BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

Economic Projections

2018 - 2021

2019:1

Outlook for the Maltese economy

Economic projections

2018-2021

The Central Bank's latest projections foresee economic growth over the coming years to remain strong from a historical perspective. Projections to economic activity have been revised upwards for 2018 due to stronger than expected private consumption growth. Conversely, economic activity in 2019 was revised marginally down due to the envisaged weaker international outlook. During the projection horizon, growth will remain high, supported by both demand and supply factors. In particular, new investment projects and increased labour supply are expected to keep potential output elevated. Domestic demand, driven by higher consumption and investment, is anticipated to remain the primary driver supporting the economic expansion over the projection horizon. Net exports' contribution to growth is expected to turn negative from 2019, reflecting higher import growth.

The pace of job creation is set to moderate, but remain strong. The labour market is expected to remain tight, with the unemployment rate projected at 4.0% by 2021.

Annual inflation, based on the Harmonised Index of Consumer Prices (HICP), is projected to edge up to 2.1% by 2021, reflecting a pick-up in domestic wage pressures.

Government finances are expected to remain in surplus over the coming years, such that the debt-to-GDP ratio is projected to decline to below 40%.

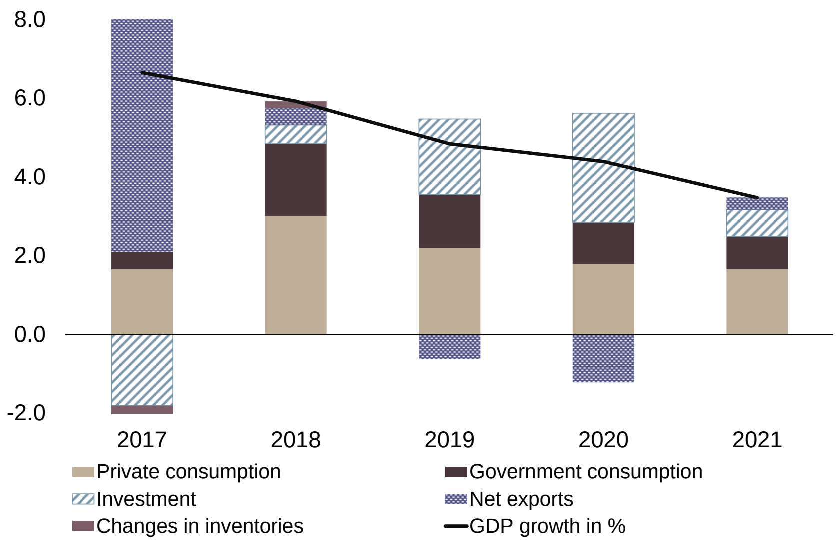
Looking ahead, the external environment has become less positive in recent quarters, which poses downside risks to projections of economic activity and inflation. Conversely the risks to public finances are to the upside (higher surpluses) due to possible slippages in the implementation of locally-financed investment projects.

1 Economic outlook

The Central Bank's latest economic projections foresee economic growth over the years 2018-2021 to remain strong from a historical perspective, though at more sustainable levels than the rate seen in 2017 (see Table 1).[1]

Compared with the Bank's previous projections, published in December, GDP growth is being revised upwards in 2018, and slightly downwards in 2019, but is otherwise unchanged. The upward revision in 2018 reflects primarily stronger than expected employment and private consumption growth. In addition, services exports also surprised on the upside, leading to an upward revision in the net export contribution. On the other hand, economic activity in 2019 is being revised slightly downwards due to the envisaged weakness in the international outlook. This led to a small downward revision to the net export contribution for this year. Growth is foreseen to ease from 5.9% in 2018 to 4.8% in 2019, 4.4% in 2020, and further to 3.5% in 2021.

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



Source: Central Bank of Malta

Domestic demand is foreseen to be the dominant driver of economic growth over the projection horizon, underpinned by all domestic demand components (see Chart 1). In the context of favourable labour market conditions, private consumption growth is envisaged to remain robust throughout the projection horizon. Government consumption is also expected to affect domestic demand growth significantly, aided by the expected increase in fiscal space. Investment growth is forecast to rise sharply in 2019 and 2020 due to the planned expenditure on infrastructure and health. On the other hand, net exports are seen as having contributed positively in 2018, but are set to dampen GDP growth in 2019 and 2020 due to

[1] The Bank's outlook for the Maltese economy is based on information available up to 31 January 2019.

