related to one-off factors that pushed up wage-related costs.

Following a sharp fall in 2011 and a further contraction in 2012, investment is expected to partially recover. The profile for gross fixed capital formation reflects the Bank's expectations about two specific projects. In particular, the Bank expects the Valletta City Gate project to carry over into 2013, while capital expenditure related to the electricity connection between Malta and Sicily is assumed to peak during the year. The remaining components of private investment are on aggregate set to contract slightly in 2013, reflecting continued weakness in the construction sector that offsets the impact of an underlying recovery in investment on machinery & equipment and in IT-related spending. In 2014 investment is set to contract slightly, owing to the envisaged completion of the Valletta City Gate project in 2013, and to lower expenditure in the energy sector. Moreover, real government investment rose strongly in 2012, when a critical mass of infrastructure projects was under way, but is foreseen to grow more moderately in 2013 and again in 2014.

Export growth is set to moderate in 2013, as merchandise exports, which rose significantly a year earlier, grow more slowly. The projection for 2013 also takes into account available projections for private consumption and real GDP growth in Malta's main trading partners, which point to subdued growth in non-travel exports. In 2014, however, overall export growth should accelerate as prospects in Malta's main trading partners improve.

Imports are also set to decelerate in 2013. Although the recovery in private consumption and private investment are expected to support imports of consumer and capital goods, the projected deceleration in exports limits the pace of expansion of other import categories. The profile for 2013 is also influenced by a negative base effect in merchandise imports, which increased exceptionally strongly in the second quarter of 2012. In 2014 import growth is expected to pick up, in line with the anticipated recovery in domestic demand and exports.

Current account set to remain in surplus

The surplus on the goods and services balance is expected to increase in 2013, mainly reflecting growth in travel receipts and a small improvement in the terms of trade.[3] In 2014 the trade balance is expected to widen slightly, though it would stabilise as a share of GDP, as nominal imports and exports are expected to grow at broadly similar rates. The effect of lower imports of capital goods, in line with the projected drop in investment, is counterbalanced by higher imports of other goods and services driven by the acceleration in demand.

Having moved into surplus in 2012, the current account balance is expected to increase further in 2013 as the trade balance improves. The current account surplus is set to narrow slightly in 2014, mainly owing to higher net outflows on the income account.

Wage and employment growth expected to moderate up to 2013

Following relatively strong growth in ULCs observed in 2012, which arose as both employment and average employee compensation outpaced real GDP growth, firms are expected to take a more cautious attitude towards recruitment in 2013 and 2014. Moreover, the number of employees in the general government sector is expected to be stable in 2013 and drop slightly in 2014. As a result, overall employment growth is expected to moderate in 2013, before edging up marginally in 2014. In turn, the unemployment rate is expected to increase slightly, from 6.5% in 2012 to 6.6% in 2013 and 2014.[4]

Productivity is set to pick up slightly in 2013, and to increase further in 2014. This reflects stronger growth in activity than in employment. After the relatively rapid rise in 2012, nominal compensation per employee is set to moderate in 2013, but should recover in 2014 in response to the improvement in productivity foreseen over the projection horizon.

ULC growth is expected to ease in 2013, mainly owing to the projected easing in wage growth that year. However, it is set to accelerate again in 2014, as the recovery in productivity is expected to be weaker than the rise in compensation per employee.

Inflation

The average year-on-year growth in HICP inflation rose to 3.2% in 2012 from 2.5% in the previous year. A key contributor to this acceleration was inflation in accommodation prices, which rose from 0.4% in 2011 to 7.3% in 2012. Further price increases in food and non-energy industrial goods also contributed, although to a lesser extent.

The projections for inflation in 2013 and 2014 are driven by technical assumptions, which include particularly favourable expectations on exchange rate developments, as well as a declining price for

[3] Data on the trade balance used in this report are consistent with NSO *News Release 049/2013* and the projections for real exports and imports reported in Table 1. The current account projections are based on balance of payments data published in NSO *News Release 055/2013*.

[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 the LFS and national accounts data. For this reason, references to the unemployment rate in this write-up may differ from those mentioned elsewhere in this *Report*.

Brent crude oil. In 2013 inflation is projected to moderate to 2.2%, driven by lower inflation in service prices and, to a lesser extent, in energy and food prices. The projections assume unchanged utility tariffs throughout the forecast horizon. In 2014 inflation is anticipated to drop further to 1.7%, as lower import prices are expected to result in an easing of inflationary pressures in non-energy industrial goods and food. Energy prices are expected to fall slightly, on the assumption that crude oil prices will be lower.

Fiscal deficit to narrow slightly in 2013, stable in 2014[5]

The Bank estimated the general government deficit-to-GDP ratio to have remained unchanged at 2.7% in 2012, but this is expected to narrow slightly to 2.6% in 2013 and 2014.

The foreseen improvement in 2013 is partly driven by restrained growth in selected items of current expenditure, particularly the compensation of employees and retirement pensions. The latter reflects the impact of the pension reform, as the retirement age for certain cohorts is postponed. The general government debt-to-GDP ratio is expected to increase over the projection horizon. Partly as a result of increased borrowing associated with EU commitments to extend financial support to euro area countries experiencing financing problems, the debt ratio is estimated to have risen from 70.3% in 2011 to 72.1% in 2012. Thereafter, it is set to increase further, though at a slower pace, to end the projection horizon at 72.9%.

Risks to the projections

The projections have been prepared against a backdrop of high uncertainty in the international economic and financial environment, particularly where the euro area is concerned.

On balance, risks to the GDP projections remain broadly balanced. The fragile situation in the euro area and the possibility that demand in Malta's main trading partners turns out to be weaker than expected remains a negative risk, which would weigh on external demand. On the other hand, export growth may accelerate if the ongoing expansion of the business and financial service sectors is maintained and extended into new export markets. A weaker than expected exchange rate would also have a favourable impact on exports. In addition, the incoming Government's policies for the energy sector would imply some upside risks to investment, though the resultant impact on GDP would be offset to some extent by increased imports.

Risks to the inflation projections are judged to be slightly on the downside, driven by the possibility of a reduction in utility tariffs.

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[5] These fiscal projections may differ from forecasts prepared by other institutions, partly owing to differences in the underlying macroeconomic projections and partly because they incorporate an independent assessment of revenue and expenditure by the Bank.