Assessment of the Update of Stability Programme 2022-2025

MFAC
MALTA FISCAL ADVISORY COUNCIL

July 2022

MFAC

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12 July 2022

The Hon Mr Clyde Caruana B.Com. (Hons) Economics, M.A. Economics
Minister for Finance and Employment
Maison Demandols,
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Valletta. VLT 2000

Dear Minister,

OVERALL ASSESSMENT OF THE MACROECONOMIC AND FISCAL FORECASTS PRESENTED IN THE UPDATE OF STABILITY PROGRAMME 2022 – 2025

As a follow-up to the letter of endorsement in relation to the macroeconomic forecasts, dated 29 April 2022, the Malta Fiscal Advisory Council is hereby presenting the full assessment report dealing with the Update of Stability Programme 2022 – 2025, in terms of the Fiscal Responsibility Act. Compliance with the fiscal rules is not assessed in view of their temporary suspension, as per European Council agreement reached on 23 March 2020.

The Malta Fiscal Advisory Council acknowledges that the Stability Programme was prepared at a time when the economy is still recovering from the COVID-19 pandemic and concomitantly, the Russia-Ukraine conflict is stifling economic recovery, along with exacerbating global supply chain disruptions and increasing price pressures. The Council accordingly recognises the high uncertainty in the preparation of both the macroeconomic and the fiscal forecasts.

Overall, the Council considers the macroeconomic and fiscal scenario for the period 2022 – 2025 to lie within its endorsable range. The Council also confirms the existence of ‘exceptional circumstances’ which under national and European law allow for greater flexibility in the conduct of fiscal policy.

The assessment carried out on the individual GDP components suggests an overall upside risk outlook vis-à-vis the profile for real GDP over the forecast horizon. The trajectory for private consumption, mostly in the short-term, could be higher than anticipated, which is supported by the still strong expectations for the labour market. Government consumption could also be higher, in particular, between 2023 and 2025, given the subdued rates that are being projected compared to historical patterns and recent trends. The MFAC is of the view that risks to investments, tilt towards the downside in the short-term, particularly given the large base effects in the last three quarters of 2021. On the contrary, there could possibly be upside risks to exports, since the MFE exerted a cautious view on some key export sectors. Consequently, such risk opinions suggest a degree of upside risk to imports of goods and services, as this variable is largely determined by the developments in the other expenditure components.

On the fiscal front, the assessment carried out on the individual revenue and expenditure components suggests the possibility of a more favourable fiscal balance in 2022 than anticipated and a neutral risk outlook for the outer years. This partially reflects an upside risk to the revenue targets, mainly due to the possibility of taxes on production and imports to be higher in view of the cautiousness adopted by the Ministry with respect to tourist numbers and the upside risks identified for household consumption. On the expenditure front, there could potentially be downside risks to intermediate consumption in the short-term, in relation to pandemic-related expenditure, and upside risks in the medium-term. In this respect, it is important that discipline is maintained to keep with the low growth targets for this component to reach the planned reduction in the fiscal balance. In turn, the risk outlook for subsidies remains highly uncertain given that expectations are highly dependent on the developments in the war between Russia and Ukraine, international energy inflation and the supply of related resources. The outlook for the other components is viewed as neutral, though there could be some upside risks to public investment over the outer forecast years. In turn, the public debt could be lower than planned, accounting for the possibly more favourable fiscal deficit in the short-term and the overall upside risks identified for GDP.

The Fiscal Council supports the government's stance that most of the pandemic-related support measures are being phased out. At the same time, new initiatives were

necessary to secure essential supplies of necessities, and to cover the rising costs of energy resulting from the conflict in Ukraine, exerting further fiscal costs. Despite these difficulties, the Council welcomes the Government's plan to lower the fiscal deficit to below 3.0% of GDP by 2024. It is important that there is a maintained effort to keep in line with the targeted debt ratios, which are planned to be kept under the 60.0% benchmark over the entire forecast period.

The government should be adequately prepared for when the fiscal rules are reinstated. Rebuilding fiscal space and ensuring debt sustainability is key, not only because of the rules but also to restore the ability to counteract possible adverse shocks and enhance the economy's overall resilience. The Government should also endeavour to implement the Recovery and Resilience Plan, making use of the grants available efficiently, while aiming to induce further investment, which is important for the country's potential growth.

Various departments contribute toward the publication of the Stability Programme and its implementation. In this respect, it is imperative that constant communication and consistency are maintained across the board. Finally, the Council would like to express its gratitude to the staff at the Ministry for Finance and Employment for the ongoing collaboration and its assistance.

Yours sincerely,

John Cassar White
Chairman

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Abbreviations

CBM	Central Bank of Malta
COM	European Commission
COICOP	Classification of Individual Consumption by Purpose
COVID-19	Coronavirus disease 2019
DBP	Draft Budgetary Plan
EBU	Extra Budgetary Unit
ECB	European Central Bank
EFB	European Fiscal Board
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
HICP	Harmonised Index of Consumer Prices
IIP	Individual Investor Programme
IMF	International Monetary Fund
LFS	Labour Force Survey
MFAC	Malta Fiscal Advisory Council
MFE	Ministry for Finance and Employment
MFF	Multiannual Financial Framework
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
pp	percentage point
RRF	Recovery and Resilience Facility
RRP	Recovery and Resilience Plan
SFA	Stock-Flow Adjustment
STEMM	Short-Term Quarterly Economic Forecasting Model
STG	sterling
TFP	Total Factor Productivity
USD	US dollar
USP	Update of Stability Programme

Executive Summary

This Report, whose cut-off date is 23 May 2022, assesses the macroeconomic and fiscal forecasts for the four-year period 2022 to 2025 contained in the Update of Stability Programme, which the Ministry for Finance and Employment submitted to the European Commission on 02 May 2022.

Both the macroeconomic and fiscal forecasts lie within the endorsable range of the Fiscal Council. At the same time, the Council highlights the uncertainty emanating from the evolution of the pandemic, the conflict between Russia and Ukraine and the subsequent effects of supply chain disruptions and increased global prices and the key assumptions shaping the macro-fiscal scenario. Any material departure from such assumptions could deviate the outturn, possibly significantly, from that presented in the Update of Stability Programme.

The official outlook points to a 4.4% growth rate in real GDP in 2022 on the back of a strong recovery registered a year earlier. Moderate growth is anticipated in 2023 at 3.9%, slightly below the potential output, before slightly easing to 3.7% and 3.5% in 2024 and 2025, respectively. Against this background, the fiscal deficit is expected to narrow to 5.4% of GDP in 2022, from 8.0% a year earlier. For the outer years, the Stability Programme targets a progressive reduction in the fiscal deficit ratio to below 3.0% of GDP by 2024 and a public debt ratio lower than 60% of GDP throughout the forecast horizon.

The risk assessment carried out by the Fiscal Council suggests a broadly positive risk outlook vis-à-vis the profile for real GDP growth over the forecast horizon. For 2022, the MFAC considers that both the fiscal balance and public debt could possibly be lower than expected by the MFE in the baseline scenario. For the outer years, the MFAC opines a neutral outlook for the fiscal balance and the possibility of a lower public debt-to-GDP ratio.

The Fiscal Council takes note that in view of the activation of the general escape clause by the European Council, it is possible for the Government to take all the initiatives deemed necessary to mitigate the adverse effects of the pandemic and the conflict between Russia and Ukraine and the subsequent effects of supply chain disruptions

and increased global prices and to stimulate the economic recovery. At the same time, the Council reminds that when economic conditions allow, fiscal policies should again be aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability.

Chapter 1
Introduction

Euro Area countries must submit an Update of Stability Programme (USP) to the European Commission (COM) by the end of April each year.[1] Malta's latest USP presents the official macroeconomic forecasts and fiscal projections prepared by the Ministry for Finance and Employment (MFE) covering the four-year period 2022 to 2025. The forecasts are prepared at a time when the economy is recovering from the severe economic shocks brought about by the COVID-19 pandemic. At the same time, significant external shocks emanating from the conflict between Russia and Ukraine are hindering the economic recovery from the pandemic in Malta and stifling global growth. Energy and commodity prices, in particular wheat and grains, have intensified inflationary pressures from supply chain disruptions. Being a small open economy, Malta is highly susceptible to these external shocks which further adds pressure to prepare macroeconomic forecasts covering a four-year horizon, at a time when the situation is highly fluid, and the outlook is subject to extraordinary uncertainty.

The Malta Fiscal Advisory Council (MFAC) continues to follow closely the discussions and decisions taken at the EU level in relation to the general escape clause and the guidance on the conduct of fiscal policy.[2] Based on the information to date, the MFAC confirms that the situation of 'exceptional circumstances' as defined in the Fiscal Responsibility Act (FRA) persists.[3] Therefore, the assessment of compliance with the fiscal rules by the MFAC is temporarily suspended until the general escape clause is revoked and the situation is no longer considered exceptional. The MFAC takes note that the European Commission is 'in favour of extending the general escape clause of

[1] The USP submitted by each country in 2022 is available here.
[2] Following the outbreak of COVID-19, on 23 March 2020 the 'general escape clause' was activated by the European Council. This clause allows governments to temporarily depart from the budgetary requirements imposed by the EU fiscal rules. This added flexibility permitted the full implementation of revenue and expenditure measures necessary to tackle the health and economic challenges created by the pandemic. The escape clause is set out in Articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) 1466/97 and Articles 3(5) and 5(2) of Regulation (EC) 1467/97. The statement by the EU Council is available here.
[3] FRA Article 2(1) defines exceptional circumstances as "a period during which an unusual event outside the control of the State has a major impact on the financial position of the general government, or a period of severe economic downturn within the meaning of the Stability and Growth Pact".

the Stability and Growth Pact through 2023', given the current uncertainty in relation to the conflict between Russia and Ukraine.[4]

EU regulations specify that when the government produces its macroeconomic forecasts, these must be endorsed by an independent institution. The Fiscal Responsibility Act (FRA) prescribes that this role is performed by the Malta Fiscal Advisory Council (MFAC). To this effect, on 29 April 2022, the Chairman of the MFAC addressed a letter to the Minister for Finance and Employment confirming that on the basis of detailed analysis and bilateral discussions, and after taking due consideration of the uncertainty inherent in macroeconomic forecasts at a time when the economy is recovering from the COVID-19 pandemic and concomitantly, the Russia-Ukraine conflict is stifling global economic recovery, the macroeconomic forecasts for the period 2022 to 2025 were considered to lie within the Fiscal Council's endorsable range.[5] This Report contains the analysis carried out to support the endorsement of the macroeconomic forecasts, as well as the assessment pertaining to the endorsement of the fiscal projections over the same timeframe.[6]

The MFAC's Report has a cut-off date of 23 May 2022 and is structured as follows. **Chapter 2** examines the methodologies, assumptions, and characteristics of the baseline scenario used by the MFE in the preparation of the macroeconomic and fiscal forecasts. **Chapter 3** evaluates the expected trajectory for the main macroeconomic variables over the period 2022 to 2025, and where relevant, identifies possible upside or downside risks. **Chapter 4** compares the latest macroeconomic forecasts with the previous official forecasts (contained in the DBP) and with those produced by other institutions. **Chapter 5** focuses on the fiscal targets for the balance and debt. It examines the plausibility of the anticipated trajectories for the main revenue and expenditure components in the budget, and identifies the direction of risk, where relevant. **Chapter 6** compares the fiscal scenario presented in the USP to that contained in the DBP, and to the latest available fiscal forecasts by other institutions. **Chapter 7** presents the conclusions.

[4] The remarks by Executive Vice-President Dombrovskis and Commissioner Gentiloni at the European Semester 2022 Spring Package press conference, may be accessed here.
[5] A copy of the letter is available here.
[6] The FRA does not prescribe that the endorsement of the fiscal forecasts should take place prior to the publication of the USP. Hence, as per usual practice, the detailed fiscal forecasts and measures underpinning the USP were forwarded to the Council after the document was published. This approach is also used in relation to the endorsement of the fiscal forecasts contained in the annual Draft Budgetary Plan (DBP).

Chapter 2
Forecast methodologies and assumptions

2.1 Preparation of the macroeconomic forecasts

The methodology used by the MFE to attain the final set of macroeconomic forecasts remained relatively the same as in previous forecast rounds. The macroeconomic projections carried out by the MFE were estimated using STEMM (Short-Term Quarterly Economic Forecasting Model), which is a quarterly Keynesian model with output determined by aggregate demand.[7] The MFE regularly updates the model's equations to ensure that these adequately reflect the latest macroeconomic underpinnings and relationship developments within both the Maltese economy and the external sector.

The model solution and forecasts are conditional on a number of exogenous assumptions mainly based on estimates and forecasts of external conditions produced by Consensus Economics and the European Commission. The model also enables room for expert judgement. Expert judgement is based on ad-hoc information and regular discussions with key stakeholders, namely government departments, authorities, and the private sector.

This is important especially in the case of Malta, given its small size and the openness of its economy. Such insight plays a significant role in shaping the value-added, employment, investment plans and trade prospects at a sectoral level, which are driven by very specific factors. The dependence on expert judgement does increase in importance during times of heightened uncertainty. The uncertainty relating to the pandemic, which is still present despite the gradual return to normality, and in particular, the added uncertainty emanating from the conflict between Russia and Ukraine and its indirect effect on global prices, further accentuates the role of such expert judgement, as past empirical relationships may not adequately capture these one-off developments. This is particularly relevant for volatile growth drivers such as gross fixed capital formation and sectors which tend to be more vulnerable to these shocks such as the accommodation and food services activities sector.

[7] Technical details about STEMM can be found here.

2.2 Assumptions underpinning the macroeconomic forecasts

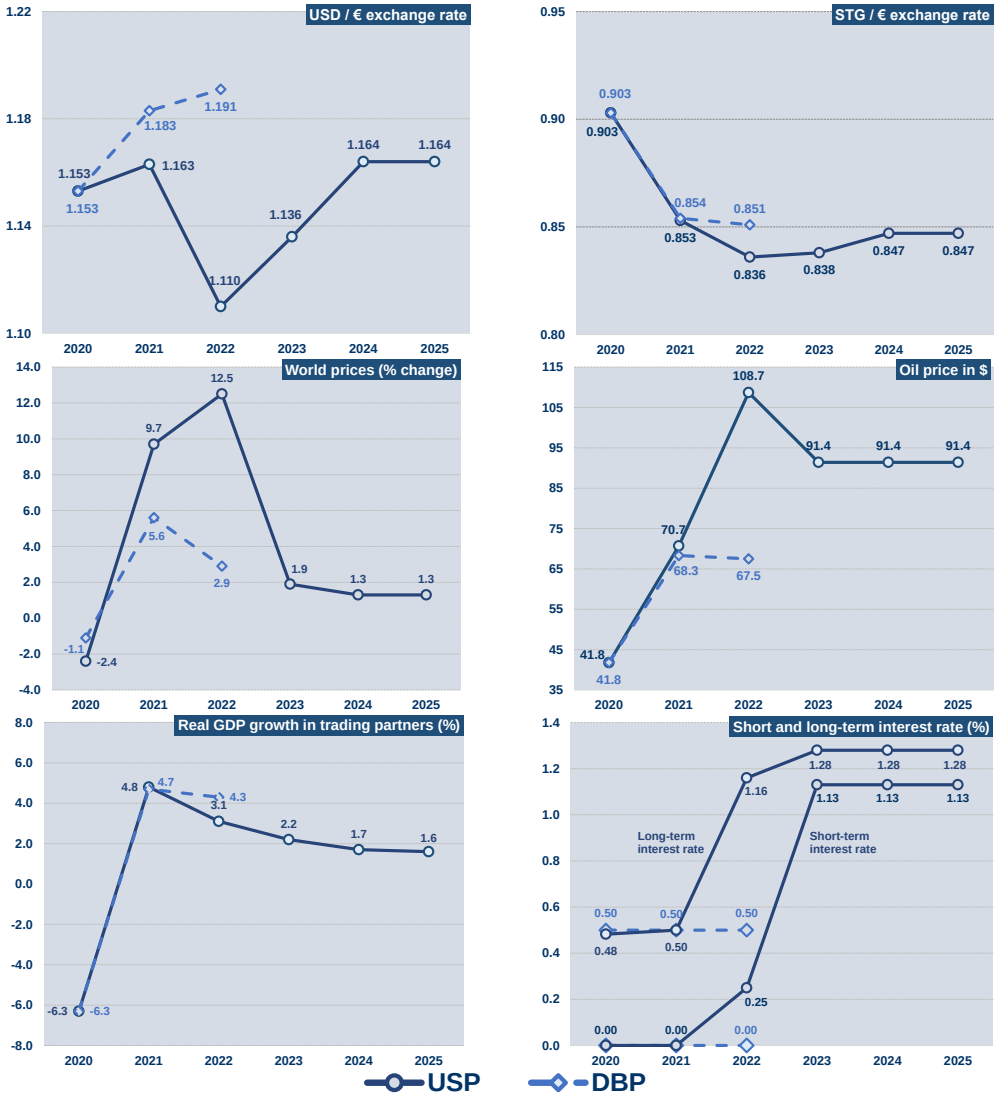
The values for the exogenous variables which are used to produce the macroeconomic forecasts continued to be obtained from authoritative and reputable sources.[8] Specifically, the March 2022 edition of 'Consensus Forecasts' was the source for the assumptions relating to the Euro-US dollar and the Euro-British pound exchange rates, world prices, oil prices and real GDP growth of Malta's main trading partners.[9] In turn, interest rate assumptions have been revised based on the European Commission's assumptions on the implied change in short and long-term interest rates since last Autumn. The trajectories of the exogenous variables assumed in the USP are compared to the figures which were used in the previous forecast round, that is the Draft Budgetary Plan (DBP) (see Chart 2.1).

For 2022, the USP is assuming a weaker value for the euro with respect to both the US Dollar and the Pound Sterling, when compared to the values assumed in the DBP. The assumed dip in the exchange rate in 2022 over 2021 is stronger vis-à-vis the US Dollar than for the Pound Sterling. However, the euro is expected to appreciate gradually in 2023 and in 2024 vis-à-vis both currencies, before remaining stable in 2025.

Global supply shortages and geopolitical factors are leading to significant increments in world prices. The recorded change in 2021's world prices was 9.7%, thus 4.1 percentage points (pp) higher than was expected at the time of the DBP. Such high global inflation is expected to continue in 2022 as world prices are assumed to increase further by 12.5%. This represents an acceleration in price growth whereas in the DBP, a deceleration was being assumed. For the rest of the forecast years, world prices are then assumed to moderate and increase at more stable rates of 1.9% in 2023 and 1.3% in 2024 and 2025. This pattern is broadly reflected in the updated outlook for oil prices. It is expected that the price of Brent crude oil will rise from $70.7 per barrel in 2021 to $108.7 in 2022. This projected oil price represents a difference of 61.0% when compared to the price level that was assumed in the DBP for 2022. In 2023, the price of oil is assumed to scale back to $91.4 and consequently remain at that level over the outer forecast years.

[8] The cut-off date for the external assumptions used by MFE was 14 March 2022.
[9] The monthly publication by Consensus Economics surveys professional forecasters for their estimates of a range of macroeconomic variables.

Chart 2.1: Main macroeconomic assumptions



Note: The DBP presented forecasts for 2021 and 2022 and hence the assumptions covered only these two years. In the case of the USP, 2020 and 2021 represent actual estimates while 2022 – 2025 represent forecasts.
Source: MFE

The profile for foreign demand (using real GDP developments in Malta's main trading partners as a proxy) also factors in a deceleration in growth in 2022, as was the case in the DBP. However, the deceleration is much stronger in the most recent update, as external conditions have weakened and the conflict between Russia and Ukraine is creating more uncertainty. Since the DBP, the outbreak of the Omicron variant during the winter months was also another factor leading to a lower growth forecast. Indeed, the economic growth of Malta's main trading partners is set to slow down to 3.1% in 2022, when compared to the anticipated growth of 4.3% estimated last October. The USP assumes further easing of growth over the rest of the forecast years, slowing

down to 2.2% in 2023, and thereafter moderating further to 1.7% and 1.6%, respectively in 2024 and 2025.

The assumption of a zero percent short-term interest rate adopted over the recent years is no longer applicable in this forecast round. Indeed, the assumption is for short-term interest rates to rise to 0.25% in 2022, before rising even further to 1.13% across the forecast horizon. With respect to the long-term interest rate, the trajectory also differs from the stability that was assumed in the DBP. The long-term interest rate is set to rise to 1.16% in 2022, compared to the 0.50% assumed in the DBP. The USP then assumes a further increase such that the long-term interest rate reaches 1.28% in 2023 and thereafter remains stable. Exogenous assumptions with respect to interest rates are sourced from the European Commission.