Table 1: Projections for the main macroeconomic aggregates for Malta[1]

	2017[2]	2018	2019	2020	2021
Real economic activity (% change)					
GDP	6.7	5.9	4.8	4.4	3.5
Private consumption expenditure	3.6	6.8	4.9	4.1	3.8
Government consumption expenditure	2.8	11.9	8.3	6.2	4.8
Gross fixed capital formation	-7.7	2.4	9.6	13.2	3.0
Exports of goods and services	5.3	1.9	2.7	2.9	3.0
Imports of goods and services	-0.1	1.8	3.7	4.4	3.1
Contribution to real GDP growth (in percentage pts)					
Final domestic demand	0.3	5.3	5.5	5.6	3.5
Net exports	8.2	0.4	-0.6	-1.2	0.3
Changes in inventories	-1.8	0.2	0.0	0.0	0.0
Real disposable household income[3]	4.9	5.4	4.5	3.5	3.6
Household saving ratio[3]	19.7	18.6	18.3	17.8	17.7
Balance of payments (% of GDP)					
Goods and services balance	20.9	20.2	18.7	16.8	16.6
Current account balance	10.4	10.2	9.2	8.0	7.9
Labour market (% change)[4]					
Total employment	5.3	5.3	4.1	3.4	2.9
Unemployment rate (% of labour supply)	4.0	3.7	3.8	3.9	4.0
Prices and costs (% change)					
GDP deflator	2.4	2.1	2.2	2.1	2.1
RPI	1.4	1.2[2]	1.7	1.8	2.0
Overall HICP	1.3	1.7[2]	1.9	2.0	2.1
HICP excluding energy	1.3	1.8[2]	1.9	2.1	2.3
Compensation per employee	1.8	2.2	2.8	3.3	3.5
ULC	0.6	1.6	2.2	2.3	3.0
Business cycle					
Potential output (% change)	6.9	5.6	5.0	4.5	4.0
Output gap (% of GDP)	0.4	0.7	0.6	0.5	0.0

[1] Data on GDP were sourced from NSO News Release 193/2018 published on 6 December 2018, while data for prices were sourced from NSO News Release 007/2019 and 010/2019 (released on 17 and 23 of January 2019).
[2] Actual data.
[3] Central Bank of Malta estimates.
[4] Employment data are consistent with the national accounts. The unemployment rate is based on the number of unemployed and employed as reported in the Labour Force Survey.

the expected recovery in import shares and the pick-up in capital-intensive investment growth. The net export contribution is projected to then contribute positively in 2021, as some investment projects are expected to reach completion by 2020 and investment in the aviation sector normalises after a period of rapid expansion.

The robust growth on the demand side should be supported by the supply side of the economy, reflecting continued increase in the labour supply due to net migrant flows, and efficiency gains. GDP growth is expected to have remained above potential until 2018. Thereafter, potential output is projected to grow in line or above real GDP. As a result a small positive output gap is set to persist until 2020, before closing in 2021.

Looking at the expenditure components in more detail, private consumption growth is assessed to have accelerated in 2018 reflecting continued support from growth in labour income. It is projected to remain dynamic over the following three years but ease when compared with 2018. The profile of private consumption mirrors the very large accumulation of savings in recent years and the projected development of real disposable income. The latter is set to accelerate this year, as a pick-up in wage growth should offset a slight deceleration in employment. In line with the expected easing of economic activity, real disposable income is then set to decelerate over the following three years, but remain strong from a historical perspective and thus supportive of continued strong increases in private consumption. Furthermore, households are expected to gradually unwind some of their accumulated savings.

The profile of real government consumption is heavily influenced by inflows related to the IIP, which are netted against consumption expenditure. More details on projected developments in public consumption can be found in section 4.

The profile of investment is strongly influenced by the interplay of expected developments in specific sectors, as well as the expectation of increased absorption of EU funds, which conditions the profile of government investment. In 2018 private investment is projected to have expanded only marginally due to the completion of energy-related projects in 2017 and lower capital outlays in the aviation sector. It is projected to recover strongly in 2019 and accelerate further in 2020 as investment in health-related projects picks up. Growth in investment should then slowdown in 2021, as some of these projects reach completion. Residential investment is foreseen to continue growing robustly but at a slower pace when compared to the last few years, reflecting some deceleration in the issuance of permits and an expected slowdown in migrant flows.

