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CENTRAL BANK OF MALTA

Economic Projections for 2014 and 2015

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ECONOMIC PROJECTIONS FOR 2014 AND 2015

Outlook for the Maltese economy[1]

The Bank's latest economic projections indicate that, following a strong acceleration in GDP growth in 2013, the pace of expansion is set to remain sustained in 2014 and 2015. Compared with the Bank's previous projection exercise, which was concluded in November 2013, the latest exercise foresees higher growth.[2] Thus, real GDP growth is set to ease marginally from 2.4% in 2013 to 2.3% in 2014, but should rise again to 2.5% by 2015 (see Table 1).

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA

	2012 (1)	2013 (1)	2014 (2)	2015 (2)
Real economic activity (% change)				
GDP	0.6	2.4	2.3	2.5
Private consumption expenditure	-0.2	1.8	2.2	2.4
Government consumption expenditure	5.4	-0.2	0.5	0.2
Gross fixed capital formation	-2.0	-3.8	7.9	5.4
Inventories (% of GDP)	-1.5	0.9	0.9	0.8
Exports of goods & services	8.6	-5.6	1.9	3.2
Imports of goods & services	6.2	-5.2	2.1	3.1
Contribution to real GDP growth (in percentage pts)(3)				
Final domestic demand	0.7	0.4	2.5	2.3
Net exports	2.6	-0.7	-0.1	0.2
Changes in inventories	-2.6	2.6	-0.1	-0.1
Real disposable household income(4)	1.6	3.8	2.1	2.0
Household saving ratio(4)	6.8	8.7	8.7	8.5
Balance of payments (% of GDP)				
Goods and services balance	6.0	5.6	4.6	4.8
Current account balance	2.0	1.4	0.2	0.5
Labour market (% change)				
Total employment	2.5	3.1	1.3	1.7
Unemployment rate (% of labour force)(5)	6.4	6.6	6.6	6.3
Prices and costs (% change)				
RPI	2.4	1.4	1.7	1.7
Overall HICP	3.2	1.0	1.6	1.9
HICP excluding energy	3.1	1.1	2.4	2.3
Compensation per employee	2.1	0.6	2.0	2.0
ULC	4.0	1.3	1.0	1.2
Public finances (% of GDP)(5)				
General government balance	-3.2	-2.9	-2.9	-2.7
General government debt	70.8	71.3	71.8	70.7
Technical assumptions				
EUR/USD exchange rate	1.29	1.33	1.36	1.36
Oil price (USD per barrel)	112.0	108.8	105.8	101.1

(1) Data on GDP were sourced from NSO *News Release* 047/2014 published on 11 March 2014. Data on the current account balance were sourced from NSO *News Release* 053/2014.
(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 and 2013 are Central Bank of Malta estimates.
(5) Data for 2013 are Central Bank of Malta estimates.

1 The Bank's outlook for the Maltese economy is based on information available up to 14 March 2014 and is conditional on the technical assumptions shown in Table 1.
2 See *Quarterly Review 2013:3*, Central Bank of Malta, pp. 86-89.

The upward revision to GDP growth in 2014 is mainly prompted by the release of GDP data covering the whole of 2013, which show that private consumption recovered much more strongly than had been anticipated in the previous projection exercise. This has a positive effect on private consumption over the forecast horizon. Moreover, compared with the previous exercise, net exports are set to make a smaller negative contribution to GDP growth in 2014. Both the November exercise and the latest exercise incorporate a decline in net exports in 2014. However, in the latest exercise, it is milder, reflecting the fact that import growth has been revised downward more strongly than export growth. This pattern of revisions reflects the outcome for 2013, which shows exports falling faster than imports, and much more strongly than had been foreseen last November. The Bank expects that in 2014 this development, which largely reflects outcomes in trade in goods, begins to be reversed.

Final domestic demand

In the current exercise, the Bank expects growth in 2014 and 2015 to be driven by domestic demand, particularly private consumption and private investment, with the latter supported by specific large projects in energy and construction. In contrast, government consumption and government investment are expected to contribute only mildly to the expansion in 2014 and to have a broadly neutral effect in the following year. Changes in inventories (which include the statistical discrepancy) are assumed to remain broadly constant as a proportion of GDP, until 2015.