Apart from the assumptions relating to the exogenous variables, the MFE consistently adopts another assumption relating to inventory adjustments.[10] As is normal practice, in the April forecast round, the MFE assumes that inventory changes do not contribute to GDP growth. This assumption is retained across all forecast years.

The high uncertainty emanating from the extraordinary rise in prices necessitated further assumptions to shape the macroeconomic scenario. In this respect, the MFE is assuming inflationary pressures as temporary and not to result in a wage-price spiral. However, inflationary shocks, specifically in food items, are expected to last throughout 2022. On the other hand, for 2022, energy inflation is expected to remain stable in the case of Malta, as the government continues to support the economy by absorbing rising energy prices. The government is also intervening in securing the supply and price of basic commodities such as wheat, grains and animal fodder.

With respect to the pandemic, the USP is factoring in the phasing out of the temporary pandemic-related support.[11] In particular, the wage-support scheme is expected to be terminated by end of May 2022. No lockdowns are assumed for 2022 and the pandemic is assumed not to persist in 2023, which would mean that travelling and tourism make further progress towards reaching back the 2019 levels. The MFE is adopting a conservative approach and assuming tourist inflows to reach 63.0% of 2019

[10] Inventory changes include the effect of changes in actual inventories as well as any statistical errors. The MFE does not forecast inventory changes but assumes a stable value.
[11] The incentives underpinning the Tourism Recovery Plan are to remain in place to support the tourism industry, which was severely hit by the pandemic.

levels in 2022, whilst in 2023, tourist numbers are assumed to rise to 83.0% of those in 2019.

2.3 The preparation of the fiscal forecasts

The process to prepare the fiscal forecasts remained the same as in the previous rounds. Various scenarios were explored, in the context of elevated uncertainty emanating from the Russia-Ukraine conflict and the recovery from the pandemic. This was necessary to budget adequate resources for the temporary fiscal mitigation measures which were being launched, as well as to align the fiscal projections with the macroeconomic outlook.

Government departments and entities continued to provide their input through cash-based estimates of their anticipated revenues and expenditures. These estimates are built on specific knowledge and information available at a departmental level, which includes past trends, expert judgment, knowledge about specific fiscal legislation, outstanding creditor and debtor balances and other ad-hoc factors.

This bottom-up approach is supplemented with a top-down approach, using the accrual-based European System of National and Regional Accounts (ESA). This process involves the forecasting of budget items using estimated relationships with their respective macroeconomic proxy bases. The main purpose of these top-down calculations is to act as an envelope, thereby maintaining prudence and supporting broad consistency between fiscal projections and the official macroeconomic outlook. This step is also necessary since the fiscal forecasts need to be presented in ESA data format rather than in Consolidated Fund format.[12]

Close coordination across the public sector remained key to providing adequate funding for the health sector, the pandemic-related schemes and economic support measures in relation to the Russia-Ukraine conflict. The fiscal projections are built on the premise that the momentum of 2021 will continue over the forecast horizon albeit at slower rates.

[12] Developments in the Consolidated Fund are not directly comparable to official statistics based on ESA. The former is primarily cash-based, while ESA has broader coverage and includes accrual adjustments.

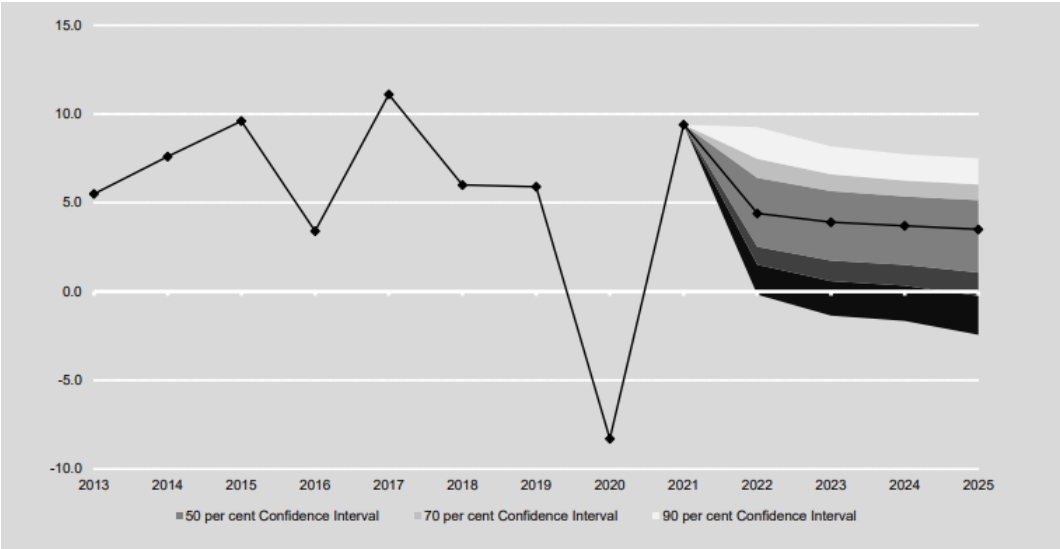
2.4 Risk outlook presented by MFE in the Update of Stability Programme

Any departure from the assumptions used by MFE could deviate the macroeconomic and fiscal outturn, from the outlook as presented in the official forecasts. Therefore, the USP presents a range of real GDP growth and fiscal balance outcomes that could arise based on alternative scenarios, which are more positive or negative relative to the baseline (see Chart 2.2 and Chart 2.3).

The scenarios considered by MFE included: different growth rates for external demand; higher interest rates; different tourism forecasts; higher investment; lower real wages; and persistent inflationary pressures and wage-price spiral scenarios.

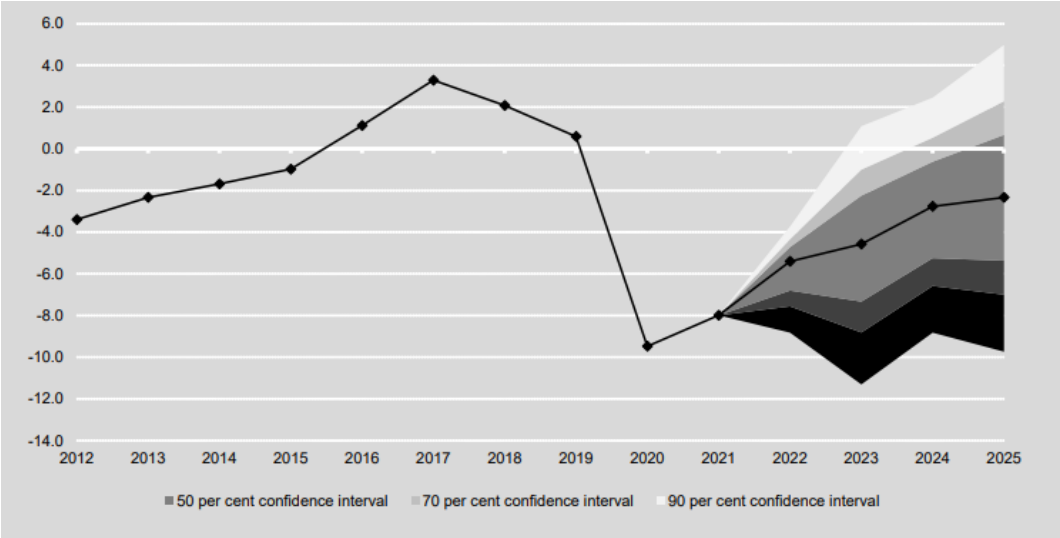
In general, nearly all scenarios point to positive real GDP growth in 2022 at the 90% confidence level. The wider range of estimates calculated over the period 2023 to 2025 portrays real GDP growth rates which are mostly positive but also include negative growth rates. The balance of risk is on the upside for 2022, but on the downside for the outer years.

Chart 2.2: Alternative real GDP growth forecasts (%)



Note: Reproduced from the USP Chart 4.1, page 50.
Source: MFE

Chart 2.3: Alternative projections for the fiscal balance (% of GDP)



Note: Reproduced from the USP Chart 4.2, page 51.
Source: MFE

On the fiscal side, the range of estimates for the balance (based on the identical alternative scenarios for the real GDP growth fan chart) encompasses the possibility of a reduction as well as a widening of the fiscal deficit in 2022. In the outer years, the outcomes indicate a yearly fiscal surplus in the most optimistic scenario (90% confidence interval) and a stream of fiscal deficits-to-GDP in the more pessimistic scenarios, within an approximate range of 12.0pp between the more optimistic and pessimistic scenarios. On balance, throughout the forecast horizon, risks are on the downside for the attainment of the projected budget balance. The main caveat of this analysis is that these calculations show fiscal estimates based exclusively on alternative macroeconomic scenarios and do not consider specific fiscal risks which might materialise.

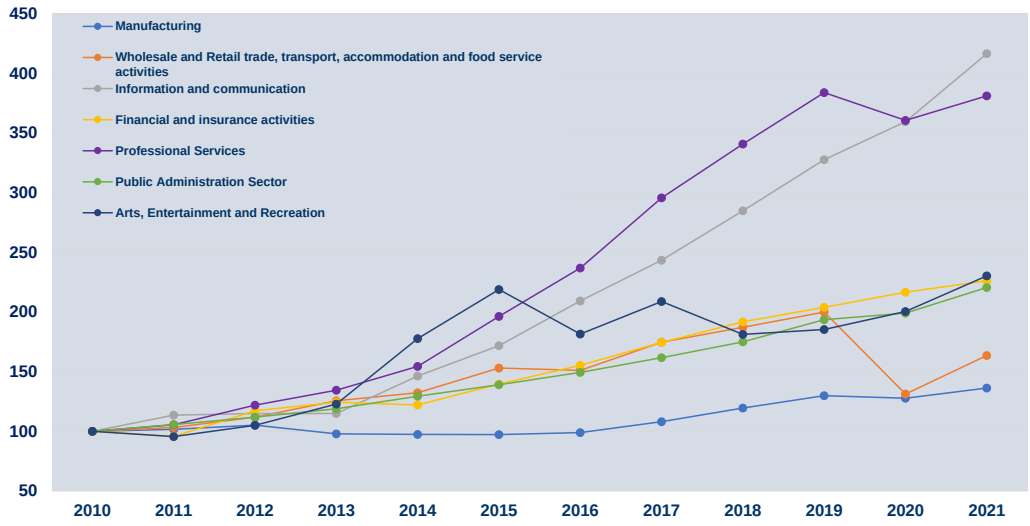
Chapter 3

Assessment of the macroeconomic forecasts 2022 – 2025

3.1 Macroeconomic outlook 2022 – 2025

The Maltese economy recovered strongly in 2021, as real GDP increased by 9.4% following the 8.3% contraction registered a year earlier, slightly surpassing its 2019 pre-pandemic level. The expansion in economic activity was mainly driven by domestic demand. Net exports also contributed positively although to a lesser extent. From the output side, growth was broad-based with the services sector being the largest contributor. Notable contributors to growth were the wholesale and retail trade, transportation and storage and accommodation and food services activities sector; the sector comprising the public administration, health and education; the information and communication sector; and the arts and entertainment sector. Save for the professional services sector; and the wholesale and retail trade, transportation and storage and accommodation and food services activities sector; all the other sectors reached their peak in 2021 (see Chart 3.1).

Chart 3.1: Gross Value Added (2010=100)



Source: Eurostat and MFAC calculations

The resurgence of the pandemic last Autumn and the spread of the Omicron variant coupled with the Russia-Ukraine conflict continued to have an adverse effect on global

economic growth. Energy and commodity prices, in particular wheat and grains, have intensified inflationary pressures from supply chain disruptions and the recovery from the pandemic. Being a small open economy, Malta is highly susceptible to these external shocks, which further adds pressure to prepare macroeconomic forecasts covering a four-year horizon, at a time when the situation is highly fluid, and the outlook is subject to extraordinary uncertainty. On a more positive note, the Ministry for Finance and Employment is expecting the domestic side of the economy to remain strong, bolstered by strong household and corporate balance sheets in conjunction with an expansionary fiscal policy.

The MFE expects real GDP to grow by 4.4% in 2022, and growth is expected to ease to 3.9% in 2023. For the outer years, growth is expected to moderate slightly, to 3.7% in 2024 and 3.5% in 2025, narrowing the negative output gap significantly (see Chart 3.2 and Table 3.1).[13]

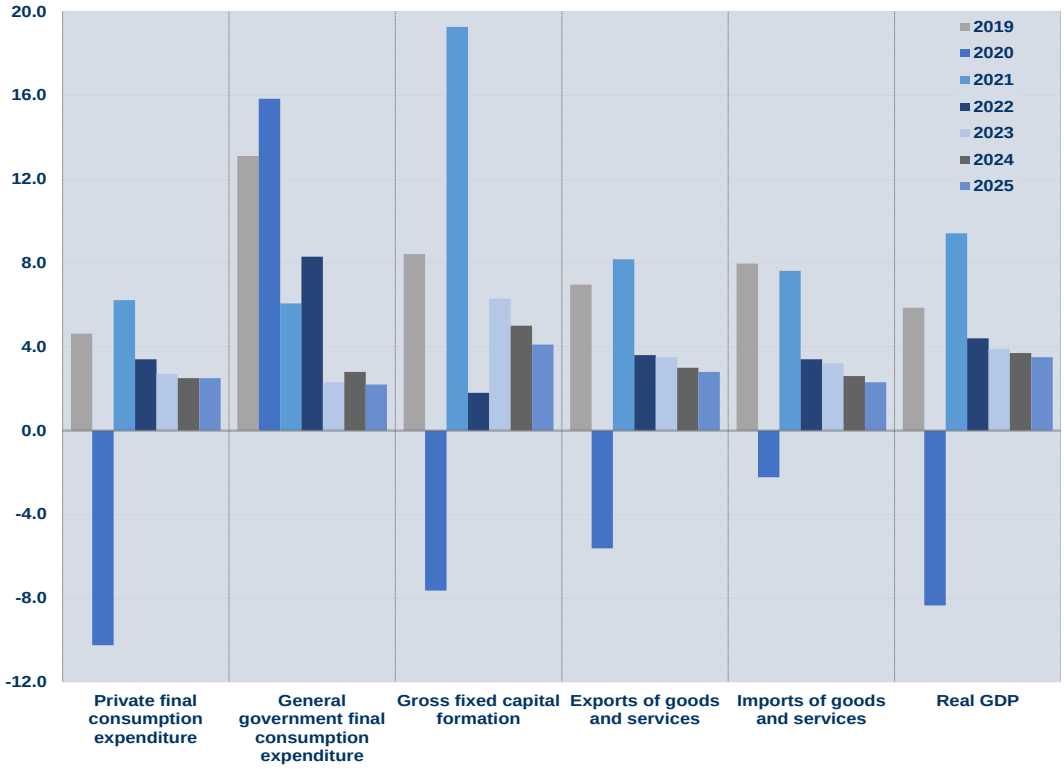
Nominal GDP increased by 11.3% in 2021 after contracting by 7.0% in the previous year, surpassing €14.5 billion. In 2022, nominal GDP growth is expected to remain in positive territory and increase by 7.5%. Nominal GDP growth is then expected to moderate to 5.8% in 2023, similar to the slowdown in the real GDP growth forecast. The difference reflects the deceleration in the GDP deflator from 2.9% in 2022 to 1.8% in 2023. The forecast profile for 2024 and 2025 is more conservative, slightly more subdued in 2024 (5.7%) and significantly lower in 2025 (5.0%). These forecasts are lower than the long-term average growth rate (6.1%) registered by nominal GDP during the last 20 years.

The forecast growth profile for the different real GDP expenditure components over the four-year period is expected to decelerate year-on-year, except for government consumption and gross fixed capital formation. In 2021, government consumption increased by 6.1%, mainly due to higher expenditure on compensation of employees and intermediate consumption, partly reflecting higher outlays on health to mitigate the effects of the pandemic. Government consumption is expected to increase by 8.3% in 2022 and then moderate to an average increase of 2.4% in the outer years. On the other hand, gross fixed capital formation is expected to increase by 1.8% in 2022 on the back of a strong base effect in 2021. Furthermore, the uncertainty regarding the

[13] Figures for 2020 and 2021 are based on the provisional values as published by the National Statistics Office (NSO) on 1 March 2022 (News Release 037/2022), while figures for the period 2022 to 2025 represent the forecasts prepared by MFE.

short-term economic outlook is also likely to impinge on business and investor sentiment, leading to the possible deferral of several projects. In 2023, GFCF is assumed to increase by 6.3% as business sentiment improves and a number of projects are expected to take off during that year. For the medium-term, the investment to GDP ratio is expected to get close to 24.0%, as the growth in investment is forecasted to outpace the growth in real GDP.

Chart 3.2: Growth rates of real GDP components – chain-linked volumes (%)



Source: MFE

In 2022, private final consumption expenditure is expected to increase by 3.4% on the back of a buoyant labour market, growth in compensation of employees and improvements in consumer sentiment as the recovery from the pandemic continues unbridling pent-up demand. Nonetheless, the growth in private final consumption expenditure is expected to be lower than that registered in 2021 (6.2%) as inflationary pressures are expected to accelerate, leading to a drop in real household disposable income. For the outer years, private consumption is expected to increase by an average of 2.6%, gradually declining the private consumption to GDP ratio to 43.0%.

Table 3.1: Macroeconomic variables 2020 – 2025 (%)

	2020	2021	2022	2023	2024	2025
Real GDP components						
Private final consumption expenditure*	-10.2	6.2	3.4	2.7	2.5	2.5
General government final consumption expenditure	15.8	6.1	8.3	2.3	2.8	2.2
Gross fixed capital formation	-7.6	19.3	1.8	6.3	5.0	4.1
Exports of goods and services	-5.6	8.2	3.6	3.5	3.0	2.8
Imports of goods and services	-2.2	7.6	3.4	3.2	2.6	2.3
Real GDP	-8.3	9.4	4.4	3.9	3.7	3.5
Contribution to real GDP growth						
Domestic demand (pp)	-3.6	8.0	3.6	3.1	2.8	2.5
Inventories (pp)	0.6	-0.4	0.0	0.0	0.0	0.0
Net exports (pp)	-5.3	1.8	0.8	0.8	0.9	1.0
Deflators						
Private final consumption expenditure	1.0	1.3	3.5	1.9	1.7	1.5
General government final consumption expenditure	2.5	2.5	3.6	1.3	2.0	1.9
Gross fixed capital formation	0.9	1.3	2.6	1.3	1.2	1.2
Exports of goods and services	0.6	2.5	4.0	1.3	1.3	1.2
Imports of goods and services	0.5	2.4	4.4	1.1	1.1	1.1
GDP deflator	1.3	1.9	2.9	1.8	1.8	1.5
Labour market						
Employment (National Accounts definition)	2.8	1.6	2.4	2.1	2.2	2.3
Unemployment rate (%) (LFS definition)	4.4	3.5	3.4	3.5	3.5	3.6
Nominal compensation of employees	1.7	7.4	5.7	5.1	4.8	4.7
Nominal compensation per employee	-0.7	5.5	3.1	2.9	2.5	2.4
Labour productivity (real GDP per person employed)	-10.8	7.7	1.9	1.7	1.5	1.2
Other macroeconomic variables						
Inflation rate (%) (based on the HICP)	0.8	0.7	3.5	2.2	1.8	1.7
Nominal GDP	-7.0	11.3	7.5	5.8	5.7	5.0

Note: Figures for 2020 and 2021 are actual, while figures for 2022 to 2025 are forecasts. All figures are sourced from MFE.