With regard to external trade, export growth is expected to moderate in 2018 due to continued weakness in goods exports and a decrease in IIP flows from the very high level recorded in 2017. In addition, services exports other than those related to the IIP are anticipated to slow down but remain robust over the projection horizon. On the other hand, goods exports are projected to recover from their currently low level. Nevertheless, the weakness in goods exports is envisaged to persist especially in the context of the weak international environment, and hence, these are foreseen to grow less rapidly than foreign demand.

Mainly mirroring the investment and export projections, import growth is expected to have turned positive in 2018. Import growth is then set to accelerate significantly in 2019 and 2020, as goods imports respond to the recovery in private investment and some pick-up in goods exports. Furthermore, import shares in services are expected to edge up from the low rates recorded in recent years. Imports are projected to slow down in 2021, though, reflecting the deceleration in private investment growth foreseen that year.

As a result of the easing in the positive net export contribution, the trade surplus is expected to narrow over the projection horizon. In turn, outflows related to primary income are envisaged to increase due to the increased profits of internationally-oriented firms.

2 Labour market

Despite the envisaged easing of economic activity in 2018, employment growth remained robust. However, as activity loses some momentum over the following three years, employment growth is foreseen to slow down. Nevertheless, both economic activity and growth in employment are expected to remain well above their historical average.

The Labour Force Survey (LFS) unemployment rate is expected to have remained at record lows in 2018, in spite of continued increases in net migration flows and increased activity among nationals. Subsequently, as employment growth and economic activity moderate, the unemployment rate is foreseen to rise, but only slowly, thus remaining low from a historical perspective.

As regards wages, surveys and the Bank's contacts from industry continue to highlight that labour market tightness and wage pressures are gaining pace. In this context, and reflecting also an expected pick-up in consumer prices and further moderate increases in productivity, growth in nominal compensation per employee is expected to accelerate over the projection horizon.

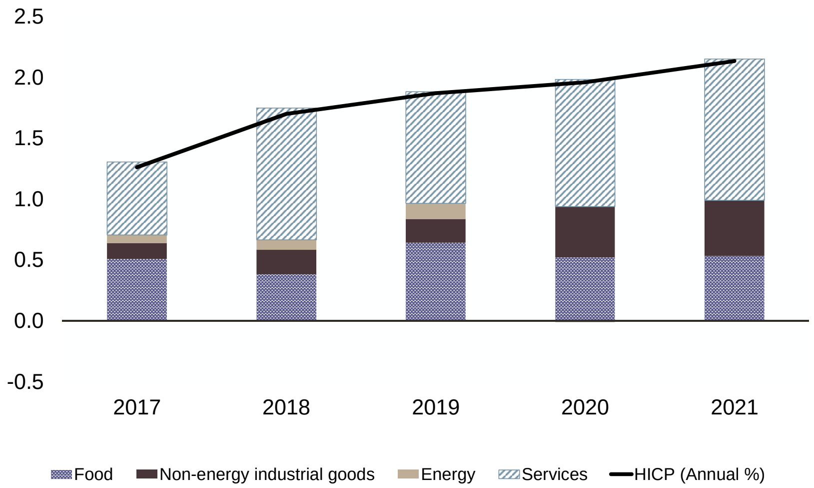
3 Prices

Against the background of external assumptions and the expected evolution of domestic cost pressures, HICP inflation in Malta is set to gradually accelerate over the forecast horizon, reaching 2.1% by 2021 (see Chart 2),[2] which nevertheless remains somewhat lower than the historical average for Malta.

The international price of oil increased strongly during 2018. It is assumed to decline progressively in the following three years. This path influences the profile of the fuel and gas price projections through a lagged and partial pass-through, while electricity prices are assumed to remain fixed during the forecast horizon as per government policy. In the first half of 2019, energy inflation is also supported by the increase in fuel prices in August 2018. Hence, energy inflation is set to remain positive in 2019, before turning negative in 2020 and 2021.

HICP excluding energy is projected to accelerate from 1.8% in 2018 to 2.3% by 2021. This is mainly underpinned by faster growth in services prices, reflecting some intensification of demand and wage pressures. Inflation in non-energy industrial goods (NEIG) is also set to pick up, mirroring a recovery in imported inflation. Food inflation is projected to remain robust throughout the forecast horizon.