After having declined by 0.2% in 2012, private consumption expanded by 1.8% in 2013. While stronger than anticipated in the Bank's November 2013 projection exercise, growth in private consumption in 2013 was still below the rise in disposable income as estimated by the Bank, leading to an increase in household savings. The Bank expects that some of these savings will be spent in 2014 and 2015. Moreover, given the expectation of additional growth in employment, disposable income will continue to rise in 2014 and 2015. Consequently, private consumption is foreseen to accelerate, growing by 2.2% in 2014 and 2.4% in 2015.

Following a 0.2% drop in 2013, government consumption is set to increase by 0.5% in 2014 and by 0.2% in 2015. These relatively modest growth rates reflect the view that Government is likely to tighten its recurrent expenditure as it seeks to correct the excessive deficit. Moreover, growth in this component, which is largely composed of intermediate consumption and salaries paid to government employees, is set to be partly offset by expected intakes from the Individual Investor Programme.[3]

Investment is set to partially recover from the decline sustained in the last three years, growing by 7.9% in 2014. Overall investment growth is set to decelerate to 5.4% in the following year. This deceleration reflects the outlook for both private and government investment.

After contracting for the third year in sequence, private investment is set to expand by 8.7% in 2014. A further 6.4% expansion is envisaged in 2015. These projections continue to be shaped by the Bank's expectations about progress in relation to the new gas energy facilities, where investment is targeted to begin in 2014 and expected to continue in 2015. Moreover, as in the previous exercise, expenditure on the electricity interconnector between Malta and Sicily is set to diminish progressively over the forecast horizon, while the Valletta City Gate project should be completed in 2014. The remaining categories of private investment are set to increase moderately in 2014 overall, supported by a number of non-residential construction projects that began towards the end of 2013, ongoing growth in investment in IT and a slight underlying increase in investment in machinery. Private investment, excluding the above-mentioned large projects, is expected to pick up more strongly in 2015.

[3] Intakes from the Individual Investor Programme are expected to be classified as receipts from sales of government output, which offset government consumption expenditure.

Government investment is set to expand by 4.4% in 2014 after dropping sharply in 2013, reflecting the Bank's assessment that some outlays that did not materialise in 2013 will be carried forward to 2014, in order to utilise EU funds that were forthcoming to Malta under the 2007-2013 EU Financial Programme. In 2015 government investment is set to expand at the slower rate of 1.1%, as the utilisation of funds under the 2014-2020 financial programme is foreseen to be low initially and gather pace later.

Net exports

Net exports, which declined notably in 2013 after recording strong growth in 2012, are set to fall further in 2014, as imports outpace exports. They are projected to pick up again in 2015, while making a small positive contribution to overall GDP growth.

Exports are set to rise in 2014, after having fallen in 2013. The increase is projected to be driven by merchandise exports, particularly exports of semiconductors, which are expected to recover from an estimated fall in 2013 in response to a more positive international outlook for the electronics industry. Service exports are also set to expand following a small fall in 2013, largely supported by the continued solid performance of the tourist industry, which is expected to benefit from the opening of new airline routes. Overall export growth is set to accelerate in 2015, in line with an expected improvement in foreign demand.

In 2014 imports are also set to partially recover from the contraction recorded in 2013 mainly on account of the foreseen strengthening of private consumption demand, higher capital imports related to investment in the energy sector and increased imports of semi-finished supplies for the semiconductor industry. Imports are projected to rise at a faster pace in 2015, as export growth accelerates.

The balance of payments

The surplus on the goods and services balance is expected to narrow in 2014, but should increase in 2015.[4] The deterioration in the trade balance in 2014 is set to be driven by movements in the goods balance, in particular, the foreseen increase in capital imports. The trade surplus is set to increase in 2015, as exports outpace imports, but is estimated to remain below the relatively high levels recorded in 2013, at around 4.8% of GDP.