* Includes Non-Profit Institutions Serving Households (NPISH)

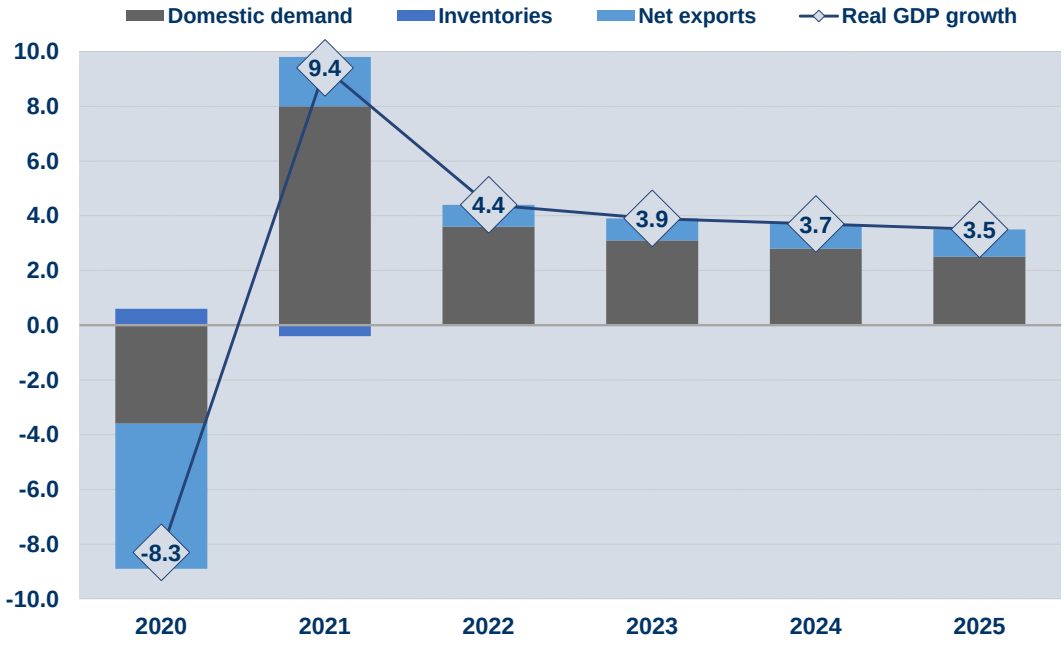
Source: MFE and NSO

Headwinds to global economic growth have intensified as a result of the Russia-Ukraine conflict and delayed global recovery from the pandemic. Coupled with these unforeseen events, supply chain disruptions and higher energy and commodity prices have intensified inflationary pressures. Based on the above, the Ministry for Finance and Employment is expecting exports of goods and services to increase by 3.6% and by 3.5% in 2022 and 2023, respectively, primarily driven by the services sector. The developments in domestic and external demand in turn are expected to increase imports by 3.4% in 2022 and by 3.2% in 2023. For the outer years, the external sector is expected to continue contributing positively to economic growth as the growth in exports outpaces the growth in imports. The external balance as a percentage of GDP is expected to reach 13.4% in 2022 and gradually increase to 15.2% in 2025.

The forecast profile for 2023 assumes that the current disruptions in inflationary pressures will subside, both due to high base effects from the previous year and due to a reactionary slowdown in demand. Over the outer years, growth is expected to ease and converge towards historical average rates. This pattern reflects the absence of special factors and base effects which shaped the forecasts for 2022 and 2023.

In terms of contributions to growth, in 2021, domestic demand was the main driver of economic growth, contributing 8.0 percentage points to GDP growth. Meanwhile, net exports contributed 1.8 percentage points to economic growth. Domestic demand is expected to remain the main contributor to real GDP growth throughout the forecast horizon while net exports are also expected to contribute positively, although to a much lesser extent (see Chart 3.3). On the other hand, no impact on growth is foreseen from changes in inventories, as the latter is assumed unchanged compared to their level in 2021.

Chart 3.3: Contributions to real GDP growth (pp)



Source: MFE

3.2 Private consumption

Real private consumption increased by 6.2% in 2021 after contracting by 10.2% in 2020, adding 2.8 percentage points to real GDP growth. This figure reflected the buoyancy of the labour market, subdued inflation rate and strong increases in compensation per employee growth, partly attributed to a base effect.

Data on the Classification of Individual Consumption by Purpose (COICOP) show that the nominal growth in private consumption was broad-based, save for communication which decreased by 1.3% when compared to 2020. The increase in 2021 was largely propelled by restaurants and hotels which contributed 4.7 percentage points to nominal growth in private consumption, followed by miscellaneous goods and services which contributed 1.6 percentage points and recreation and culture which contributed 1.5 percentage points. Notable growth rates were also recorded in education expenditure, health, transport and furnishings, household equipment and routine household maintenance categories.

In 2022, the Ministry for Finance and Employment is projecting the growth in private consumption expenditure to slow down and increase by 3.4% on the back of slower

growth in employment, relatively subdued growth in compensation per employee, heightened inflationary pressures and declines in real household disposable income. Concomitantly, the wage support scheme is expected to be terminated in May 2022. At the same time, household balance sheets are expected to remain supportive of private consumption growth. Albeit the labour market is to remain relatively strong, private consumption expenditure is still projected to stabilize in the outer years and increase by 2.7% in 2023 and by 2.5% in both 2024 and 2025.

3.3 Government consumption

Following the growth rate of 6.1% in real government consumption in 2021, this component is expected to increase by 8.3% in 2022. For the outer years, real government consumption growth is expected to be more subdued. In 2023, real government consumption is expected to rise by 2.3%, whereas in 2024 and 2025, the estimated growth rates are 2.8% and 2.2%, respectively.

The significantly lower growth (at chain-linked volumes) for government consumption in the outer forecast years reflects the temporary expenditure base effects caused by the pandemic and the Russia-Ukraine conflict, as well as an element of expenditure restraint.[14] The factors explaining such outlook can be traced to the specific budgeted amounts for the items which make up government consumption.[15]

The budgeted allocations underpinning the USP lead to an estimated 12.3% growth in nominal government consumption in 2022, only slightly higher than the 10.5% nominal

[14] New initiatives are undertaken every year. However, these are normally announced in the previous year (in the Budget Speech), or else during the year in progress. Hence, information about fiscal initiatives applicable for the outer years is generally not available. This is one of the reasons for expecting subdued growth forecasts for government consumption in the outer years.

[15] Government consumption is made up of intermediate consumption, compensation of employees, consumption of fixed capital and social transfers in kind, less market output, output for own final use and payments for non-market output. Refer to Chapter 5 in this Report for an assessment of the forecast trajectory for the relevant budget components.

growth recorded a year earlier (see Chart 3.4).[16,17] This slight increase in government consumption mainly reflects the lower market output in 2022.[18] The upward effect created by market output is partially outweighed by the reduction in the growth rate of compensation of employees, consumption of fixed capital, and intermediate consumption.[19]

In 2023, nominal government consumption growth is forecast to slow down to 3.5%. Growth in compensation of employees, although rising slightly slower than in 2022 is the main contributor to government consumption growth for 2023. In 2023, Intermediate consumption has little effect on government consumption as it is assumed to fall slightly, due to the non-repetition of pandemic-related expenditures, while the downward drag created by market output is limited (since it is expected to be only slightly higher than the previous year).

Subsequently, in 2024 and 2025, the forecast growth in nominal government consumption is expected to rise slightly to 4.8% and 4.1%, respectively. The expansion in the budget allocation for compensation of employees is roughly stable, while that for intermediate consumption envisages a return to limited growth.[20] The forecast profile for the remaining components within government consumption does not exert a significant impact on the overall pattern for the period 2024 to 2025.

[16] The nominal growth rates in government consumption for 2020 and 2021 which are quoted in the text are consistent with the updated fiscal data used by MFE in the preparation of the USP and which are assessed in Chapter 5 of this Report. The growth rates for 2020 and 2021 are not identical to those indicated in the GDP statistics published by NSO through News Release 037/2022. Since the macroeconomic forecasts are finalized before the detailed fiscal forecasts, Table 2.1 of the USP quotes slightly different nominal growth rates for government consumption in 2020 and 2021, respectively, 18.3% and 8.6%.

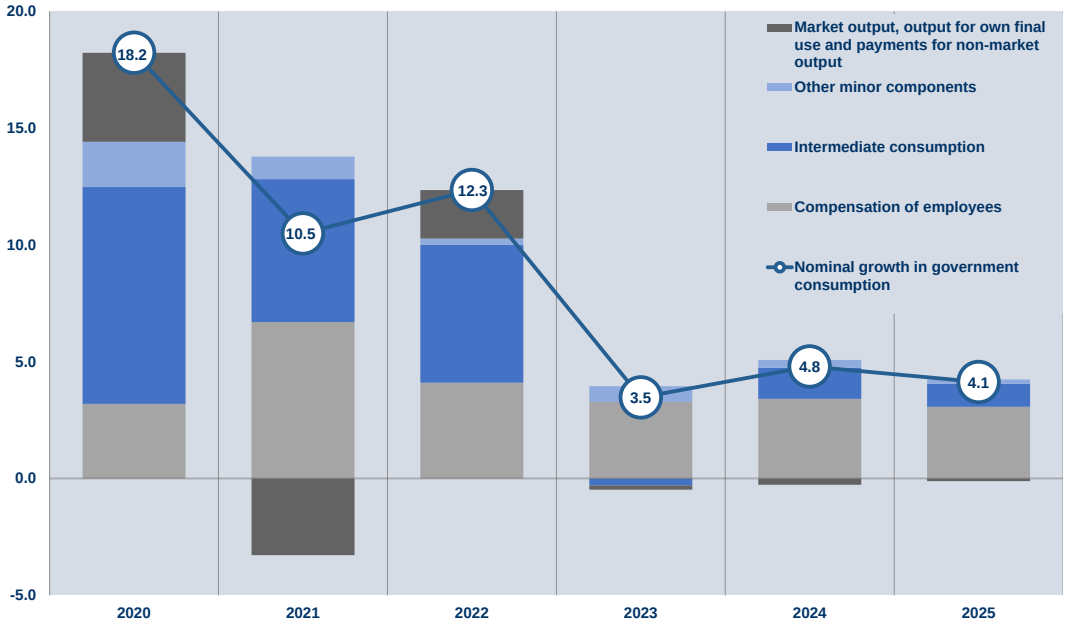
[17] The heading “other minor components” referred to in the chart includes social transfers in kind and consumption of fixed capital.

[18] When estimating the value of government consumption, certain items (market output, output for own final use and payments for non-market output) are deducted from the other expenditure components. Since the USP assumes that in 2022 the total for these items will be less than in 2021, this corresponds to a deduction of a lower value, thus explaining the upward push to government consumption resulting from these sources.

[19] Compensation of employees represents the public sector wage bill and not only includes government departments but also the employees of entities classified as Extra-Budgetary Units (EBUs).

[20] The budget allocation for intermediate consumption tends to be more volatile than compensation of employees because this component is more discretionary.

Chart 3.4: Breakdown of nominal government consumption growth (pp, %)



Source: MFAC calculations

3.4 Gross fixed capital formation

Following a significant expansion of 19.3% in 2021, real investment is expected to increase at a subdued rate of 1.8% in 2022. On the other hand, the MFE's forecast expects real investment to grow more rapidly in the outer years. Gross fixed capital formation is expected to increase by 6.3% in 2023, followed by subsequent increases of 5.0% and 4.1% in 2024 and 2025, respectively. Underpinning the forecast for 2022 is the assumption of a higher than usual deflator for gross fixed capital formation, as this is expected to reach 2.6%. For the outer years, the investment deflator is assumed to hover around 1.3%.

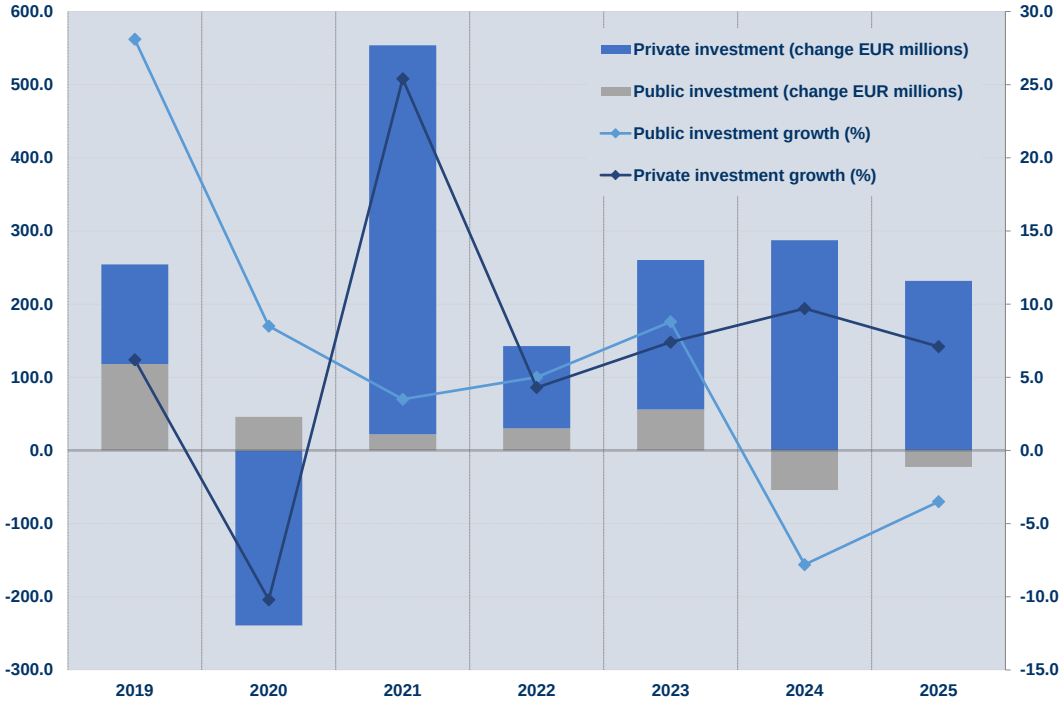
For 2022, the MFE is projecting a subdued growth rate for investment, given the uncertainty with respect to the short-term outlook, the deferral of several one-off projects, and a large base effect from 2021. On the other hand, the acceleration expected in 2023 factors in an improvement in business and investor sentiment, whilst numerous projects are assumed to start being realised. The MFE is then assuming a slight moderation in investment growth over the rest of the forecast years. The forecasts for gross fixed capital formation embody information on the utilisation of the

RRF funds as well as projects funded from the Multiannual Financial Framework (MFF) for the period 2021-2027.[21]

Information about investment spending in nominal terms suggests that in 2022 the bulk of the expected increase in investment is projected to stem from the private sector (see Chart 3.5). Though the projected growth rates for public and private investment in 2022 are relatively similar, respectively at 5.0% and 4.3%, public investment accounts for slightly less than one-fifth of total investment, and thus the change in private sector investment in absolute terms is still much larger.

In 2023, private and public investments are planned to rise at an even higher rate than 2022. Indeed, in absolute terms, the change in gross fixed capital formation in 2023 is expected to be almost double that in 2022. Moreover, similar to 2022, the rate of growth of private investment is still assumed to be slightly less but close to that of the public sector.

Chart 3.5: Public and private sector investment in nominal terms



Note: Data for 2019 - 2021 refers to actual data, whilst 2022 – 2025 represents forecasts by the MFE. Private consumption is calculated by the MFAC as a residual of total investment minus public investment.
Source: MFE and MFAC calculations

[21] The USP assumes gross fixed capital formation financed from RRF grants to be 0.4% of GDP in 2022, 0.5% in 2023, 0.6% in 2024 and 0.4% in 2025.

The expected moderation in total investment growth in 2024 reflects different public and private investment paths. Private investment is expected to continue accelerating further, increasing by close to 10.0% in nominal terms. This growth is partially offset by a reduction in the public investment budget. A similar scenario is forecasted for 2025, whereby private investment is expected to continue rising, albeit slower than in 2024, but public investment is again acting as a partial drag on total investment growth.

Amongst the GDP expenditure components, gross fixed capital formation has exhibited the most volatility over the past years. Significant swings were recorded, whereby growth has been extraordinary at times, whilst in other years it was negative, even pre-pandemic. Such inherent volatility makes it more challenging to produce accurate forecasts for this component. The MFE's approach is to factor in only one-off projects with a high probability of realisation while assuming a relatively high import content.[22] This reduces the risk that discrepancies in this component spill over to the overall GDP growth forecast.

3.5 Exports of goods and services

In 2021, real exports of goods and services expanded by 8.2%, thus rebounding strongly from the contraction of 5.6% experienced in 2020. For 2022, the MFE's forecast is that the volume of exports rises further, but more moderately, growing by 3.6%, mainly driven by services. Such growth is practically repeated in 2023, as exports are assumed to increase by 3.5%. For the outer forecast years, export growth will gradually decelerate to 3.0% in 2024 and 2.8% in 2025. Underpinning this forecast trajectory is an increase in the deflator for exports to 4.0% in 2022 in view of the rising world prices, which then subsides to around 1.3% over the rest of the forecast years.

The forecast profile for exports accounts for the assumed developments in Malta's main trading partners. The conflict between Russia and Ukraine and the indirect effects emanating from the war, particularly inflation, is hindering the recovery of foreign demand from the downturn experienced due to the pandemic. As such, the growth forecast for these main trading partners in 2022 is significantly lower than was forecasted at the time of the DBP, as is the case for the updated export growth forecast. The growth trajectory of these main trading partners is projected to decelerate

[22] For most of the one-off investment projects, the MFE assumes an import content of between 75% and 86%.

gradually over the outer forecast years, consistent with the deceleration in export growth. At the same time, it is noteworthy that Malta's growth in exports is larger than growth in world GDP as weighted by the country's main trading partners. This pattern is consistent with the regression estimations which suggest that Malta's exports (for various categories) tend to have a higher than unitary elasticity with respect to real GDP developments in Malta's main trading partners.[23,24]

The assumed euro exchange rate also plays a role in shaping the growth forecast for exports. In 2022, the euro is expected to weaken, both in relation to the US Dollar and also to the Pound Sterling. On the other hand, for 2023 and 2024, the euro is expected to gradually appreciate back to the rate recorded in 2021, thus exerting a marginal negative impact on exports, whilst in 2025, the rate is assumed to remain constant as at 2024 levels.

Almost every sector contributing to export growth is expected to register increased activity in 2022. Tourist numbers are expected to pick up when compared to 2021, reaching 63.0% of 2019 levels in 2022 on account of ameliorated international health developments and the lifting of travel restrictions. This ratio is still considered conservative, as stated in the USP. This approach is based on the possibility of a potential resurgence in infections and rising prices of essentials, including energy and food, which might restrict the ability of certain households from discretionary travelling. For 2023, the MFE is projecting more recovery, and thus an improvement in tourist numbers that reach 83.0% of the level in 2019.

The moderation of export growth over the forecast horizon to an average of 3.1% per annum is in line with the external assumptions employed. In addition, the non-repetition of the disruptions caused by strict border controls due to the pandemic is helping the country in its process to have better export developments. On the other hand, the assumed pace at which other countries manage to return to normality is hampered by other external events. Moreover, growth in exports is also underpinned by how much global supply disruptions persist and by the policies adopted to control for inflation.

[23] The report describing STEMM states that "the elasticity of world GDP on sectoral exports is relatively high when compared to literature, exacerbating the response of exports to changes in foreign demand". The Report is available here.
[24] This also explains the larger downward revision for exports between the USP and the DBP when compared to the downward revision in the growth of Malta's main trading partners.

3.6 Imports of goods and services

Real imports of goods and services are projected to grow by 3.4% in 2022, a deceleration when compared to the 7.6% growth in 2021. Growth in 2023 is to remain similar but slightly less at 3.2%. Thereafter, the projection is that imports will moderate further and increase by 2.6% and by 2.3% in 2024 and 2025, respectively. The forecast for 2022 is underpinned by a high deflator of 4.4% (the highest deflator amongst the expenditure components), but thereafter, the deflator is assumed to scale back to 1.1% in 2023 and remain constant for subsequent periods.

Being a small and open economy, the forecast trajectory for imports typically reflects the anticipated dynamics in domestic demand and exports and their assumed import content. As such, in 2022, growth in imports is forecast to decelerate, moving in line with the projected deceleration in final domestic demand and exports. The upsurge in world prices (as weighted by main trading partners) estimated at 12.5% in 2022 is inflating the import prices, leading to a negative terms of trade scenario. The weakening of the euro vis-à-vis the US Dollar and the Pound Sterling is further inflating the price of certain imports.

Since the pandemic, not only have global prices increased for several commodities, but also did the cost of freight and transport. Being an island, Malta is further exposed to such shocks. Moreover, suppliers are declining to enter into long-term supply agreements because of the uncertainty and the volatility being experienced in various markets, creating difficulties in the production of other goods and less guaranteed delivery for clients.[25]

Despite these challenges, all components making up the value of imports are assumed to increase in nominal terms in 2022 and 2023. Furthermore, given that investment activity is assumed to accelerate from 2023, the importation of capital goods is also assumed to contribute positively to import growth.

For the outer forecast years, imports are assumed to keep on increasing but to grow at a more moderate rate, despite a scenario of world price increments returning to low levels. The developments in imports over the period 2023 – 2025 similarly reflect the

[25] This information is sourced from the Central Bank Business 2022 Vol.2 No.1, available here.

growth trajectory of domestic demand and exports, which are both forecasted to keep rising but consecutively at a slower yearly rate.

This dependence means that any deviation from the anticipated profile for the other GDP expenditure components could have a material impact on the growth rates for imports over the forecast horizon. This is particularly more so in the case of investment, which in Malta is assumed to have a very high import content.