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



Source: Central Bank of Malta

[2] This section does not feature an update of the Bank's outlook on prices from 2019 onwards, when compared with the projections released on 14 December 2018.

4 Public finance

The headline budget balance is expected to remain in surplus throughout the forecast horizon, sustained by large positive primary balances (see Table 2). However, the general government surplus is expected to decline from 3.5% of GDP in 2017 to 2.1% of GDP in 2018 and 1.6% in 2019. The balance is then expected to recover, reaching 1.9% of GDP by 2021. This profile is mainly driven by developments in capital expenditure net of capital revenue.

Compared with the Bank's earlier projections, the government surplus has been revised up throughout the forecast horizon, reflecting a more positive assessment for 2018, mainly due to higher than expected increases in tax revenue. The upward revision to the primary surplus projections has consequently led to a downward revision in the general government debt-to-GDP ratio throughout the forecast period.

Overall, the share of tax revenue items in GDP is expected to remain broadly in line with the ratio in 2017. The share of current taxes on income and wealth in GDP is expected to increase, driven by higher income tax revenue on the back of strong underlying growth in compensation of employees and operating surplus. On the other hand, the ratio of taxes on production and imports is expected to decline, driven by slower growth in consumption. Revenue from social contributions is also expected to increase at a smaller pace than GDP, in line with the provisions of Maltese law which limit these contributions.

Meanwhile, the share of other current revenue in GDP is set to decline significantly. This is due to the forecast profile of income from the IIP, which is set to decline substantially from the high levels received in 2017.

The share of current spending items in GDP is also expected to decrease over the forecast period, led by a decreasing social payments ratio. The latter reflects forecast low unemployment as well as the impact of an increase in the statutory retirement age in 2018, which limited pension expenditure growth. The ratio of interest payments in GDP is also expected to decrease, reflecting lower financing needs as well as the prevailing low interest rate environment.

Other current primary expenditure is forecast to grow broadly in line with nominal GDP. This mainly reflects robust growth in compensation of employees and in intermediate consumption throughout the projection horizon. The former is driven by higher recruitment and allowances in the health and education sectors. The profile of intermediate consumption in GDP is set to be mainly driven by higher health-related costs.

The shortfall in the balance between capital revenue and capital expenditure is expected to have increased sharply in 2018 and to decline somewhat by the outer years of the forecast period. The increased

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

	2017[2]	2018	2019	2020	2021
Headline Aggregates					
Total revenue	39.2	38.8	38.5	38.5	38.4
Total expenditure	35.7	36.7	36.9	36.7	36.5
General Government Balance	3.5	2.1	1.6	1.8	1.9
of which: Primary Balance	5.3	3.7	3.0	3.0	3.0
General Government Debt	50.2	45.0	41.5	38.1	34.9
Detailed Breakdown					
Current Revenue	38.3	37.8	37.2	36.9	36.9
Current taxes on income and wealth	13.9	14.0	14.2	14.3	14.5
Taxes on production and imports	12.4	12.5	12.3	12.2	12.2
Social contributions	6.2	6.2	6.1	6.0	6.0
Other current revenue[3]	5.8	5.1	4.7	4.4	4.3
Current Expenditure	32.6	32.4	32.3	32.1	32.1
Compensation of Employees	11.3	11.3	11.3	11.3	11.4
Social benefits	10.1	9.8	9.8	9.7	9.7
Intermediate Consumption	6.4	6.7	6.7	6.7	6.6
Interest payments	1.8	1.6	1.4	1.3	1.2
Subsidies	1.2	1.2	1.2	1.2	1.2
Other current expenditure[4]	1.8	1.9	1.9	1.9	1.9
Gross savings	5.7	5.3	4.8	4.8	4.8
Capital Revenue	0.8	1.0	1.4	1.5	1.5
Capital taxes	0.2	0.2	0.2	0.2	0.2
Other capital revenue[5]	0.6	0.9	1.2	1.3	1.3
Capital Expenditure	3.1	4.3	4.6	4.6	4.4
Investment	2.2	2.8	3.4	3.5	3.3
Capital transfers	0.9	1.5	1.2	1.2	1.1
Other capital expenditure[6]	0.0	-0.1	-0.1	-0.1	-0.1
Capital Revenue Net of Capital Expenditure	-2.2	-3.2	-3.2	-3.1	-2.9
Underlying Budgetary Position					
Cyclical component	0.5	0.6	0.6	0.5	0.3
Temporary government measures	0.0	0.0	0.0	0.0	0.0
Structural balance	3.0	1.5	1.0	1.3	1.6

[1] CBM calculations based on NSO News Release 193/2018 (published on 6 December 2018) and News Release 8/2019 (published on 18 January 2019).
[2] Actual data.
[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.