The current account balance is expected to remain in surplus over the forecast horizon. Nonetheless, the surplus is set to narrow slightly in 2014, in line with expected developments in the trade balance, and an expected deterioration in the income account. In 2015 the balance should improve, in line with the increase in the goods and services balance.

The labour market

In 2013 employment continued to outpace real GDP growth, implying a drop in productivity. Over the projection period, however, employment is set to expand at a reduced pace. In 2014 private firms are expected to take a more cautious attitude towards recruitment to restore productivity. Moreover, the number of employees in the general government sector, which is estimated to have increased sharply in 2013, is assumed to fall slightly. Employment growth is set to accelerate slightly in 2015, with total employment rising by 1.7%.

In 2013 compensation per employee increased slightly, going up by 0.6%. As a result, and given the decline in productivity, ULCs increased moderately, by 1.3%. In 2014 productivity growth is set to turn positive following three consecutive annual declines. The favourable effect of increased productivity on ULCs, however, is partly offset by faster growth in average wages. Consequently, in 2014 ULCs

[4] Data on the trade balance used in this Report are consistent with NSO *News Release* 047/2014 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* 053/2014.

are set to increase by 1.0%, slightly less than in the previous year. With GDP continuing to outpace employment, a further gain in productivity is foreseen in 2015. As in 2014, however, growth in nominal compensation per employee is set to be stronger than that in productivity. As a result, ULCs are expected to increase.

Following a small rise in 2013, the unemployment rate is set to stabilise at 6.6% in 2014, before easing to 6.3% in 2015.[5]

Fiscal position

The Bank estimates that the general government deficit-to-GDP ratio narrowed to 2.9% in 2013, from 3.2% in 2012. This narrowing is seen to have been driven by buoyant direct tax revenue (relative to GDP), receipts from sale of output and a drop in intermediate consumption, with the ongoing pension reform programme also assessed to have had an impact in limiting expenditure on social benefits.

The deficit ratio is expected to stabilise in 2014, before narrowing slightly to 2.7% in 2015.

In 2014 social benefits are set to rise more strongly compared with 2012 as employees who did not retire in 2013 as a result of the pension reform do so in 2014. This is counterbalanced by restraint in other expenditure categories, notably intermediate consumption and compensation of employees. The latter is assumed to moderate substantially following the exceptionally strong increase seen in 2013. The reduction in the deficit ratio in 2015 is also supported by inflows from the Individual Investor Programme announced in the 2014 Budget and direct taxes paid by corporations.

Inflation

The average year-on-year inflation rate, as measured by the HICP eased to 1.0% in 2013 from 3.2% in 2012. This deceleration was largely driven by service prices, which contracted by 0.2% after they had increased by 3.2% in 2012. However, food and non-energy industrial goods inflation also slowed down, while energy prices fell.

In 2014 HICP inflation is set to accelerate to 1.6%, mainly owing to an upswing in services price inflation, which is expected to turn positive after an extraordinary negative outturn in 2013. In particular, accommodation prices are expected to accelerate. Slightly faster growth in prices of food and non-energy industrial goods is also expected to push up inflation. These developments outweigh a decline in energy prices, the latter reflecting the planned reduction in electricity tariffs announced by Government. Inflation is then expected to accelerate further, to 1.9% in 2015, reflecting movements in the prices of non-energy industrial goods and a further pick-up in services price inflation, mainly due to developments in accommodation rates and prices charged by restaurants.

The inflation rate projections for 2014 and 2015 are dampened by technical assumptions, which include a decline in the US dollar, the price of oil and a stronger euro.

Risks to the projections

Risks to the GDP growth projections are slightly on the downside, reflecting the fragility of the global economic recovery. In particular, weaker than expected expansion in the euro area economy would weigh on external demand with negative implications for Malta's export growth. Investment could also be weaker than expected, if any of the major infrastructure projects under way encounter delays, and investment in construction takes longer to recover than envisaged. Risks to the inflation projections are also assessed on the downside and relate to weaker than expected price pressures in advanced economies and in the euro area, in particular.

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[5] 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*.