3.7 Inflation and deflators

In 2021, the HICP inflation rate was 0.7%, slightly lower than that recorded in 2020. In 2022, inflation is expected to pick up momentum, increasing to 3.5%.[26] However, inflation is then expected to subside and return marginally below the target for price stability of 2.0% as set by the European Central Bank (ECB) throughout the rest of the forecast horizon.

In 2022, the acceleration in HICP is mostly attributed to higher food prices, mainly in unprocessed food and to moderate increases in processed food. Other contributors are increased demand for services and higher non-energy industrial goods prices. Energy inflation for 2022 is assumed to be stable given the absorption of energy price increases by the government for the year. Most of the projected increases in prices in 2022 relate to imported inflation since the assumed trajectory for growth in world prices is relatively high, while the assumed exchange rate of the euro with both the US Dollar and the British Pound is expected to depreciate. Throughout the rest of the forecast years, prices are expected to normalize with lower contributions expected from each component. At the same time, the expected wage dynamics exert a limited impact on inflation, as the average compensation per employee is forecast to be rather stable across the forecast horizon.

The deflators for the various GDP components all exhibit heightened growth in 2022 but are then expected to subside throughout the rest of the forecast horizon. In fact, all deflators are expected to grow by more than 2.0% in 2022 and then return below or at 2.0% for the rest of the forecast period. In 2022, import prices are projected to rise faster than export prices, implying a small deterioration in the terms of trade for the first

[26] The average annual inflation rate from January 2022 to April 2022 was 4.6%.

time since 2013. The pattern of export prices rising at a faster rate than import prices is expected to return in the period between 2023 and 2025.[27]

3.8 Labour market

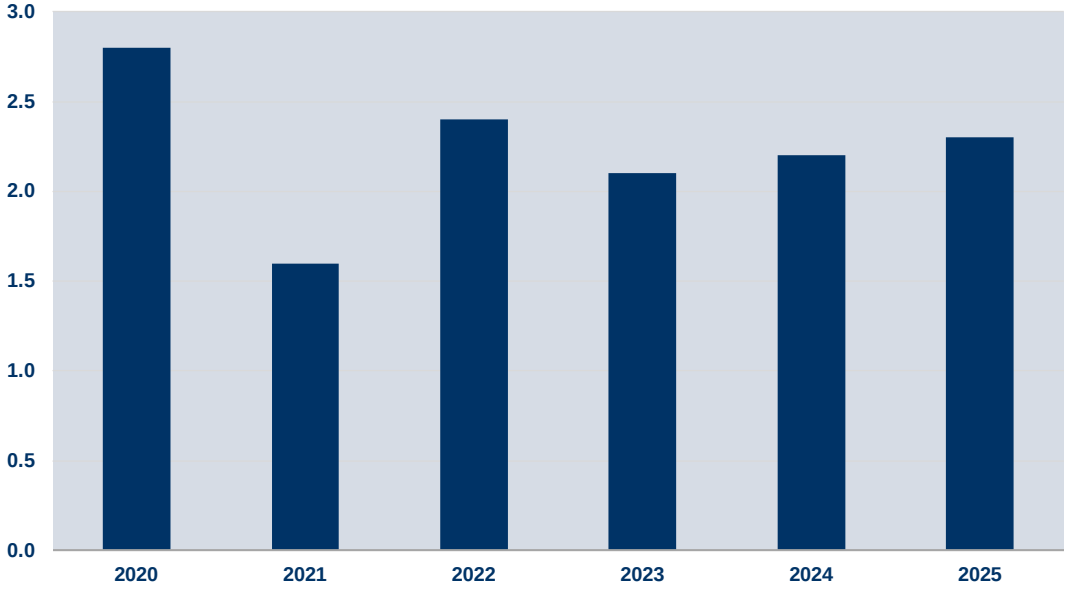
Despite the adverse economic shocks recorded in 2020 because of the pandemic, employment growth was broad-based and rose by 2.8% during that year. Three factors are likely to have contributed to such a positive outturn. The broad-based wage support schemes offered by the government enabled businesses to maintain their employee headcount, despite the much lower demand. At the same time, the administrative procedures to be eligible for government assistance could have contributed to improving the representativeness of labour statistics, yielding an upward revision in the number of jobs. Some operators have also expanded their workforce to meet the higher demand for specific goods and services induced by the pandemic, compensating for declines in other sectors.

In 2021, employment increased by 1.6% as the wage support schemes were extended also over this year. The recovery in economic activity particularly in job-rich sectors has also contributed to the growth in employment. For the four-year forecast horizon, the Ministry for Finance and Employment is expecting a positive momentum in economic activity to generate jobs but less strongly than in previous years. In 2022, employment is projected to increase by 2.4% and then reach an average of 2.2% in the outer years (see Chart 3.6).

In 2020, the unemployment rate (based on the Harmonised definition) rose above the average observed in recent years due to the pandemic and stood at 4.4%. Consequently, in 2021 the unemployment rate dipped back to 3.5%. Over the forecast period, the unemployment rate is expected to remain stable at 3.4% in 2022, 3.5% in 2023 and 2024, and marginally increase by 0.1 percentage points in 2025 (see Chart 3.7).

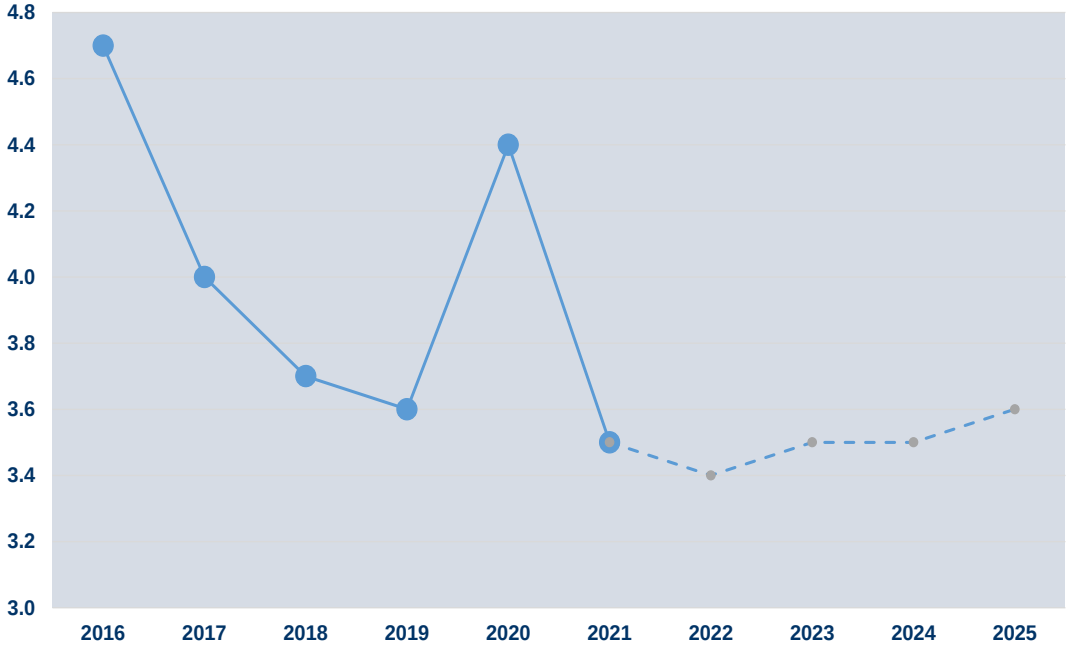
[27] The MFAC has produced a thematic chapter on inflation developments in last year's Annual Report. The report is available here.

Chart 3.6: Employment growth (%)



Source: MFE

Chart 3.7: Unemployment rate (%)



Source: MFE

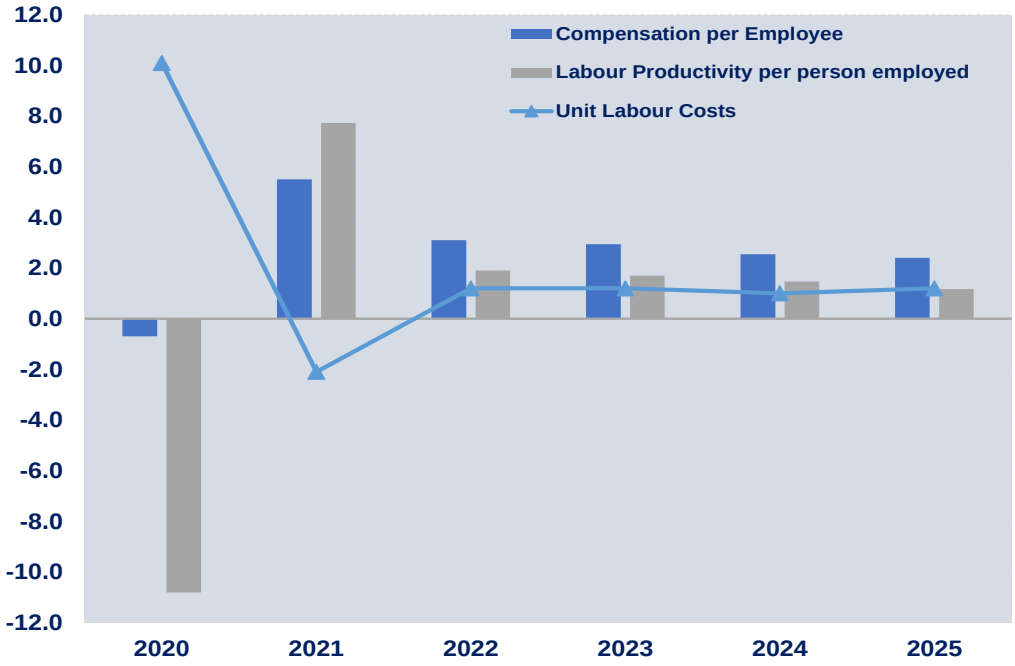
3.9 Productivity developments

Unit labour costs in 2020 increased by 10.1% because of a drop in real labour productivity (-10.8%) which more than outpaced the negative growth registered in compensation per employee (-0.7%).

Part of the increase in unit labour costs was reversed in 2021 as the increase in labour productivity more than outpaced the increase in compensation per employee. Labour productivity growth in 2021 was driven by a strong recovery in economic activity which outperformed growth in employment.

In 2022, nominal compensation per employee is projected to increase by 3.1% relative to an increase of 1.9% in labour productivity. As a result, nominal unit labour costs are expected to increase by 1.2%. A similar profile is expected for the outer years whereby compensation per employee outpaced growth in labour productivity. Consequently, nominal unit labour costs are expected to increase by an average of 1.1% between 2023 and 2025 (see Chart 3.8).

Chart 3.8: Nominal unit labour costs (%)



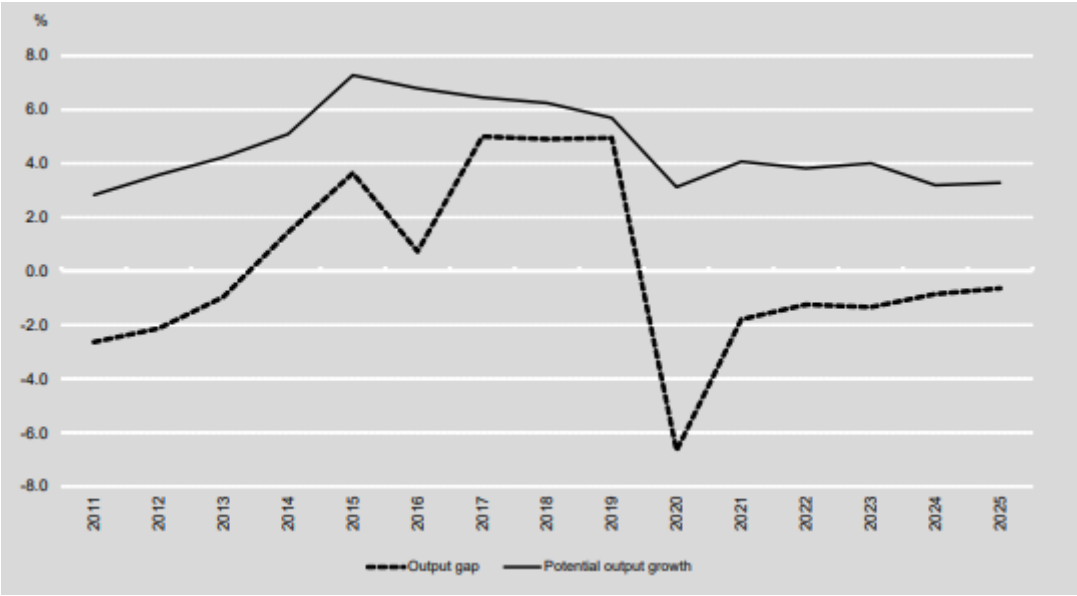
Source: MFE and MFAC calculations

3.10 Potential output and the output gap

Potential output and the output gap are estimated by the Ministry for Finance and Employment using the commonly agreed methodology across the EU.[28] This is based on the production function approach, with growth driven by labour, capital, and total factor productivity.

In 2021, potential output growth is estimated to have increased to 4.1% after recovering from a low rate of 3.1% a year earlier. When compared to the average growth registered between 2011 and 2019 (5.4%), potential GDP growth is still expected to remain significantly low by historical standards, standing at 3.8% in 2022 and at 4.0% in 2023, before declining to 3.2% and 3.3% in 2024 and 2025, respectively (see Chart 3.9).

Chart 3.9: Potential output growth and output gap estimates (%)



Note: Reproduced from the USP22-25 Chart 2.2, page 23.
Source: MFE

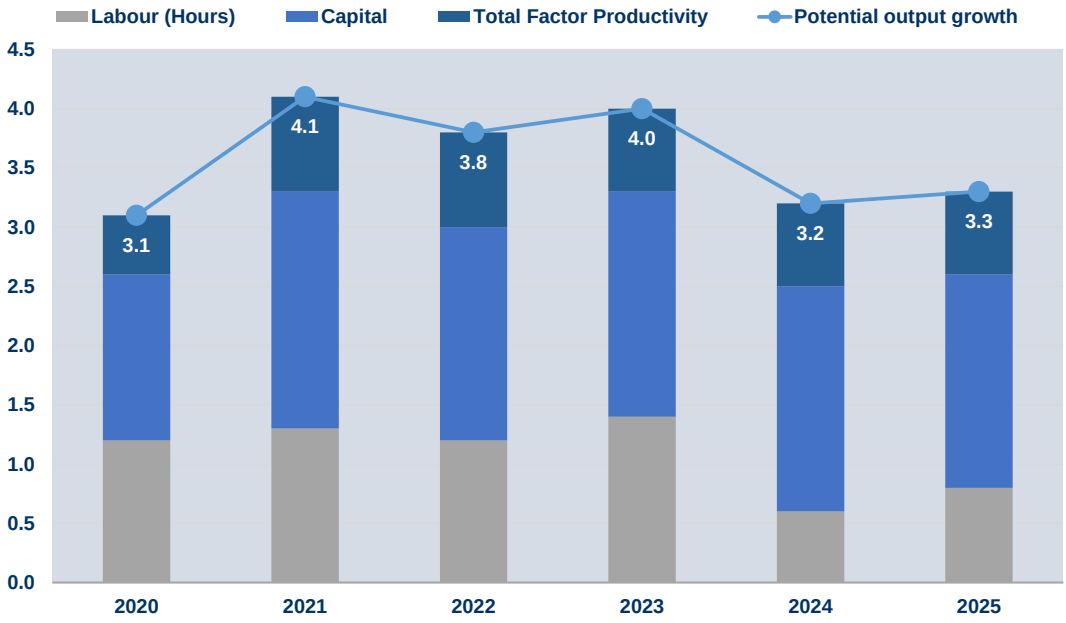
Capital accumulation is expected to be the main driver of potential output growth while the contribution from labour hours is also expected to contribute positively although to a much lesser extent. This outlook is in line with the potential growth composition observed in 2020 and 2021 (see Chart 3.10).

[28] For further details on the commonly agreed methodology, please see here.

Throughout the forecast horizon, total factor productivity is expected to contribute the least to potential GDP growth.[29] The contribution from total factor productivity is expected to remain positive throughout the forecast horizon, contributing 0.8 percentage points in 2022 and 0.7 percentage points in the outer years.

The recovery in potential output growth coupled with an even stronger recovery in GDP in 2021 narrowed the output gap significantly to -1.8% from -6.7% in 2020, implying that there still exists some degree of underutilisation of the economy's productive capacity.[30] The recovery process is expected to continue over the forecast horizon as the output gap is expected to narrow down even further but remain within negative territories, standing at -0.6% in 2025.

Chart 3.10: Sources of potential output growth



Source: MFE

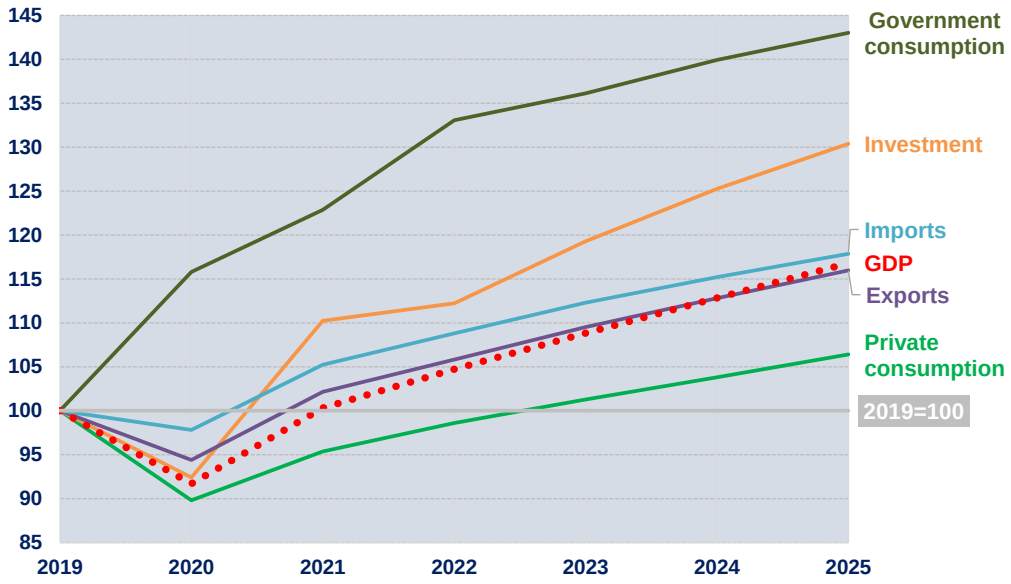
[29] Total factor productivity (TFP) (also referred to as Solow residual) is a measure of productive efficiency in that it measures how much output can be produced from a certain amount of inputs. For relatively small percentage changes, the rate of TFP growth can be estimated by subtracting growth rates of labour and capital inputs from the growth rate of output. A negative TFP indicates that potential output growth is lower than can be attributed to the accumulation of labour and capital.

[30] A positive output gap means that the economy would be operating above potential, signalling an overutilisation of resources.

3.11 Macroeconomic risk outlook

Given the heightened uncertainty prevailing in relation to the possible short-term and medium-term economic effects, the MFAC's macroeconomic risk outlook focuses on the expected profile for each real GDP component over the entire forecast horizon, rather than on the yearly growth rates separately (see Chart 3.11).[31,32] The macroeconomic prospects are very sensitive to the assumptions employed, especially in relation to the timing and speed of global economic growth and inflationary developments. Any material departure from such assumptions could deviate the outturn, possibly significantly, from the official outlook presented in the Update of the Stability Programme. The USP explicitly acknowledges that "despite an expected improvement in economic activity, the situation going forward remains overshadowed with uncertainty. Uncertainty related to the war in Ukraine along with the epidemiological evolution imply that the overall balance of risks remains skewed towards the downside". Assessing the plausibility of the forecast profile over the forecast horizon for the different expenditure components rather than focusing on each year in isolation is therefore considered more suitable.

Chart 3.11: Index for the Real GDP components 2019 – 2025 (2019=100)



Source: MFAC calculations

[31] The MFAC adopted this approach for its risk assessment since the start of the pandemic, that is, from the assessment of the macroeconomic forecasts produced in April 2020 as part of the USP 2020 – 2021.
[32] Chart 3.12 represents an index whereby 2019 levels for each GDP component is equivalent to 100.

All the real GDP expenditure components that suffered a significant hit in 2020 due to the pandemic have all surpassed the pre-pandemic levels in 2021, except for private consumption expenditure. While the growth in real private consumption expenditure was a robust 6.2% in 2021, this was not enough to outpace the decline of 10.2% in 2020. On the other hand, while exports recovered to 2019 levels, out of all the expenditure components, exports achieved the lowest margins. This reflects the fact that private consumption expenditure and exports experienced the largest impact in absolute terms when the pandemic hit.