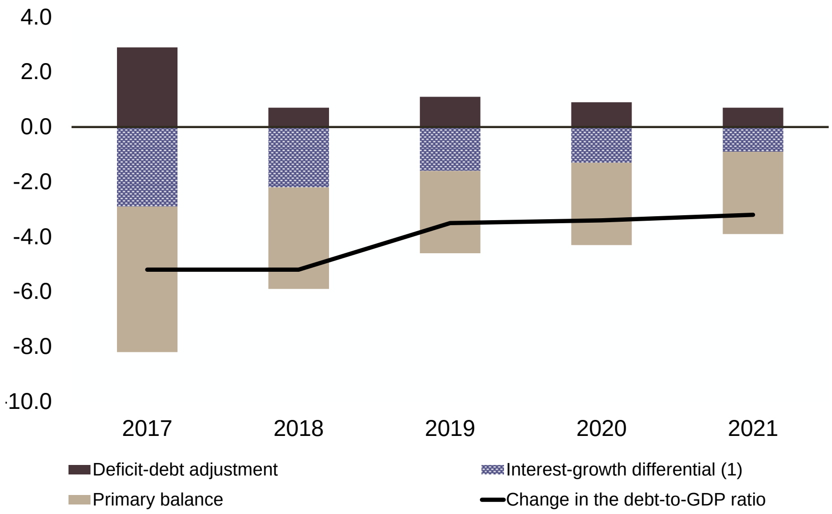
shortfall in 2018 partly reflects a one-time capital transfer reflecting the acquisition of landing rights from AirMalta. Investment on domestically-funded projects is expected to pick up as work on nationwide road building projects gathers pace. Meanwhile, spending on projects which are partly-financed by EU funds under the 2014-2020 funding framework is also expected to increase compared with the outcome in 2017.

The Central Bank of Malta also produces estimates of the structural government balance, which measures the underlying budgetary position corrected for the economic cycle and temporary government measures. This is computed using a methodology applied within the ESCB, which differs from the approach used by the European Commission and the Maltese Government.

The Central Bank expects a positive cyclical component which declines over time. In addition, no significant temporary measures are expected to take place throughout the forecast period. Overall, the structural surplus is set to decline from 3.0% of GDP in 2017 to 1.0% of GDP by 2019, before improving to 1.6% by 2021. This reflects the above-mentioned developments in the headline balance. It is thus expected to remain above the medium-term budgetary objective of a balanced budget in structural terms.

The general government debt-to-GDP ratio is forecast to decline from 50.2% in 2017 to around 35% by 2021, 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

5 Risks to the projections

Risks to the GDP growth projections are slightly tilted to the downside in 2019 and broadly balanced thereafter. In the short to medium-term, the main downside risks are external. In particular, economic growth in some of Malta's trading partners has surprised on the downside in recent quarters, and if weaknesses persist it is likely to affect negatively Malta's export performance. In addition, the prospect of a no-deal Brexit might lead to a further deterioration in the international outlook. On the other hand, downside domestic risks are more of a long-term nature. In particular, environmental and infrastructural constraints may become binding after a prolonged period of above average economic activity. In the short to medium-term, domestic risks are tilted to the upside. Despite the significant upward revision to private consumption growth in this projection round, the savings ratio remains elevated from a historical perspective, and hence there is further room for growth than that envisaged in this outlook. In addition, a number of large projects that are still in planning stage have not been factored in this projection exercise, and are likely to pose upside risks to our investment projections especially in the outer years.

Risks to inflation are slightly to the downside. They relate to renewed downward pressures on prices if the deterioration in the world economic outlook persists, as well as the possible impact of Brexit on the EUR/GBP exchange rate. On the other hand, labour tightness could bring about stronger than expected increases in wage pressures.

Risks to public finances tilt on the upside (i.e. balance-improving). These stem from possible slippages in the implementation of locally financed investment projects.