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CENTRAL BANK OF MALTA

ECONOMIC PROJECTIONS FOR 2012 AND 2013

Report published in the Quarterly Review 2012:2

ECONOMIC PROJECTIONS FOR 2012 AND 2013

Outlook for the Maltese economy[1]

The Bank is presenting its latest macroeconomic projections which cover 2012 and 2013. These indicate that, after having slowed down in 2011, real gross domestic product (GDP) growth is expected to moderate further this year before recovering in 2013.

The projections' profile is broadly similar to that published in the *Annual Report 2011*, although the Bank now foresees a sharper slowdown in 2012 and a stronger pick-up in the following year.[2] In its latest exercise, the Bank is projecting real GDP growth to slow down to 1.4% this year, before picking up to 2.2% in 2013 (see Table 7.1). This compares with growth rates of 1.6% and 2.0%, respectively, in the previous round.

Since the finalisation of the *Annual Report 2011*, the intensification of the sovereign debt crisis in the euro area and its expected impact on business and consumer behaviour prompted a downward revision in the projections for private consumption and, in 2012, investment. With regard to investment, the downward revision mainly reflects a reassessment of the outlook for the private sector. The renewed uncertainty regarding the strength of external demand prospects is reflected in a downward revision in the growth rate of exports in 2013.

Final domestic demand expected to drive growth

In both 2012 and 2013, growth in economic activity is expected to be largely driven by final domestic demand, with private consumption being the main engine of growth in 2012 and private consumption and gross fixed capital formation having a broadly equal contribution to economic growth in the following year. With exports rising slightly faster than imports, net exports are foreseen to contribute modestly to GDP growth in both years.

Following a strong recovery in 2011, private consumption is expected to slow down in 2012, driven by a deceleration in disposable income, which is expected to have a negative effect on purchasing power. Private consumption is set to recover slightly in 2013, as economic activity gradually picks up.

Following the significant increase in 2011, public consumption is set to slow down over the projection horizon, in line with the Government's commitment to reduce the fiscal deficit. The Bank's projections assume that the expenditure restraint implied by the recurrent expenditure cuts announced in January 2012 will be maintained throughout the projection horizon. In particular, the Bank's projections assume a deceleration in intermediate consumption, average wage growth to remain moderate and employment to gradually decline through a partial replacement of retiring public sector staff.

Gross fixed capital formation is expected to recover from the sharp contraction recorded in 2011. In 2012 and, to a lesser extent, in 2013 investment is set to be bolstered by capital projects expected to be undertaken by Enemalta and by spending on the City Gate Project in Valletta.

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1 The Bank's outlook for the Maltese economy in 2012 and 2013 is based on information available up to 24 May 2012 and is conditional on technical assumptions indicated in Table 7.1. The projections did not take into account the GDP data for Malta that were published on 8 June 2012.

2 See *Annual Report 2011,* Box 2: Economic Projections for 2012 and 2013, pages 58-61.

Table 7.1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA

	2011[1]	2012[2]	2013[2]
Real economic activity (% change)			
GDP	2.1	1.4	2.2
Private consumption expenditure	3.1	1.0	1.3
Government consumption expenditure	3.9	1.0	0.7
Gross fixed capital formation	-13.4	3.3	6.5
Inventories (% of GDP)	-2.6	-2.6	-2.4
Exports of goods & services	1.0	1.5	3.1
Imports of goods & services	-1.0	1.4	3.1
Contribution to real GDP growth (in percentage pts)			
Final domestic demand	0.8	1.2	1.8
Net exports	2.2	0.2	0.2
Changes in inventories	-0.9	0.0	0.1
Balance of payments (% of GDP)			
Goods and services balance	4.9	5.2	5.6
Current account balance	-3.2	-2.8	-2.3
Labour market (% change)			
Total employment	2.4	0.9	1.1
Unemployment rate (% of labour supply)	6.4	6.5	6.4
Prices and costs (% change)			
Overall HICP	2.5	2.7	1.9
HICP excluding energy	1.8	2.6	2.1
Compensation per employee	0.4	1.2	2.1
ULC	0.8	0.7	1.0
Public finances (% of GDP)			
General government balance	-2.7	-2.2	-2.5
Government debt	72.0	72.6	71.9
Technical assumptions			
EUR/US$ exchange rate	1.392	1.304	1.300
Oil price (US$ per barrel)	111.0	114.6	107.9
10-year euro area bond yield (%)	4.3	4.2	4.5

[1] Data on GDP were sourced from NSO News Release 049/2012 published on 9 March 2012.
[2] Central Bank of Malta projections.

However, in 2012 capital expenditure on these two projects is expected to be partly offset by an underlying contraction in spending on equipment and more moderate underlying growth in expenditure on the construction of commercial property. At the same time, residential construction is expected to contract moderately in the context of a weak property market. The further acceleration in gross fixed capital formation in 2013 reflects a gradual recovery across its different components, as business sentiment is foreseen to improve.

Exports are projected to grow slowly in 2012, reflecting the impact of weak foreign demand on the manufacturing and tourism sectors. In 2013 exports are expected to expand more strongly as external demand responds to a recovery in key economies.

After having declined in 2011, imports are set to register moderate growth in 2012, mainly underpinned by purchases of fuel for re-export and services. Imports of capital goods are also expected to increase in response to higher gross fixed capital formation. In contrast, the deceleration in private and government consumption is expected to dampen imports of consumer goods, while the projected weakness in manufacturing exports is reflected in an expected drop in imports of industrial goods. In 2013, import growth is set to recover further in line with the foreseen acceleration in private consumption, investment and merchandise exports.