From 2022 to 2025, out of all GDP components the USP envisages the most progress for general government final consumption expenditure and gross fixed capital formation. For the former variable, the MFE expects public consumption expenditure to continue increasing, albeit at lower rates than in the pandemic years. By 2025, general government final consumption expenditure is expected to reach 143.0% of the 2019 levels. On the other hand, after having recovered quickly in 2021, gross fixed capital formation is expected to record a subdued rate in 2022 on the back of a base effect. Growth in investment is then expected to accelerate over the outer years. In absolute terms, investment is expected to be 30% higher than the 2019 levels. Private consumption expenditure is expected to fully recover and slightly surpass the pre-pandemic levels by 2023.

On the external side, the MFE expects exports to grow at conservative rates over the forecast horizon. The MFE is expecting the exports/GDP ratio to decline by 3.6 percentage points over the forecast horizon as the growth in GDP outpaces the growth in exports. The combined prospects for domestic demand and exports pave the way for a smooth increase in imports over time. Imports are expected to be nearly 18.0% higher in 2025 relative to 2019, whereas exports are expected to be 16.0% higher.

Overall, the output loss which was suffered by the Maltese economy in 2020 was fully recovered in level terms by 2021. In 2022, real GDP is forecast to reach 4.7% above its 2019 level. The 3.9% average growth in real GDP between 2022 and 2025 is expected to drive the real GDP level in 2025 to be 16.8% higher than in 2019.

The conservative forecast for private consumption, to the extent that by the end of the forecast horizon its profile lags the expected recovery in GDP, provides room for an upside risk associated with this variable (i.e., it offers the possibility that the variable turns out higher than anticipated). This view is supported by the anticipated

developments in the labour market, which is still assumed to remain strong over the forecast horizon. This upside risk appears most pertinent to the short-term forecast horizon, particularly when compared to the slightly higher consumption forecasts published by the COM and CBM.

Another upside risk is associated with government consumption. In this case, the forecast horizon envisages a growth profile in the outer years that is much more subdued than experienced pre-pandemic and when compared to the average growth rate experienced in the last decade. The upside risk appears more pertinent for the period 2023 to 2025 since the expected average growth rate is 2.5 times lower than the average growth rate registered in this component over the past decade.

The anticipated growth in gross fixed capital formation largely hinges on the materialisation of a number of large-scale projects. The MFE adopted a cautious approach on this front and only included large-scale projects with a certain level of political will and investor commitment to undertake the project in the baseline scenario. Furthermore, the MFE has also remained cautious when projecting underlying investment. On the other hand, the fact that several risk factors could impinge negatively on foreign direct investment and given the large base effects in the last three quarters of 2021, the MFAC is of the view that risks tilt towards the downside in the short-term.

The MFAC is of the view that export forecasts appear low when benchmarked with historical averages. While, in general, the MFAC acknowledges the elevated uncertainty emanating from the Russia-Ukraine war and the resurgence of the pandemic last Autumn, upside risks exist for exports over the short-term horizon, especially when juxtaposed with the more upbeat forecasts by the COM and CBM and the historical averages recorded in the last decade. The USP assumes a conservative growth in inbound tourists and some key export sectors.

The interplay of upside risks for private consumption, government consumption and exports suggests upside risks for both imports and GDP, spread over the forecast horizon.

Chapter 4
Comparison across different macroeconomic forecasts

4.1 Introduction

The plausibility of the macroeconomic scenario presented in the USP can be further assessed by comparing it to the outlook presented in the DBP 2022 (previous round) and then tracing the new information which could justify the direction of the revisions carried out. A further check is possible by juxtaposing the macroeconomic forecasts produced by the Ministry for Finance and Employment to those of other institutions, namely the COM, CBM, International Monetary Fund (IMF), and credit-rating agencies (Fitch, Moody's, S&P and Scope) and assess the extent of variability between these forecasts.

The caveat is that the suite of forecasts is not necessarily perfectly comparable due to different information available at the time of preparation. The scenarios considered may also be different, such as in relation to the severity and duration of the effects of the pandemic and the recent developments concerning the conflict between Russia and Ukraine. Different assumptions and methodologies, as well as diverse expert judgement, can be other sources of discrepancy. Nonetheless, the MFAC considers such comparisons as a valid benchmark to support the assessment carried out in Chapter 3.

4.2 Comparison with the DBP 2022

According to the USP, in 2022, real GDP growth is expected to be more moderate than envisaged in the DBP (see Table 4.1). Indeed, the USP adjusted the real economic growth for 2022 down by 2.1pp compared to the outlook presented in the DBP. Between the two forecast rounds, the real GDP estimate for 2021 was revised. Indeed, in the DBP the MFE was assuming real GDP growth to be 4.8% in 2021, whilst the actual turnout (used in the most recent forecast within the USP) was 9.4 %.

Table 4.1: Macroeconomic forecasts by MFE, COM, and CBM (%)

	2022				2023		
	DBP	USP	COM	CBM	USP	COM	CBM
	Growth rate in GDP components in real terms						
Private consumption	4.0	**3.4**	3.8	6.4	**2.7**	3.4	4.8
Government consumption	2.7	**8.3**	9.0	4.8	**2.3**	1.4	3.0
Gross fixed capital formation	8.8	**1.8**	2.5	-0.9	**6.3**	4.9	4.6
Exports of goods and services	6.6	**3.6**	5.5	5.8	**3.5**	4.7	3.8
Imports of goods and services	5.5	**3.4**	6.0	4.3	**3.2**	4.3	2.9
Real GDP	6.5	**4.4**	4.2	6.0	**3.9**	4.0	5.3
	Contributions to real GDP growth						
Domestic demand (pp)	4.4	**3.6**	4.0	3.6	**3.1**	2.9	3.7
Inventories (pp)	0.0	**0.0**	0.0	0.0	**0.0**	0.0	0.0
Net exports (pp)	2.1	**0.8**	0.1	2.5	**0.8**	1.1	1.6
	Deflators						
Private consumption	1.6	**3.5**	-	-	**1.9**	-	-
Government consumption	2.5	**3.6**	-	-	**1.3**	-	-
Gross fixed capital formation	1.2	**2.6**	-	-	**1.3**	-	-
Exports of goods and services	2.1	**4.0**	-	-	**1.3**	-	-
Imports of goods and services	1.9	**4.4**	-	-	**1.1**	-	-
GDP	2.1	**2.9**	2.8	2.7	**1.8**	2.6	2.3
	Other macroeconomic variables						
Inflation rate (HICP)	1.7	**3.5**	4.5	3.4	**2.2**	2.6	2.0
Employment growth*	2.2	**2.4**	2.1	2.6	**2.1**	2.0	2.3
Unemployment rate	4.0	**3.4**	3.6	3.5	**3.5**	3.6	3.6
Compensation per employee	2.1	**3.1**	3.8	3.4	**2.9**	2.9	3.1

Note: Figures by the COM were published as the Spring 2022 economic forecasts, while those by the CBM were published in its Economic Projections 2022:1 and partly updated in its Annual Report 2021.

** Figures may not be directly comparable as definitions may vary.*

Sources: MFE, COM, CBM

The lower contribution from net exports in 2022 is attributed to a larger downward revision of 3.0pp in export growth than the 2.1pp lower forecast for the growth in imports. The lower export growth is consistent with the lower expected growth in Malta's main trading partners and higher world prices. On the other hand, the lower import growth is consistent with the lower expectations for domestic demand. This reflected the updated lower growth in private consumption and gross fixed capital formation, which outweighed the substantial increase in the outlook for government consumption growth. Alongside supply-chain issues, the further rise in world prices is a key factor in the downward revision of import growth. This is reflected in the deflator for imports, which was revised upwards by 2.5pp since the DBP, the highest among the rest of the deflators.

Indeed, the generally low expected price dynamics were revised upwards in the USP, with the GDP deflator being raised from 2.1% to 2.9%. This revision can be traced from an increase in all the GDP expenditure deflator components, recording a broad-based average increase of around 1.8pp. The forecast for the HICP inflation rate has also been revised upwards, from 1.7% to 3.5% for 2022.

On the other hand, the prospects for the labour market remained broadly similar across both rounds. Employment is expected to expand by 2.4% in 2022, merely 0.2 pp higher than indicated in the DBP. The unemployment rate forecast was adjusted downwards, from 4.0% in the DBP to 3.4% in the USP while the growth in compensation per employee increased from 2.1% to 3.1%, respectively.

4.3 Comparison with the forecasts produced by other institutions

Detailed macroeconomic forecasts for 2022 and 2023 are also published by the COM and CBM.[33] The COM's forecasts are based on the information available up to the fourth quarter of 2021 (as published through NSO News Release 037/2022), whereas those by the CBM incorporate actual data up to the third quarter of 2021 (as published through NSO News Release 217/2021). Thus, the forecasts by the COM may be

[33] The COM's latest figures relate to the Spring 2022 forecast round published on 16 May 2022, while the CBM's latest forecasts are those published on 28 April 2022 in its 2021 Annual Report. The CBM's forecasts were finalised on 11 February 2022 and thus pre-date the latest release of national accounts on 1 March 2022 and the geopolitical tensions and conflict in Europe.

considered more comparable to those in the USP since they are both based on similar information.

For 2022, the three institutions expect a slower growth in real GDP compared to 2021 (see Table 4.1). Likewise, the three institutions anticipate a slowdown in real GDP growth in 2023. The forecasts for real GDP growth by the MFE and the COM are broadly aligned, with the COM projecting slightly slower growth in 2022 and only 0.1pp higher in 2023. On the other hand, the CBM's real GDP forecasts are higher but follow a similar projection path to that assumed by MFE and COM.

There is consensus regarding the drivers of real GDP growth in 2022 and 2023. For both years, all institutions anticipate growth to be mainly driven by domestic demand, while the positive contribution from external demand is not as strong as that from the domestic side. The three institutions also assumed that inventory dynamics exert no material impact on growth.

The outlook for private consumption for 2022 and 2023 by the COM and CBM is more optimistic than indicated in the USP. In relation to government consumption, the MFE and COM both projected a similar pattern of solid growth in 2022, followed by a much lower growth the year after. On the other hand, the CBM is projecting slower growth in government consumption in 2022 and somewhat higher growth in 2023. This discrepancy in expectations by the CBM is in part attributed to the fact that the latest fiscal plans were not available when the CBM's forecasts were prepared.

The USP and the COM's forecasts also exhibit a similar investment pattern, characterised by subdued growth in 2022, but then accelerating in 2023. In this case, the MFE's numbers are less optimistic in 2022 but higher in 2023. On the other hand, the CBM's forecast points towards negative growth in investment in 2022 but then to recover moderately in 2023. These differences must be interpreted against the difficulty in forecasting this expenditure component and the consequent higher subjectivity used in the forecasting process. In addition, differences in data availability to the institutions given that the forecasts were prepared at different times, also leads to certain variations.

The expected trade dynamics vary across institutions, but all expect lower growth in exports and imports for 2022 and 2023, than the actual growth registered in 2021. However, the COM and CBM forecast exports to be higher relative to MFE's forecasts

in 2022, by 1.9pp and 2.2pp, respectively. Countering such differences is the higher estimate for imports, which is forecast to be 2.6pp higher by the COM and 0.9pp higher by the CBM. In particular, the significantly higher forecast for imports by the COM contributes to only a marginal contribution from net exports towards GDP growth in 2022. For 2023, the COM's and CBM's export growth forecast is also higher than that projected by the MFE. The COM is also projecting a higher growth in imports in 2023, whilst that by the CBM is slightly lower than expected by MFE. Nonetheless, for 2023 exports are expected to grow by more than imports across all institutions.

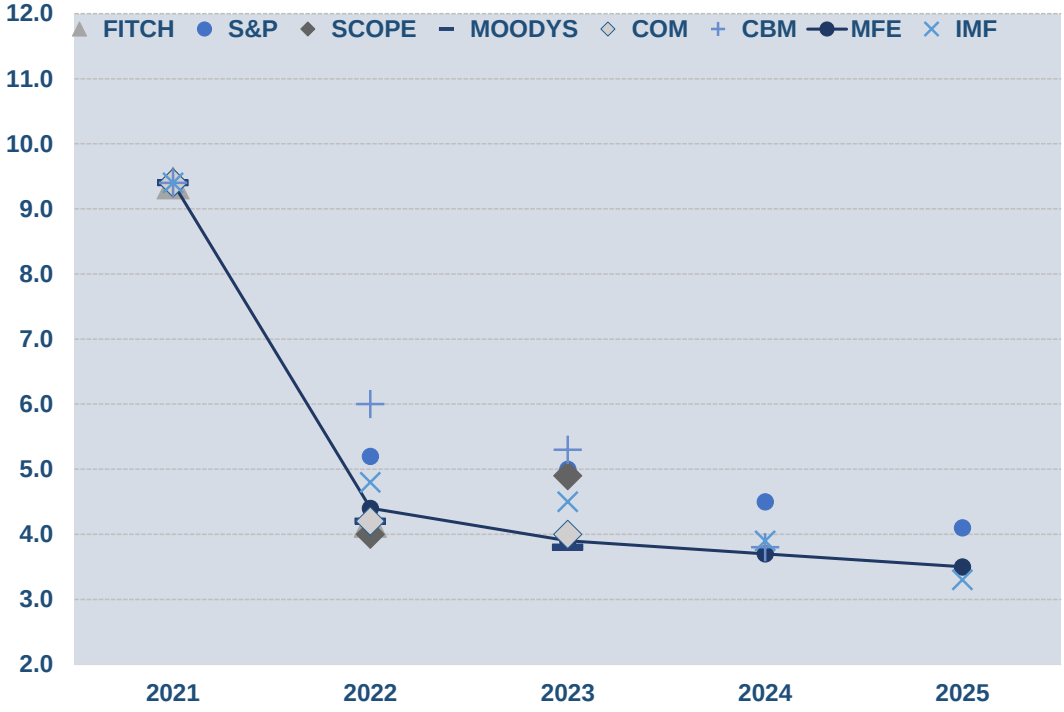
Both the MFE and the CBM expect a similar inflation rate in 2022, at around 3.5%, whereas the COM expects a higher rate of 4.5%. However, all institutions expect inflation to get closer to 2.0% by 2023. The forecast growth in the GDP deflator is similar across institutions in 2022, hovering close to 2.8%. On the other hand, in 2023, the MFE expects the largest fall in the GDP deflator, as the COM and CBM still forecast the deflator to stay above 2.0%.

In relation to the labour market, there is consensus across all institutions that both for 2022 and 2023, the unemployment rate will continue hovering around the 3.5% level, in line with the rate recorded in 2021. However, some variations are noticeable in the employment forecasts, as the USP indicates slightly higher growth in employment than the COM and marginally lower than the CBM in both years. In the case of the COM, the slower increase in jobs in 2022 is compensated for through a higher forecast growth in compensation per employee than indicated in the USP, whereas the same growth is expected in 2023.

Besides the before-mentioned institutions, the IMF and four credit rating agencies (Fitch, Moody's, S&P and Scope) publish macroeconomic forecasts for Malta (see Chart 4.1). The pattern for real GDP growth indicated in the USP broadly fits within the range of forecasts by these institutions throughout the period 2022 to 2025.

For 2022, all institutions expect a slowdown in real GDP growth from that recorded in 2021. Indeed, the range of forecasts varies between 4.0% (Scope) and 5.2% (S&P). Similarly, for 2023 almost all institutions expect real GDP growth to decelerate further but to a lesser extent than in 2022. The downward variations in growth between 2022 and 2023 range from 0.2pp (S&P) to 0.7pp (CBM). All institutions are seeing growth falling across with a similar trajectory in 2024 and 2025, but those by S&P are slightly more elevated in both years.

Chart 4.1: Real GDP growth forecasts by institution (%)[34]



Source: MFE, COM, CBM, IMF, Fitch, S&P, Scope, Moody's

4.4 Assessment

The revisions for 2022 carried out by the MFE in the USP from their previous forecast round (DBP 2022) confirm that the MFE's projections present a slightly more cautious economic outlook reflecting in large part the prevailing uncertainties in relation to the evolution of the pandemic, the conflict between Russia and Ukraine and the subsequent effects from supply chain disruptions and increased global prices. Indeed, the real GDP growth forecast for the year has been lowered. In turn, the forecasts for the outer years build on the premise of continued growth but at a more subdued rate. Indeed, the forecasts for 2023 to 2025 anticipate a return to more stable growth rates. The fact that all other independently produced forecasts show very similar real GDP growth rates, offers some reassurance that based on the information available to date, the scenario as presented within the USP appears to be one around which there is broad consensus. This while still acknowledging the inevitable high degree of uncertainty that prevails.

[34] Not all institutions extend their forecast until 2025.

Chapter 5

Assessment of the fiscal forecasts 2022-2025

5.1 Fiscal outlook 2022 – 2025

The pandemic led to two consecutive years of large fiscal deficits, following a run of fiscal surpluses from 2016 to 2019. Nonetheless, the recovery in national output turned out quicker than was envisaged in the previous forecast vintage. This has led to a less adverse fiscal balance for 2021 than anticipated. Indeed, the fiscal balance for the year was a deficit amounting to 8.0% of nominal GDP, which follows that of 9.5% in 2020 (see Table 5.1).[35] Public expenditure is planned to remain higher than revenue throughout the forecast horizon, but the deficit is targeted to decline progressively in each forecast year, to 2.4% of GDP by 2025. The largest improvement is planned to take place in 2022, as the fiscal deficit-to-GDP ratio is targeted to be reduced by 2.6pp, thus down to 5.4%.

Table 5.1: Main fiscal developments (% of nominal GDP)

	Total Revenue	Total expenditure	Fiscal balance	Structural balance*	Gross debt
2020	36.9	46.3	-9.5	-6.4	53.4
2021	37.5	45.5	-8.0	-7.2	57.0
2022	38.1	43.6	-5.4	-4.9	58.6
2023	38.1	42.7	-4.6	-4.0	59.4
2024	37.6	40.3	-2.8	-2.4	58.6
2025	36.9	39.3	-2.4	-2.1	57.2

* As percent of potential GDP

Source: MFE

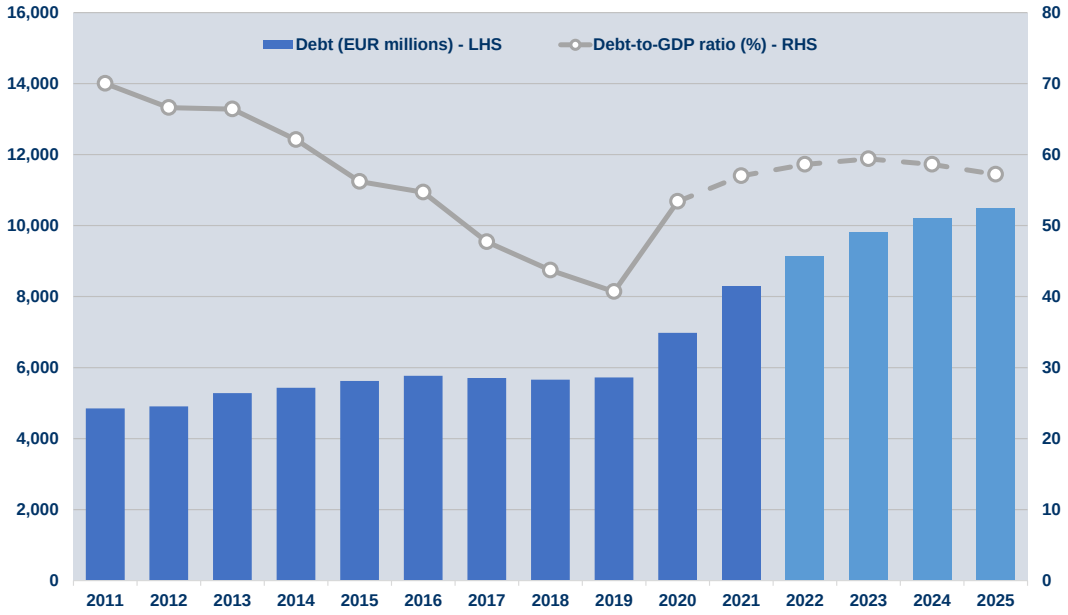
The trajectory for the structural fiscal balance over the period 2022 to 2025 broadly follows a similar path as the headline fiscal balance, improving each year, with the

[35] A deterioration in public finances was also observed across the euro area due to the pandemic. The euro area fiscal deficit was estimated at 5.1% of GDP in 2021.

largest decline also expected in 2022.[36] For the outer forecast years, the estimated magnitude of the output gap and temporary factors get smaller, thus leading to a structural balance (as percent of potential GDP) that is slightly closer to the headline fiscal balance (as percent of nominal GDP).[37]

The large deficits in 2020 and 2021 led to a steep increase in the debt ratio, contrary to the consistent declines which were experienced since 2011 (see Chart 5.1). The public debt-to-GDP ratio climbed to 53.4% in 2020 and to 57.0% in 2021. Though still increasing in 2022 and 2023, the increment is marginal compared to the previous two years. This planned increment in the debt ratio is concomitantly planned to be reversed in the outer years. The rather stable debt projections by the MFE indeed reflect the target that the debt ratio remains close to, but below, the 60.0% of GDP mark over the whole forecast period.

