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ECONOMIC PROJECTIONS FOR 2013 AND 2014

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ECONOMIC PROJECTIONS FOR 2013 AND 2014

Outlook for the Maltese economy[1]

According to the Bank's latest projections for the Maltese economy, the growth rate in 2013 should gain momentum after the slowdown recorded in 2012. The forecast for real gross domestic product (GDP) growth in 2013 is unchanged from the Bank's previous exercise, which was presented in the *Annual Report 2012*, but is slightly higher for 2014.[2]

Thus, real GDP growth is expected to accelerate from 0.8% in 2012 to 1.4% in 2013 and to 1.9% in 2014 (see Table 7.1).

Table 7.1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA

	2012 (1)	2013 (2)	2014 (2)
Real economic activity (% change)			
GDP	0.8	1.4	1.9
Private consumption expenditure	-0.6	1.0	2.1
Government consumption expenditure	5.5	1.0	0.7
Gross fixed capital formation	-2.5	3.2	7.0
Inventories (% of GDP)	-2.2	-2.1	-1.9
Exports of goods & services	5.2	1.8	2.7
Imports of goods & services	4.4	1.8	3.6
Contribution to real GDP growth (in percentage pts)(3)			
Final domestic demand	0.4	1.3	2.5
Net exports	1.0	0.1	-0.6
Changes in inventories	-0.6	0.0	0.0
Balance of payments (% of GDP)			
Goods and services balance	5.8	6.1	5.9
Current account balance	0.4	0.6	-0.6
Labour market (% change)			
Total employment	2.1	1.4	1.4
Unemployment rate (% of labour force)	6.5	6.5	6.4
Prices and costs (% change)			
RPI	2.4	1.7	1.3
Overall HICP	3.2	1.4	1.4
HICP excluding energy	3.1	1.6	2.2
Compensation per employee	2.4	1.4	2.4
ULC	3.7	1.4	1.9
Technical assumptions			
EUR/USD exchange rate	1.285	1.311	1.308
Oil price (USD per barrel)	112.0	105.5	100.0

(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 *Review*.

[1] The Bank's outlook for the Maltese economy is based on information available up to 21 May 2013 and is conditional on the technical assumptions included in Table 1.
[2] See *Annual Report 2012*, pp. 63-66.

Domestic demand drives economic growth over the projection horizon

The Bank expects growth over the projection horizon to be driven by domestic demand, particularly private consumption, which should recover this year and pick up further in 2014. Government consumption is also set to support the expansion over the forecast horizon. Meanwhile, investment is projected to boost overall activity in 2013 and, particularly, in 2014, as expenditure on the construction of a new gas-fired plant and liquid gas facilities gathers pace.

Net exports are expected to expand in 2013, but should do so at a more moderate pace than in 2012. In 2014, however, they are set to drop, with their contribution to GDP growth turning negative under the impact of higher imports related to the projected increase in domestic demand, notably investment.

After having dropped by 0.6% in 2012, private consumption is set to grow by 1.0% in 2013 and by 2.1% in 2014. The recovery is expected to be driven by growth in real disposable income, partly under the impact of the gradual reduction in the income tax rate paid by households in selected income tax bands. The holding of general elections and the subsequent approval of the Budget 2013 earlier this year should provide further stimulus to private consumption in the near term.

Government consumption is also expected to increase in 2013 and 2014. However, its contribution to growth is set to moderate relative to 2012 as expenditure restraint is assumed to continue in the context of the stated policy objective to bring the fiscal deficit-to-GDP ratio to below 3.0%. Moreover, part of the rise in government consumption in 2012 reflected one-off increases in the wage bill following the conclusion of a number of collective agreements in the general government sector during the year. The importance of this element is expected to lessen over the forecast horizon.

After having contracted in 2012, investment (gross fixed capital formation) is expected to recover in 2013 and to increase more strongly in the following year. The Bank's projections take into account the launch, earlier this year, of a major project in the energy sector, which entails the construction of new gas storage facilities, a new gas-fired plant and the eventual conversion of existing power facilities to run on gas. With this project assumed to begin late in 2013, its impact also largely explains why the contribution of domestic demand to GDP growth in 2014 is higher than in the projections presented in the *Annual Report 2012*.

The profile for investment also continues to be shaped by the Bank's expectations about two other specific projects. In particular, the Bank expects the Valletta City Gate project to be completed in 2013, whereas capital expenditure related to the electricity connection between Malta and Sicily is assumed to peak during the year. In contrast, investment in dwellings is expected to remain weak, while investment on machinery & equipment, after excluding the specific projects mentioned above, is set to contract further. IT-related spending also supports overall investment in 2013, reflecting the continued expansion of the services sector.

In 2014 investment is set to grow strongly, mainly because of the new initiatives in the energy sector, but also in view of the Bank's expectation of a gradual recovery in underlying investment in equipment & machinery and in construction.