Wages and employment expected to grow mildly

The slowdown in economic activity in 2012 is expected to lead to a deceleration in employment growth, but this should accelerate in the following year. The private sector is projected to account for all job creation during the projection horizon, as the Government continues to implement a policy of employment restraint. The unemployment rate is expected to rise slightly in 2012, to 6.5%, before easing back towards its 2011 level in the second year of the projection horizon.[3]

Growth in compensation per employee is envisaged to recover gradually over the projection period. Nonetheless, it should remain moderate due to the prevailing uncertainty characterising the business outlook and generally soft conditions in the labour market. Unit labour costs (ULCs) are expected to decelerate slightly in 2012, as productivity levels increase. With wage awards outpacing productivity gains in 2013, this tendency is projected to be reversed.

Inflation temporarily accelerates but eases in 2013

After reaching an average of 2.5% in 2011, year-on-year Harmonised Index of Consumer Price (HICP) inflation is projected to rise to 2.7% in 2012, before falling to 1.9% in 2013. These forecasts imply an upward revision of 0.8 and 0.3 percentage point, respectively, compared with those published in the *Annual Report*. The upward revision reflects more recent developments in Malta's HICP data. The projections also take into account the Bank's assumptions about movements in international oil prices and exchange rates. They also reflect its expectation that water and electricity tariffs will remain unchanged over the forecast period.

In 2012 inflation excluding energy is projected to rise to 2.6% from 1.8% in 2011, as a result of faster growth in prices of services. In contrast, energy price inflation is expected to moderate to 4.3% in line with the deceleration in international oil prices.

In 2013 HICP inflation is expected to ease to 1.9%, as food price inflation is set to moderate and energy prices are projected to decline. The annual rate of change in service prices is expected to edge down marginally. In contrast, the weakness of the euro is anticipated to contribute to a pick-up in non-energy goods inflation. As a result, HICP excluding energy inflation should fall to 2.1%.

Trade surplus contributes to a narrowing of the current account deficit

The surplus on the goods and services account is expected to increase as a percentage of GDP in 2012, mainly as a result of improvement in the goods balance. In particular, in nominal terms, goods exports are expected to increase more rapidly than imports, in line with the foreseen weakening of domestic consumption.

[3] The unemployment rate for this projection exercise is computed as the ratio of the number of unemployed obtained from the Labour Force Survey (LFS) to a measure of the labour force based on the LFS and National Accounts information. For this reason, the unemployment rate presented in this Chapter may differ from that presented elsewhere in this *Review*.

In 2013 a further improvement is anticipated, reflecting a more broad based acceleration across the various export categories, especially services, as foreign demand picks up in response to a healthier global economic environment. This acceleration is expected to outweigh the positive impact on imports of stronger projected growth in domestic demand.

As current transfers and the income account are expected to continue to record sizeable net outflows, the current account balance is forecast to remain in deficit throughout the projection horizon. The improvement in the trade balance, however, should contribute to a progressive narrowing of the current account deficit, which is set to decline to 2.3% of GDP by 2013.

Fiscal consolidation continues in 2012

The general government deficit in 2011 narrowed to 2.7% of GDP and is expected to decrease further in 2012, as revenue continues to outpace expenditure. Revenue growth in the first year of the projection horizon partly reflects one-off receipts in relation to amnesty schemes and the granting of a concession to operate the National Lotteries, while fiscal consolidation measures announced in January 2012 account for the projected restraint in government expenditure. The deficit is expected to widen again in 2013, as the impact of one-off receipts fades away and capital transfers to Air Malta, the national airline, double. These factors outweigh the effect of the continued restraint in recurrent expenditure and of the pension reform, which implies an increase in the retirement age in 2013 and, consequently, slower growth in pension spending.

The general government debt, expressed as a share of GDP, is projected to rise in 2012 before edging down in 2013. The forecast in this regard is affected by additional borrowing connected with financial support to euro area countries with a European Union/International Monetary Fund programme, which is expected to peak in 2012.

Risks to the projections

It should be noted that the Bank's projections were prepared against a backdrop of a highly uncertain international economic and financial environment, particularly with regard to the future of the euro area. It cannot be excluded, therefore, that this outlook would be overtaken by events.

This notwithstanding, risks to the GDP projections are on balance tilted to the downside, particularly for 2012. The main negative risk to the projections for this year is the debt crisis in the euro area that would impact on Malta's external environment. While the diversification of the Maltese economy has underpinned a high degree of resilience in recent years, the economic situation in the euro area could deteriorate by more than expected. In such a scenario, exports would be weaker than implied in the baseline. Private investment may also be weaker than expected if export-oriented firms do not anticipate an improvement in business prospects. Furthermore, investment may be subject to risks if the major projects mentioned above were to encounter delays in implementation, although in such a case the related decline in imports would, to some extent, offset the negative impact on GDP growth. Additionally, should the fiscal stance turn out to be tighter than expected, this would entail some downside risks for domestic demand.

On the other hand, upside risks to growth could also emanate from a decisive resolution of the euro area sovereign debt crisis. This could lead to an improvement in business and consumer sentiment and to a stronger rebound in external demand, thus boosting Malta's exports. Similarly, a further weakening of the euro could boost Malta's exports to non-euro area trading partners with upside risks for GDP growth.

With regard to inflation, risks are judged to be tilted slightly to the upside. A key factor in this regard relates to water and electricity tariffs. Inflationary pressures could also emerge as a result of higher than expected wage increases awarded to the civil service in terms of the new collective agreement currently under negotiation. These could precipitate broader increases in labour costs and consumer prices. On the other hand, if economic activity in the euro area remains weak for a prolonged period of time, imported inflation and domestic price pressures could be dampened.