Chart 5.1: Public debt (% of nominal GDP)



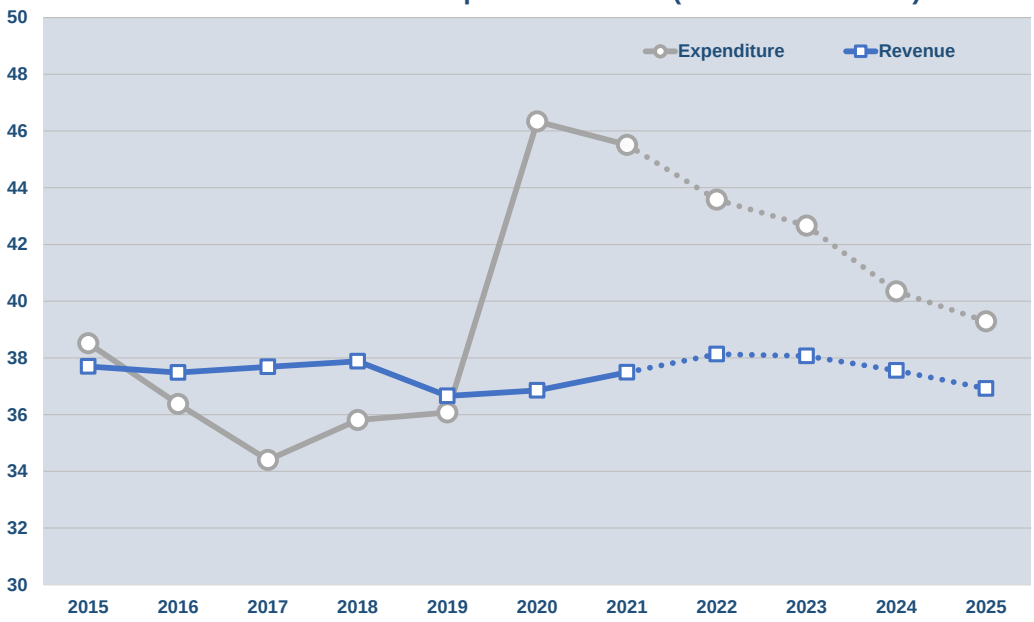
Note: Figures for 2022-2025 are forecasts produced by MFE.
Source: Eurostat, MFE

In 2020, the expenditure-to-GDP ratio rose abruptly, by 10.2 pp, to 46.3% (see Chart 5.2). The expenditure ratio remained elevated in 2021, though it was scaled back to 45.5%. It is expected that over the forecast period, the ratio slides back consecutively,

[36] The structural balance refers to the fiscal balance net of cyclical effects and one-off and temporary measures. It is expressed as a percent of potential output.
[37] The output gap is forecast to almost close over the forecast period, getting down to -0.6% of potential GDP in 2025.

to closer ratios to those recorded pre-pandemic. An average yearly drop of 1.6pp is expected over the four forecast years, with the larger declines targeted in 2022 and 2024. The materialisation of such plans would place the expenditure-to-GDP ratio to just below 40.0% in 2025.

Chart 5.2: Total revenue and total expenditure ratios (% of nominal GDP)



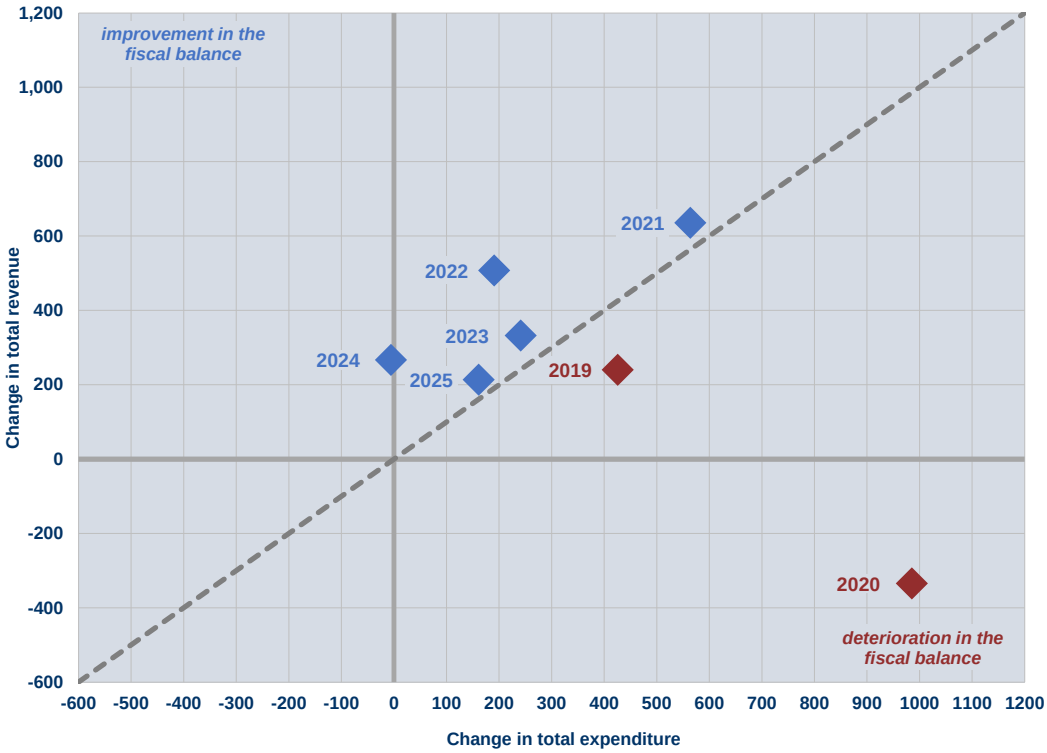
Note: Figures for 2022-2025 are forecasts produced by MFE.
Source: Eurostat, MFE

The forecast profile for the revenue-to-GDP ratio is different, as it is expected to remain much more stable throughout the forecast horizon. The ratio is set to increase marginally in 2022, to 38.1%, and remain constant in 2023, as the increase in total revenue is proportionally the same as that in national output. For the outer years, the MFE is then projecting a marginal decline, with the ratio expected to fall to 36.9% in 2025.

In absolute terms, the fiscal deficit is projected to contract further in each forecast year, following an improvement in the fiscal balance amounting to €71.3 million recorded in 2021. The plan is that the fiscal deficit is lowered most in 2022 and 2024. Indeed, the target is that in 2022 a correction of €316.3 million in the fiscal deficit occurs. This reflects a lower increase in expenditure (€190.8) when compared to the recent years, which is more than offset by an increase in revenue of €507.2 million (see Chart 5.3). Such developments follow the very large deterioration in public finances experienced in 2020 which reflected the simultaneous rise in expenditure and drop in revenue due to the pandemic.

Further correction is envisaged to take place in 2023, 2024, and 2025, which is based on the premise that during these years, revenue rises by more than expenditure. Though in 2023 revenue is set to increase by less than in 2022, the increment in revenue is still higher than the planned increase of €241.3 million in expenditure. In 2024, expenditure is planned to practically be left the same as in the previous year, thus the planned correction in the fiscal balance of €272.0 million almost entirely reflects the increase in revenue planned during that year. For the last forecast year, the planned rise in revenue and expenditure is closer than for the rest of the years, and concomitantly, the targeted improvement in the fiscal balance is lower, at €52.0 million.

Chart 5.3: Annual changes in total revenue and total expenditure (EUR millions)



Note: Anywhere above the dashed line (blue diamonds) indicates combinations of revenue and expenditure developments leading to an improvement in the fiscal balance, whereas anywhere below the dashed line (red diamonds) indicates combinations that lead to a deterioration in the fiscal balance. Anywhere along the dashed line corresponds to a stable fiscal balance which happens when the absolute changes in revenue and expenditure are equal.

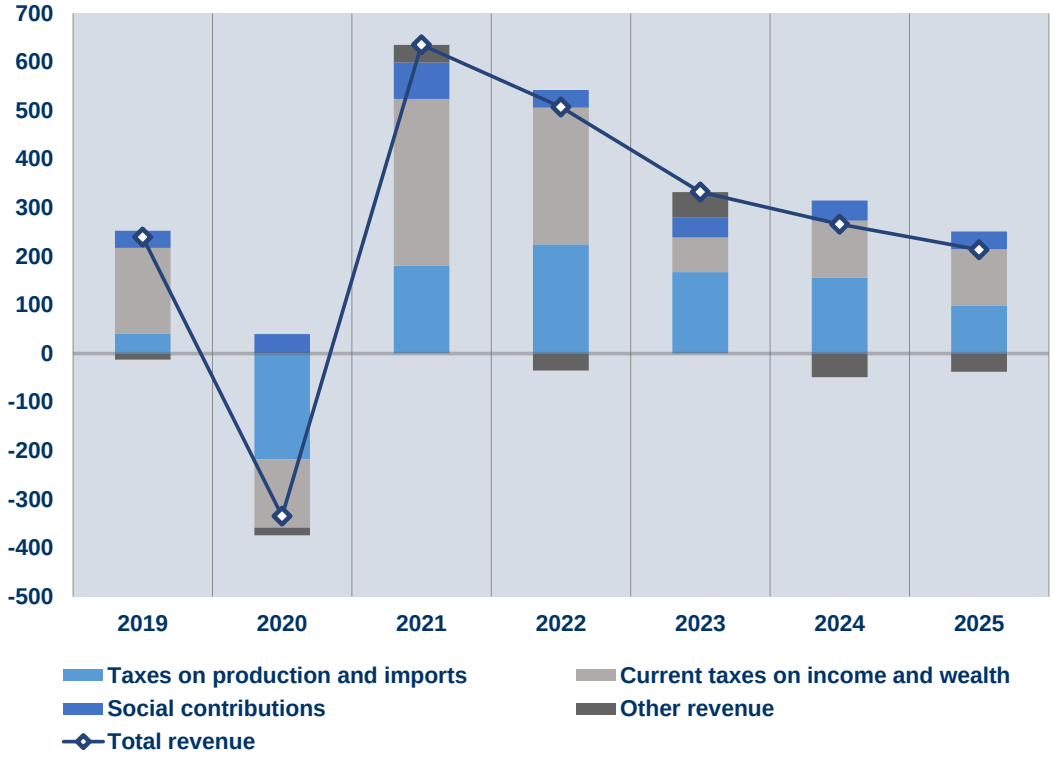
Source: MFE

Following the widespread revenue reductions in 2020, all major revenue components rebounded with substantial increments in 2021 (see Chart 5.4). Similar increments to those in 2021 are planned to continue for the two largest revenue sources (current taxes on income and wealth and taxes on production and imports) in 2022. The largest

source of additional revenue is again set to be current taxes on income and wealth, contributing an additional €281.8 million. The increment in taxes on production and imports in 2022 is set to be even higher than that recorded in 2021, while the additional revenue from social contributions is set to be completely offset by the anticipated decline in the 'other revenue' component'.[38]

For the rest of the forecast years, both current taxes on income and wealth, and taxes on products and imports are still projected to experience growth, though not to the same extent as in 2022, consistent with the further moderation of economic growth. The forecast annual increases in social contributions, extend a broadly stable pattern throughout the forecast horizon. On the other hand, the change in 'other revenue' turns to positive in 2023 but is then set to register less revenue in 2024 and 2025.

Chart 5.4: Yearly changes in revenue components (EUR millions)



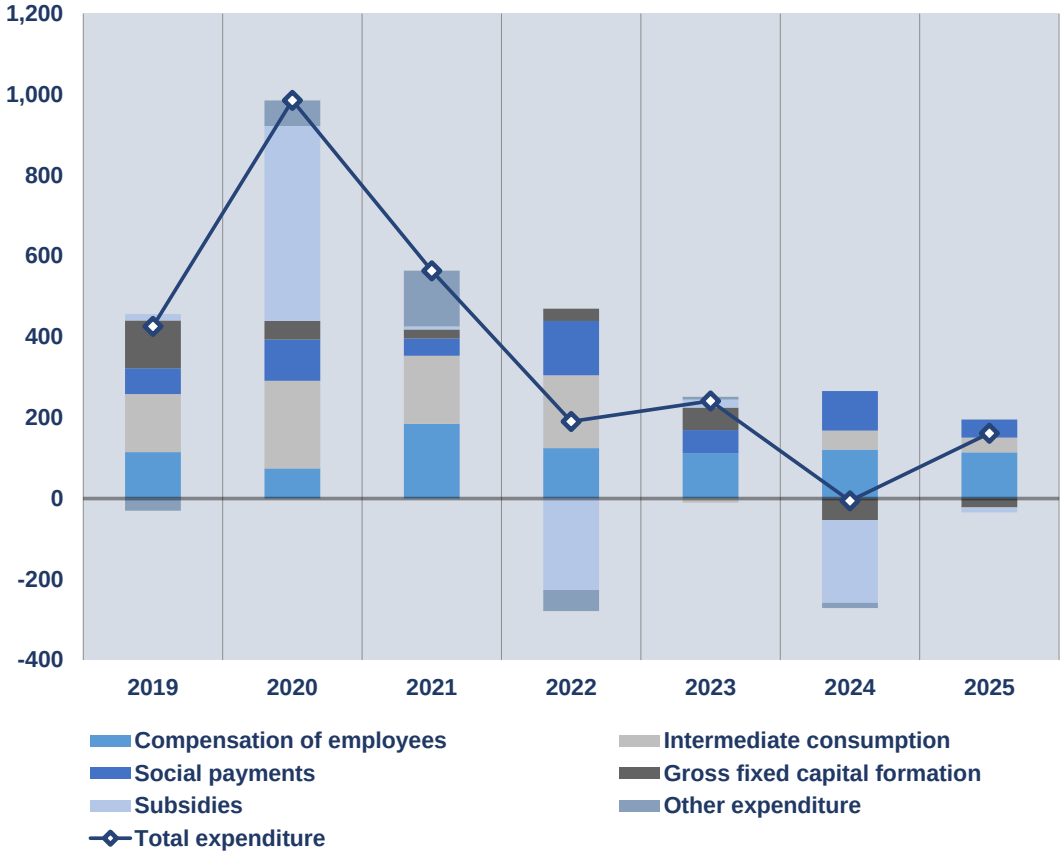
Source: MFE

Turning on to expenditure, higher subsidies and larger outlays on intermediate consumption accounted for most of the strong increase in expenditure in 2020 (see Chart 5.5). Subsidies remained elevated in 2021 (at similarly the same level of 2020), as pandemic support continued, but are planned to be reduced significantly in 2022,

[38] Other revenue comprises capital taxes, property income and 'other' revenue.

broadly remain at the same level in 2023 and again scaled back significantly in 2024. On the other hand, intermediate consumption in 2022 is planned to keep on rising at a relatively similar magnitude as in 2021. The increment in intermediate consumption is set to be of a lesser magnitude over the rest of the forecast years.

Chart 5.5: Yearly changes in expenditure components (EUR millions)



Source: MFE

The forecast annual increments in compensation of employees extend a broadly stable pattern throughout the forecast horizon, thereby rising by a similar amount each year. For social payments, despite that each year such expenditure shall be higher, there is slightly more variability across the years, with larger increments in 2022 and 2024. Public investment (gross fixed capital formation) is set to increase in both 2022 and 2023, which is then followed by two years of marginally lower investment. Finally, 'other expenditure' shall initially decline in 2022, and thereafter is assumed to remain rather stable over each of the forecast years.[39]

[39] Other expenditure comprises interest expenditure, capital transfers payable and 'other' expenditure.

Table 5.2: Fiscal developments in absolute terms (EUR millions)

	Actual		Forecasts			
	2020	2021	2022	2023	2024	2025
Total revenue	**4,813.4**	**5,448.6**	**5,955.8**	**6,288.0**	**6,554.4**	**6,767.9**
Taxes on production and imports	1,395.1	1,575.7	1,800.1	1,967.4	2,123.2	2,221.1
Current taxes on income and wealth	1,686.6	2,029.8	2,311.7	2,383.4	2,501.4	2,618.3
Social contributions	839.9	914.9	950.9	991.4	1,032.7	1,068.9
Capital taxes*	22.6	29.3	22.9	24.4	25.8	27.2
Property income*	84.3	81.4	68.3	79.1	79.2	79.2
Other revenue*	784.9	817.4	801.9	842.3	792.1	753.1
Total expenditure	**6,051.1**	**6,615.0**	**6,805.8**	**7,047.0**	**7,041.4**	**7,202.9**
Compensation of employees	1,584.9	1,769.6	1,894.4	2,006.6	2,127.5	2,241.3
Intermediate consumption	1,190.7	1,359.3	1,539.2	1,529.1	1,576.0	1,612.8
Social payments	1,347.1	1,389.5	1,524.1	1,580.9	1,678.6	1,723.5
Gross fixed capital formation	585.1	607.4	637.6	693.6	639.7	617.4
Subsidies	678.2	685.7	458.8	478.7	274.3	262.2
Interest expenditure**	172.5	212.0	166.1	174.7	188.1	200.7
Capital transfers payable**	167.3	161.9	169.2	199.7	174.9	162.7
Other expenditure**	325.3	429.6	416.3	383.7	382.2	382.3
Fiscal balance	**-1,237.7**	**-1,166.3**	**-850.0**	**-759.0**	**-487.0**	**-435.0**
Gross debt	**5,702.8**	**8,284.4**	**9,150.7**	**9,812.9**	**10,223.0**	**10,480.6**
Nominal GDP	13,059.9	14,533.8	15,618.0	16,517.6	17,452.4	18,332.3

Note: Some figures might not add up due to rounding.

* Considered as part of ‘other revenue’ elsewhere in this Report.

** Considered as part of ‘other expenditure’ elsewhere in this Report.

Source: MFE

A detailed assessment of the forecasts for the various revenue and expenditure components follows (see Table 5.2). The analysis contributes to the overall outlook and opinion of the MFAC vis-à-vis the targets for the fiscal balance and public debt outlined in the latest USP.

5.2 Assessment of the revenue projections

The projections for the different components making up total revenue are analysed separately. The assessment consists in a review of the projected trajectory for each variable, with a focus on the consistency with the macroeconomic scenario as presented in the USP, and the estimated magnitude of any fiscal measures, or known factors, which are relevant over the forecast horizon.

An important set of measures implemented by the government at the beginning of the pandemic and extended to 2021 related to tax deferrals. These were applicable to the three main tax sources: taxes on production and imports; current taxes on income and wealth; and social contributions. The impact of these tax deferrals was estimated by MFE and fully imputed, thereby exerting no impact on revenue in ESA terms.

5.2.1 Taxes on production and imports

In 2021, taxes on production and imports increased by €180.6 million, corresponding to a 12.9% growth rate over 2020 (see Table 5.3). This increase nearly recovered the revenue shortfall experienced in the previous year. In 2022, taxes on production and imports are expected to increase by €224.4 million or 14.2% growth over 2021.