Export growth is set to moderate in 2013. Merchandise exports, which rose significantly a year earlier, and exports of non-travel services are projected to expand more slowly this year in the context of subdued growth in foreign demand. Inbound tourism is set to provide continued support to total exports, partly on account of an increase in the number of airline routes serving the country and continuing instability in a number of competing destinations. In 2014, however, overall export growth should accelerate in line with the expected improvement in the economies of Malta's main trading partners.

Imports too are set to decelerate in 2013. Although the recovery in private consumption is expected to support imports of consumer goods, the projected deceleration in exports dampens the expansion of other import categories. In 2014 import growth is expected to pick up in line with the anticipated recovery in both domestic demand and exports. The profile for investment in the energy sector also has a specific bearing on imports that year.

Current account set to remain in surplus in 2013, then swing to deficit in 2014

The trade surplus is expected to widen in 2013, reflecting developments on the services account. In particular, services exports are set to expand more strongly than imports of services, offsetting a small deterioration in the balance of trade in goods.[3] In 2014 the trade balance is expected to narrow as nominal imports respond to the recovery in aggregate demand.

Having moved into surplus in 2012, the current account balance is expected to improve further as a share of GDP in 2013, as the positive trade balance widens and net outflows on the income account, which were relatively large in 2012, diminish. The current account, however, is set to swing into deficit in 2014, reflecting the narrowing of the trade surplus along with higher net outflows on the income account.

Wage and employment growth expected to moderate in 2013

Following relatively strong growth in unit labour costs (ULC) observed in 2012, which arose as nominal compensation per employee increased whereas productivity fell, firms are expected to utilise more fully any current overemployment before additional hiring. Moreover, the number of employees in the general government sector is expected to be stable in 2013 and then to drop slightly in 2014. As a result, overall employment growth is projected to moderate in 2013, and then to remain stable in 2014.

The unemployment rate is expected to remain unchanged at 6.5% in 2013, and to ease slightly to 6.4% in the following year.[4]

ULC growth is expected to ease in 2013, owing to the projected moderation in nominal compensation per employee, after the relatively strong increase in 2012. Nominal compensation per employee is set to recover in 2014 in response to an improvement in productivity. The latter is set to stabilise in 2013 and to begin to grow again in 2014, when activity starts to outpace employment. However, since the recovery in productivity is set to be weaker than the rise in compensation per employee, ULC is foreseen to increase again in 2014.

Inflation

Following a strong increase in 2012, which was largely driven by movements in accommodation prices and, to a lesser extent, food prices and prices of non-energy industrial goods, the inflation

[3] Data on the trade balance used in this Box 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 Labour Force Survey (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 Box may differ from those mentioned elsewhere in this *Review*.

rate based on the Harmonised Index of Consumer Prices is set to moderate to 1.4% in 2013 and to remain at that level in 2014.

The projections for inflation for 2013 and 2014 are driven by technical assumptions, particularly the declining price of Brent crude oil. In 2013, moreover, tourist accommodation prices are set to moderate sharply following the very strong increase last year. These factors, and the impact of falling oil prices on transport costs, should lead to an easing in energy and service inflation in 2013.

The projection for inflation in 2014 assumes a drop in electricity and water tariffs that year, in line with the Government's commitments. This further drop in energy prices would offset a pick-up in the price of services.

Fiscal deficit is expected to narrow slightly[5]

The general government deficit-to-GDP ratio widened to 3.3%, from 2.8% in 2011. It is expected to narrow to close to 3.0% in both 2013 and 2014, as revenue is projected to grow slightly faster than expenditure.

The recovery of VAT arrears, growth in corporate tax revenue and Budget 2013 increase in excise duties contribute to revenue growth over the projection horizon. However, the impact of these factors is in part offset by the absence of one-off items that pushed up revenue in 2012 and by the revisions to income tax bands announced in the Budget.

At the same time, the fiscal projections assume restrained growth in selected items of current expenditure, particularly intermediate consumption and compensation of employees. Expenditure on pensions is also set to grow moderately in 2013, as the pension reform postpones retirement of certain cohorts to 2014. Growth in compensation of employees is expected to slow down this year, after having been boosted by the signing of a number of collective wage agreements in 2012. It should slow further in 2014 on the assumption that retiring employees in the government sector are not fully replaced. Intermediate consumption embeds an element of restraint, in line with the Government's commitment to contain recurrent expenditure.

The general government debt-to-GDP ratio is expected to increase over the projection horizon, reaching close to 74% in 2014.

Risks to the projections

Risks to the GDP projections are 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 key negative risk which would weigh on output. The possibility of additional fiscal consolidation measures represents another downside risk to economic activity. 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.

Risks to the inflation projections are judged to be broadly balanced. A weaker euro than expected would increase domestic prices of imports. On the other hand, weakness in the euro area would imply additional downward pressures on foreign prices, including commodity prices.

[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.