Over the outer years, indirect taxes are then expected to grow by 9.3% and by 7.9% in 2023 and 2024, respectively, which on average is slightly above the 7.9% average growth recorded over the five-year period 2015 to 2019 (pre-pandemic). The materialisation of this scenario would place the ratio of indirect taxes to nominal GDP at 12.2% in 2024, which is above the ratio recorded in the pre-pandemic years (see Chart 5.6). Although the growth in nominal GDP outpaces the growth in nominal private consumption expenditure (which is the most relevant tax base for indirect taxes) over the forecast horizon, this is more than offset by the growth in tourism exports which is expected to register strong growth between 2022 and 2024. For 2025, the MFE is

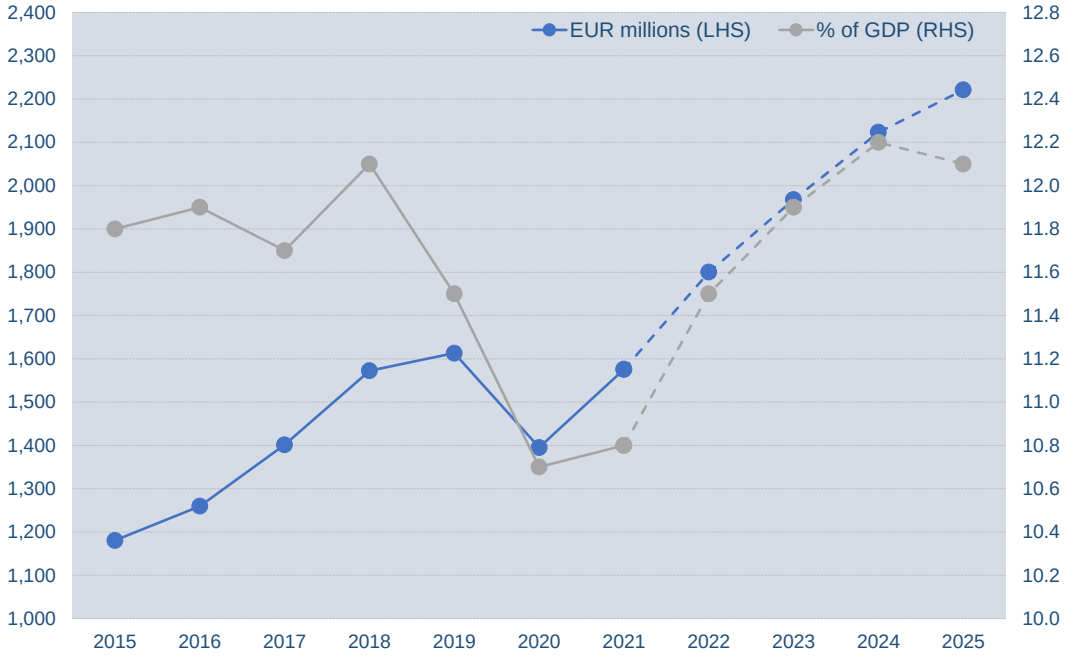
assuming further deceleration, primarily given the lower growth assumed for tourism exports due to normalisation.

Table 5.3: Taxes on production and imports

	Taxes on production and imports		Growth in private consumption		Growth in tourism exports
	Growth (%)	Change (EUR millions)	Nominal (%)	Real (%)	Nominal (%)
2019	2.6	40.6	6.6	4.6	7.9
2020	-13.5	-217.9	-9.2	-10.2	-79.8
2021	12.9	180.6	7.5	6.2	91.9
2022	14.2	224.4	7.0	3.4	70.9
2023	9.3	167.4	4.6	2.7	31.7
2024	7.9	155.8	4.2	2.5	22.2
2025	4.6	97.9	4.0	2.5	8.5

Source: MFE

Chart 5.6: Taxes on production and imports



Source: MFE

Revenue from taxes on production and imports turned out to be stronger than anticipated in the previous Update of the Stability Programme. Taxes on production and imports was largely propelled by upward developments in tourist expenditure,

coupled with stronger than anticipated private consumption expenditure. This was partly offset by the fiscal impact of extended reduced taxation on the transfer of immovable property, and new and extended fiscal measures resulting in lower excise applicable on petroleum products, as well as more moderate behavioural responses with respect to the relative tax bases than anticipated.

5.2.2 Current taxes on income and wealth

Current taxes on income and wealth are expected to increase by €281.8 million, or 13.9%, in 2022 (see Table 5.4). Direct taxes are anticipated to grow at a much slower rate in 2023, up by 3.1%. The forecast growth rates for the outer two years is expected at an average of 4.8%. Both personal and corporate income taxes are expected to contribute to the recovery in direct taxes over the forecast horizon, consistent with the expected increases in compensation of employees and gross operating surplus.[40]

Table 5.4: Current taxes on income and wealth

	Growth (%)	Change (EUR millions)	Compensation of employees (%)	Gross operating surplus (%)
2019	10.7	176.6	9.4	8.8
2020	-7.7	-140.4	1.7	-5.8
2021	20.4	343.3	7.4	13.5
2022	13.9	281.8	5.7	3.7
2023	3.1	71.7	5.1	5.4
2024	4.9	118.0	4.8	3.0
2025	4.7	117.0	4.7	5.1

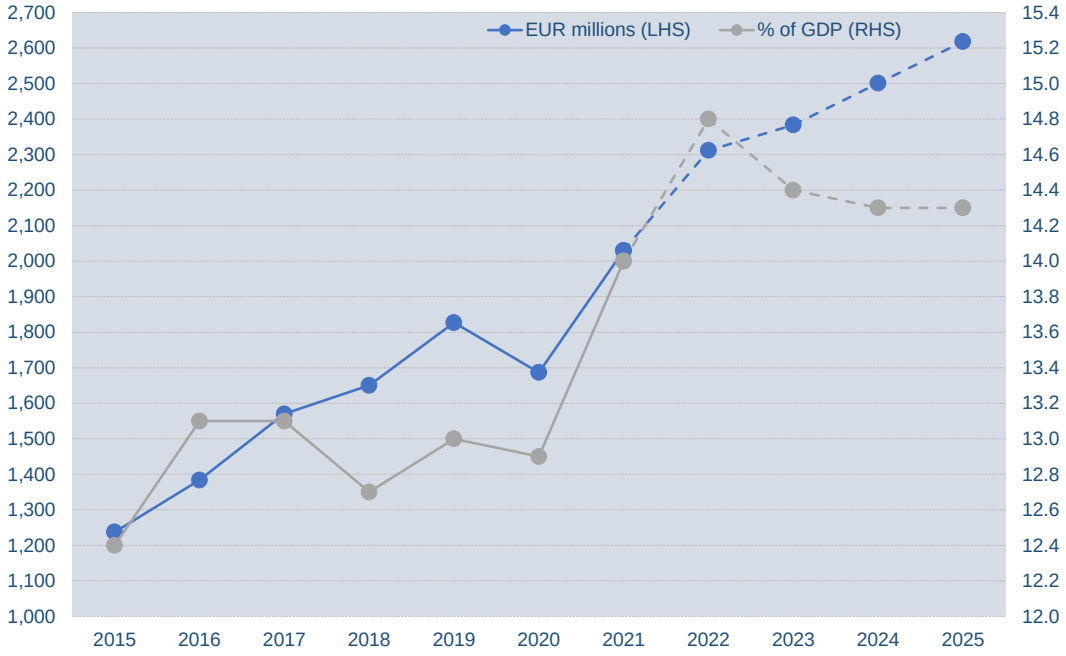
Source: MFE

In 2022, direct taxes are expected to grow at a slightly faster rate than either compensation of employees or gross operating surplus while in 2023, the opposite is expected. In 2024, the expected growth in direct taxes is slightly above the range of growth rates for compensation of employees and gross operating surplus while in 2025, it fits within the range.

[40] Compensation of employees and gross operating surplus are the two most relevant proxy tax bases for direct taxes.

Following the robust increase in current taxes on income and wealth in 2021, after the dip experienced in 2020, the ratio of direct taxes to nominal GDP increased by 1.1 percentage points (from 12.9% to 14.0%). The expected strong increase in direct taxes in 2022 is expected to drive the ratio of direct taxes to nominal GDP to 14.8% before slightly declining to 14.4% in 2023 and 14.3% in the outer years of the forecast horizon (see Chart 5.7). When compared to the growth rates recorded pre-pandemic, it is notable that the forecast scenario assumes lower growth outlook for compensation of employees and gross operating surplus.

Chart 5.7: Current taxes on income and wealth



Source: MFE

5.2.3 Social contributions

The 2022 forecast growth in social contributions, at 3.9%, is low when compared to the average growth rate (7.1%) recorded in the recent 5 years prior to the pandemic (see Table 5.5). This allows for a possible slowdown since even when the pandemic hit, social contributions increased, contrary to what has happened to direct and indirect taxes. The resilience of social contributions is explained by the fact that these were automatically being deducted from the wage support measures which were provided by the government.[41]

[41] This creates an equivalent impact on the revenue and expenditure side of the budget.

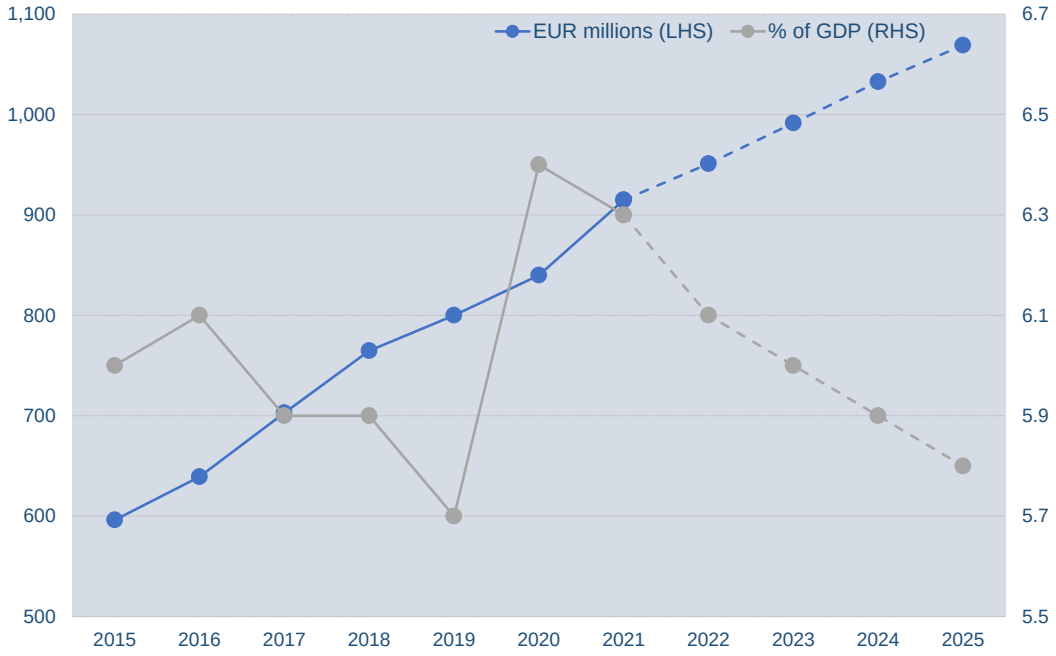
Table 5.5: Social contributions

	Growth (%)	Change (EUR millions)	Compensation of employees (%)
2019	4.6	35.3	9.4
2020	5.0	39.8	1.7
2021	8.9	75.0	7.4
2022	3.9	36.0	5.7
2023	4.3	40.5	5.1
2024	4.2	41.3	4.8
2025	3.5	36.3	4.7

Source: MFE

Over the forecast horizon, nominal GDP is expected to grow at a faster pace than social contributions. Thus, the ratio of social contributions to GDP is expected to fall gradually to 5.8% by 2025 (see Chart 5.8).

Chart 5.8: Social contributions



Source: MFE

Such developments would offset almost entirely the upward spike created in 2020 (due to the higher social contributions and the fall in nominal GDP).[42] The forecast trajectory

[42] The drop in nominal GDP was driven by gross operating surplus whereas compensation of employees was resilient. This explains why social contributions still increased in 2020.

is entirely driven by the developments in the tax base and the statutory increase in the payment ceiling, as no additional policy changes or measures are being factored in the baseline scenario. Over the forecast horizon, the growth in compensation of employees is expected to outpace the growth in social contributions.

5.2.4 Other revenue components

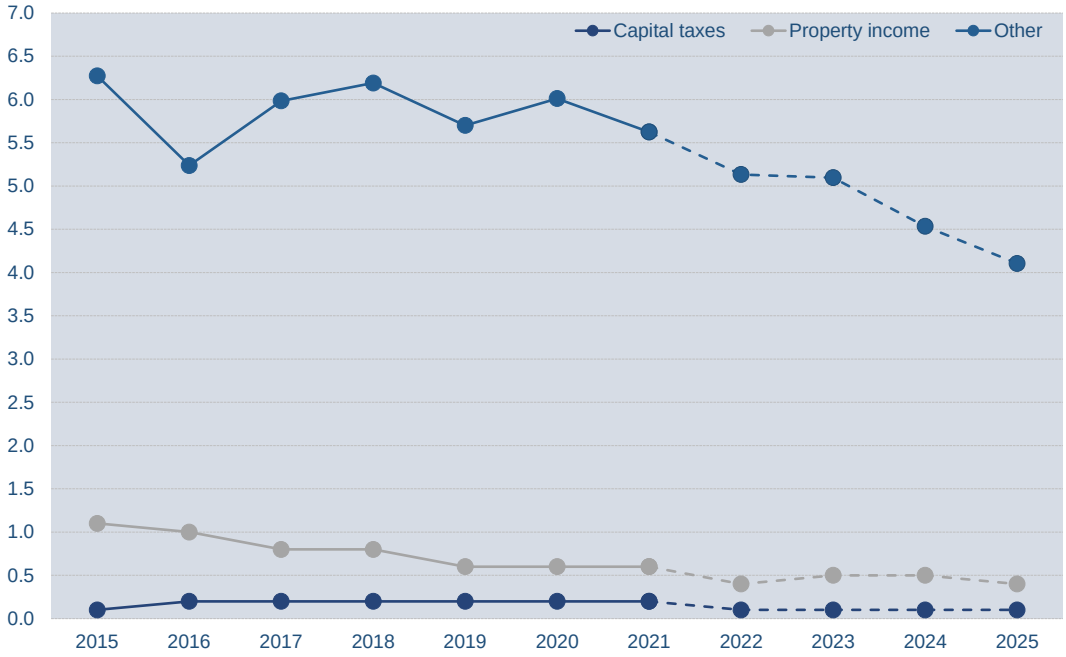
Taxes on production and imports, current taxes on income and wealth, and social contributions together account for the bulk of total revenue. In 2021, their combined share made up 83.0% of total revenue. Throughout the forecast horizon, this share is expected to increase gradually to 87.3% in 2025. The remaining revenue components consist of capital taxes, property income and 'other revenue'. The latter includes EU funds, as well as the proceeds from the Individual Investor Programme (IIP) and the new residency programme which replaced it towards the end of 2020.[43] The forecast trajectories for the revenue components as percentage of nominal GDP are shown in Chart 5.9.

Throughout the forecast horizon property income and capital taxes are assumed to broadly maintain their ratios to nominal GDP stable and low, comparable to the values recorded in 2021 (respectively 0.6% and 0.2%). As a result, these items exert a limited influence on the overall fiscal scenario for the period 2022 to 2025.

Fluctuations in the revenue from the remaining miscellaneous components are more material. In 2022, the combined amount from the other revenue sources is set to decrease by €15.5 million on a year earlier. The bulk of this revenue is associated with EU funds. For the rest of the forecast years, other revenue is projected to increase by €40.4 million in 2023 and then decline by €50.2 million in 2024 and by €39.1 million in 2025. Throughout the forecast horizon, the target revenue from the residency programme is stable and much less pronounced than in pre-pandemic years.

[43] Malta's Granting of Citizenship for Exceptional Services by Direct Investment Regulations (S.L. 188.05), under the Maltese Citizenship Act Cap. 188, LN437 of 2020, allow for the granting of citizenship by a certificate of naturalization to foreign individuals and their families who contribute to the country's economic development. The legal notice is available here.

Chart 5.9: Other revenue components (% of nominal GDP)



Source: MFE

5.3 Assessment of the expenditure projections

The forecasts for the different expenditure components are analysed separately. The assessment consists in a review of the projected trajectory for each variable and the estimated magnitude of the fiscal measures or known factors which are relevant over the forecast horizon. The outlook for certain categories remains very sensitive to the assumptions about the size and duration of pandemic-related expenditures and the budgetary measures announced by Government to shield households and businesses from the increases in the international price of oil and ensure stability in the price of cereals (including wheat) as well as security of supply. Another determining factor is the planned timeframe and priority areas for the utilisation of the EU funds (including the RRF grants and the MFF)

5.3.1 Compensation of employees

Expenditure on compensation of employees is projected to increase by 7.1% in 2022, which represents a slower growth compared to that registered in 2021 (see Table 5.6). However, the growth in compensation of employees in 2021 was higher than targeted

in the previous forecast round, following a slower than usual growth in the previous year due to restricted recruitment because of the pandemic.

Table 5.6: Compensation of employees

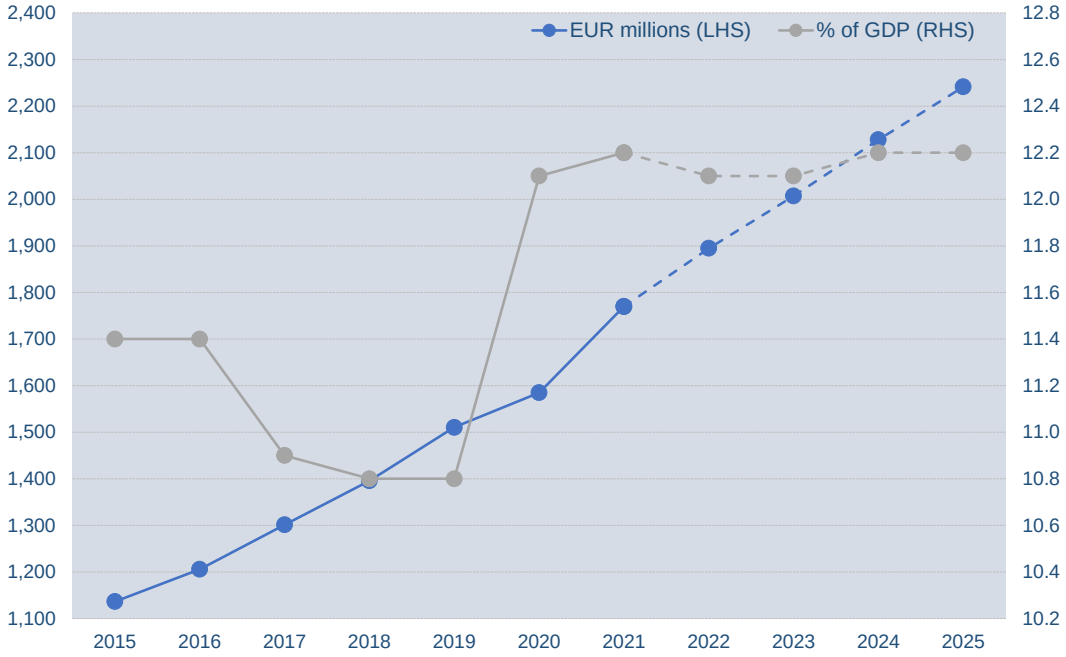
	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2019	8.2	114.7
2020	4.9	74.4
2021	11.7	184.7
2022	7.1	124.8
2023	5.9	112.2
2024	6.0	120.8
2025	5.4	113.8

Source: MFE

Over the period 2022 to 2025, the yearly average expansion in the budget allocation for the public sector wage bill is slightly more than 6.0%. The rather stable trajectory is reflected in the component's ratio to GDP which is targeted to stay between 12.1% and 12.2% over the four forecast years (see Chart 5.10). The ratio had risen abruptly in 2020 because of the contraction in nominal GDP which acts as the denominator. The budget allocation on public sector wages is expected to rise at a similar pace to the growth in nominal GDP, thus maintaining stability. This would keep the ratio above the ratios recorded in the years prior to the pandemic.

The public sector wage bill is mainly driven by the number of public sector employees and their average wage. Employment within government departments is decentralised, and Ministries are free to determine their employment levels, based on the planned recruitment, as envisaged in the ministries' and departments' plans. However, the public sector employees include not only those in government departments but also all the employees within public sector entities and within institutions classified as Extra-Budgetary Units (EBUs). The allocations for compensation of employees for the period 2023 to 2025 by EBU's has been raised compared to the previous forecast rounds to create a balance between past trends and expected price and wage developments. Individuals employed by EBUs may be covered by separate collective agreements and employment contracts, although they should still be expected to follow the government's general guidelines on wages.

Chart 5.10: Compensation of employees



Source: MFE

5.3.2 Intermediate consumption

In 2022, intermediate consumption is expected to rise by €179.9 million or 13.2% (see Table 5.7). This represents a slight deceleration from the growth, in percentage terms, of a year earlier. The additional expenditure mainly reflects an increase in programmes and initiatives classified as intermediate consumption, including increased pandemic-related expenses and additional outlays on carbon credits.[44] The forecast accounts for the expected attenuation of the expenses related to the pandemic in line with the improvement of the situation.[45]

[44] Carbon credits will enable public and private entities to invest in green and environmental projects with the aim of creating a carbon credit surplus that could then be acquired, on a voluntary basis, by other public or private entities to help them meet their own carbon targets.
[45] Items that are classified as intermediate consumption include outsourced health services and medical supplies.

Table 5.7: Intermediate consumption

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2019	17.3	143.8
2020	22.2	216.6
2021	14.2	168.6
2022	13.2	179.9
2023	-0.7	-10.2
2024	3.1	47.0
2025	2.3	36.7

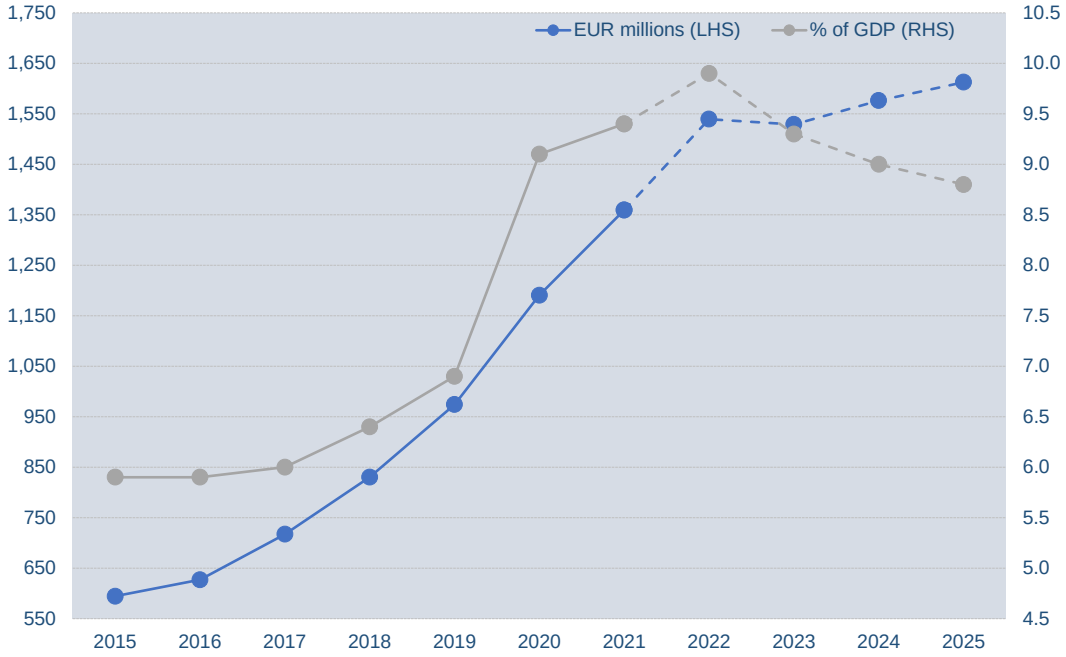
Source: MFE

The reduction of COVID-19 related expenditures explains the -0.7% planned reduction in the budget on intermediate consumption in 2023, which represents a decrease of €10.2 million. Subsequently, the expansion in the budget allocation on intermediate consumption is contained to 3.1% in 2024 and 2.3% in 2025. Meanwhile, the ratio of intermediate consumption to GDP is expected to increase to 9.9% of GDP in 2022 and remain above the pre-pandemic level across the forecast horizon, albeit falling to 8.8% of GDP by 2025 (see Chart 5.11).

It is acknowledged that this component tends to be volatile over time particularly as it has a rather strong discretionary element. However, it may be challenging to remain within budget in the outer forecast years as the planned developments are much lower than the 13.3% average growth recorded over the five-year period 2015 to 2019 (pre-pandemic).[46] Over time, initiatives have tended to be replaced by other expenditures. This pattern effectively makes it more difficult for intermediate consumption to depart from previous trends, unless driven by specific cost saving initiatives. The government is aware that control, in particular over intermediate consumption expenditure, is necessary to reach the targeted fiscal consolidation growth path over the medium-term, hence the planned cost savings from this component.

[46] The budgeted expenditure amounts specified in the USP sometimes act as an envelope on expenditure without the full granular specification, thereby creating instances when certain amounts are initially categorised under one heading (using historic ratios), but ex-post are reallocated to other headings when detailed information becomes available. This approach tends to limit the comparability between actual and forecast data, an observation that does not apply only to intermediate consumption but to the other expenditure components too.

Chart 5.11: Intermediate consumption



Source: MFE

5.3.3 Social payments

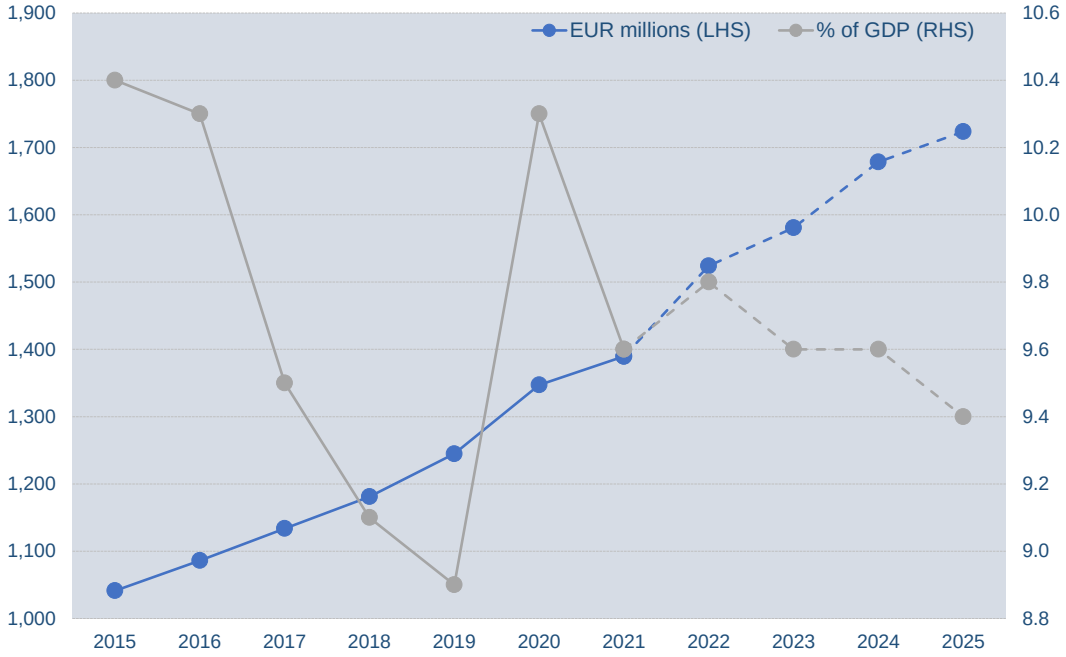
The substantial increase in the ratio of social payments to nominal GDP in 2020 was partially reversed in 2021 (see Chart 5.12). This reflected the lower growth in social payments (numerator), given the base effect from 2020, and the growth in nominal GDP (denominator). In 2022, the ratio of social payments to nominal GDP is expected to increase given that social payments are expected to rise by 9.7%, equivalent to an additional €134.7 million (see Table 5.8).

Table 5.8: Social payments

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2019	5.4	63.8
2020	8.2	102.2
2021	3.1	42.4
2022	9.7	134.7
2023	3.7	56.7
2024	6.2	97.8
2025	2.7	44.9

Source: MFE

Chart 5.12: Social payments



Source: MFE

In the outer forecast years, growth in social payments is expected to average 4.2%, comparable with those recorded over the five-year period 2015 to 2019 (pre-pandemic). In terms of discretionary measures, a main development is that relating to free public transport to all residents, which measure is planned to start in October of 2022. The expenditure forecasts build on the assumption that outlays on social payments grow at a slower pace than nominal GDP from 2023 onwards. This factor underpins the resumption of the downward trend in the social payments to GDP ratio portrayed in the forecasts.

5.3.4 Gross fixed capital formation

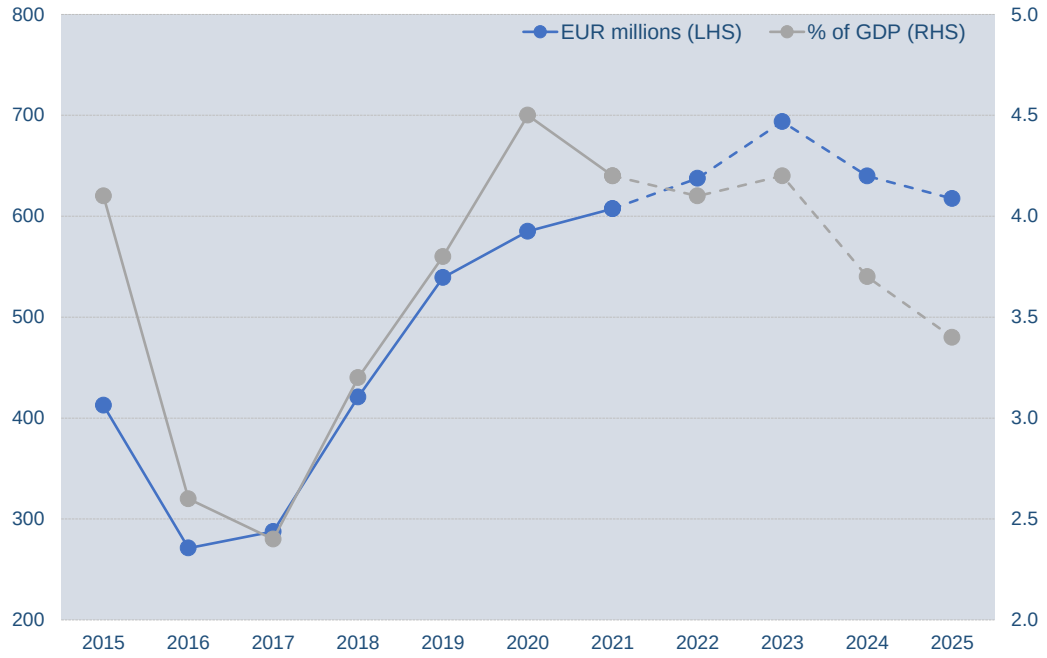
The planned spending with respect to public investment is somewhat volatile across the forecast years. Indeed, growth in government investment has historically tended to be volatile. In 2022, the allocation for public investment is expected to be higher than in the previous year by €30.2 million, and in 2023, public investment is targeted to increase further by €56.1 million when compared to 2022 (see Table 5.9). However, these increments are planned to be reversed in 2024 and 2025, thus leaving the level of public investment, close to, though marginally higher than the level in 2021 (see Chart 5.13).

Table 5.9: Gross fixed capital formation

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2019	28.1	118.3
2020	8.5	45.9
2021	3.8	22.3
2022	5.0	30.2
2023	8.8	56.1
2024	-7.8	-53.9
2025	-3.5	-22.3

Source: MFE

Chart 5.13: Gross fixed capital formation



Source: MFE

The ratio of public investment to GDP is expected to remain elevated and stay close to 4.2% in 2022 and 2023, before declining to 3.7% in 2024 and 3.4% in 2025. The figures for public investment include those incorporated in the Recovery and Resilience Plan (RRP).[47] The RRF grants are entirely planned to be used as public investment, with the intention to boost the recovery from the pandemic and elevating potential growth. All grants are planned to be utilised between 2022 and 2025, as no funds are

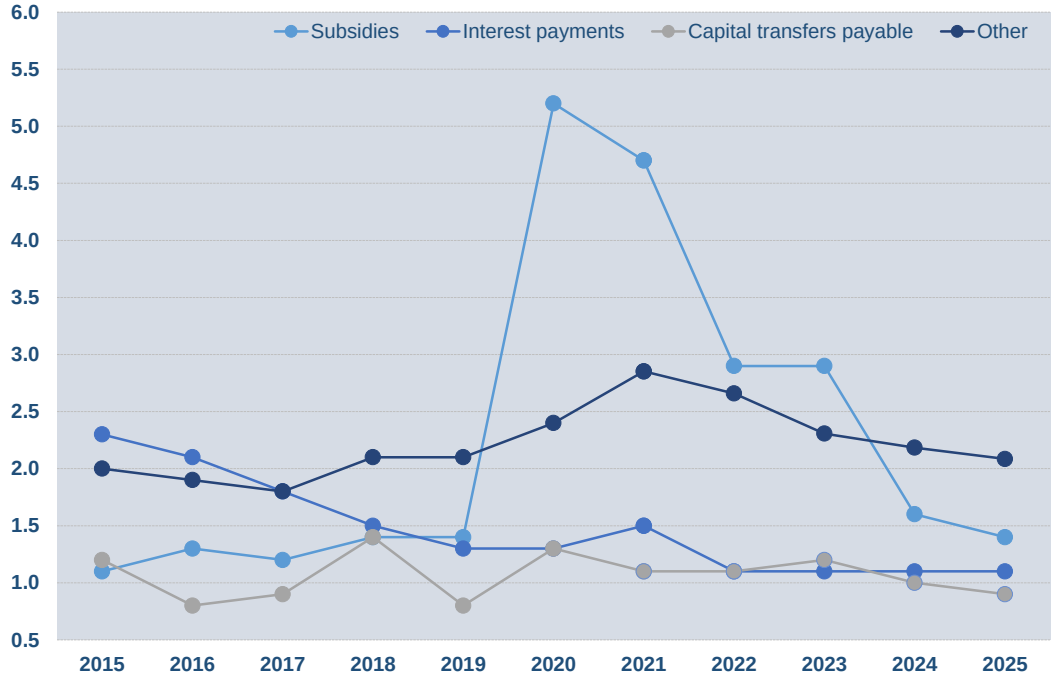
[47] Further information on Malta's RRP is available here.

allocated in 2026.[48] The government is planning to shift public investment from that on public infrastructure, road and transport networks to incentives encouraging more green and digital investment. Other investment projects are also funded from the Multiannual Financial Framework (MFF) for the period 2021-2027.[49]

5.3.5 Subsidies and other expenditure components

The share of subsidies and the other components in total expenditure has increased during the years of the pandemic. Subsidies increased to more than 5.0% of nominal GDP in 2020 and remained elevated at 4.7% in 2021 (see Chart 5.14). This surge mainly reflected the assistance provided by the government to support employment through various initiatives, primarily the wage support scheme administered by Malta Enterprise.

Chart 5.14: Other expenditure components (% of nominal GDP)



Source: MFE

In 2022 and 2023, the plan is to reduce the allocation for subsidies to 2.9% of nominal GDP. This reflects two developments. On one hand, the subsidies allocated towards

[48] Investment financed from RRF grants are expected to amount to 0.4%, 0.5%, 0.6%, and 0.4% of GDP respectively in each year from 2022 to 2025.
[49] Further information on the MFF is available here.

COVID support are planned to be reduced significantly. Indeed, in 2022, sustainable enterprise schemes are planned to account for only around 20% of the level in 2021. This accounts for the gradual phasing out of the wage subsidy scheme through lower rates per employee eligible during the first months of the year, but largely because of the scheme's termination in May.

On the other hand, additional expenditure was introduced in 2022 to tackle rising energy prices. The fiscal projections for 2022 suggest a total budgetary impact of 1.13% of nominal GDP arising from discretionary measures to offset the impact of inflation hikes.[50] The largest outlays represent compensation for higher imported electricity prices, projected at €81.2 million in 2022, while €30.0 million are being factored towards support on petroleum products. The Ministry is exerting prudence in allocating more expenditure for 2023 with respect to mitigating high energy prices than is envisaged for 2022. However, such calculations are subject to revision, also given that these critically depend on exogenous factors and external developments relating to the conflict in Ukraine and the supply of energy from abroad. The budgetary impact of these discretionary measures is projected to subside significantly in the outer forecast years.

A Gas Stabilisation Fund was also created in 2022 to pay operators, being authorised importers and sellers in bulk or in gas cylinders, to compensate for the shortfall between a fair market price and the actual (stabilised) consumer price. Moreover, commodity price and supply security measures were implemented to aid the importers of grain, wheat and animal fodder.

Spending on interest payments is expected to drop in 2022, as the MFE is factoring a lower implicit interest rate on debt. Between 2023 and 2025, interest payments are projected to increase by €11.5 million on average, with the implicit interest rate on debt assumed to remain relatively constant. Such developments would leave interest expenditure at 1.1% percent of nominal GDP over the whole forecast period.

In 2022, capital transfers are assumed to retain a close level to that in 2021. On the other hand, a higher allocation for capital transfers is being budgeted for 2023, with the

[50] The MFE explained that the budgeted figures for the various discretionary measures relating to the mitigation of inflationary pressures were incorporated into the projections but these were not identified separately in Table 3.3 (of the USP) in time for publication of the USP. Therefore, Table 3.3 shows a different budgetary impact than quoted above.

level increasing to €199.7 million. This reflects the intention of the government to provide financial assistance to the national airline, to undertake further restructuring. The budgeted amounts are €10.0 million in 2022 and €75.0 million in 2023. However, such assistance is currently under discussion with the COM as well as with national stakeholders. The target is that capital transfers in 2024 and 2025 are to scale back to around 1.0% of nominal GDP from 1.2% in 2023.

In terms of the 'other expenditure components', the MFE is assuming their ratio to nominal GDP to fall consecutively and get close to 2.0% by 2025, thus more similar to the ratios recorded pre-pandemic. Most of the developments in the 'other expenditure' component reflect EU Own Resource payments. In 2022, the forecasts factor in the added expenditure from the already distributed economic stimulus cheques, whilst tourism support schemes are to subside compared to their level in 2021.

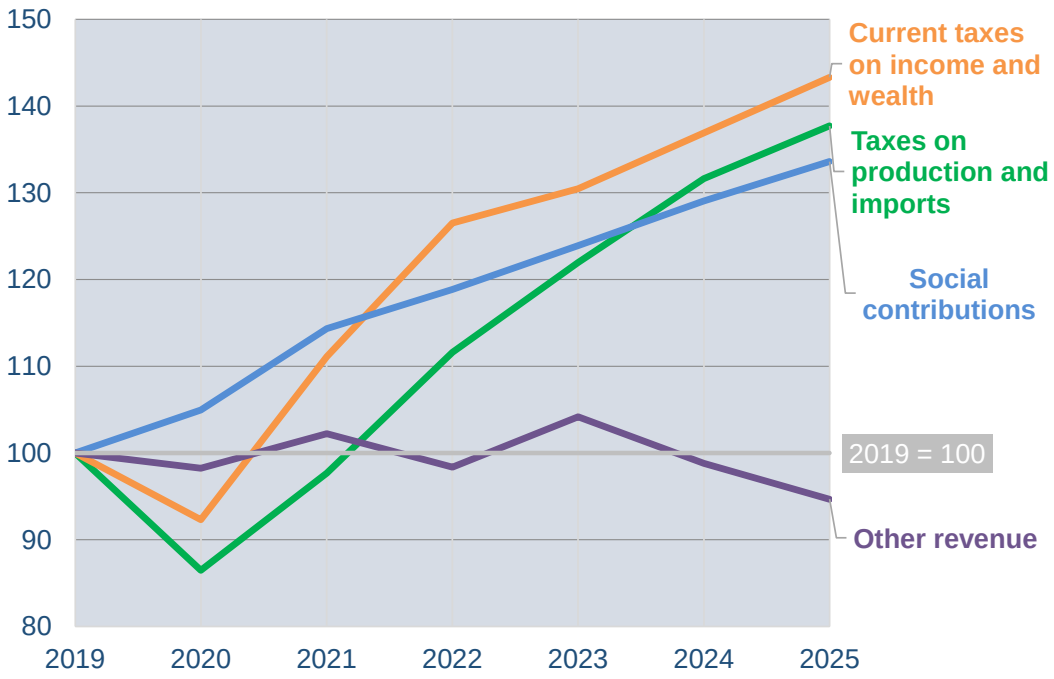
5.4 Fiscal risk outlook

In 2020, COVID-19 significantly impacted public finances as it lowered various revenue streams and drove public expenditure up. Direct and indirect taxes have returned to pre-pandemic levels in 2021 and are projected to surpass the 2019 level across the forecast horizon. The impact on public finances hinges on the global outturn of the pandemic, the Russia-Ukraine conflict and ensuing global supply disruptions. The MFAC's risk outlook thus focuses on the joint profile pattern for each revenue and expenditure component over the forecast horizon, using 2019 as the base year, rather than for each year separately (see Chart 5.15 and Chart 5.16).

The risk assessment for public finances takes the macroeconomic scenario as presented in the USP as given. The upside risk identified by the MFAC vis-à-vis the profile for real GDP for the period 2022 and 2025 mitigates the extent of risks to the revenue components. Nevertheless, a different composition of growth (which may be more or less tax rich) than envisaged in the USP could still influence the trajectory for certain revenue components.[51]

[51] Refer to Chapter 3 in this Report for further details.

Chart 5.15: Index for the revenue components (2019 = 100)



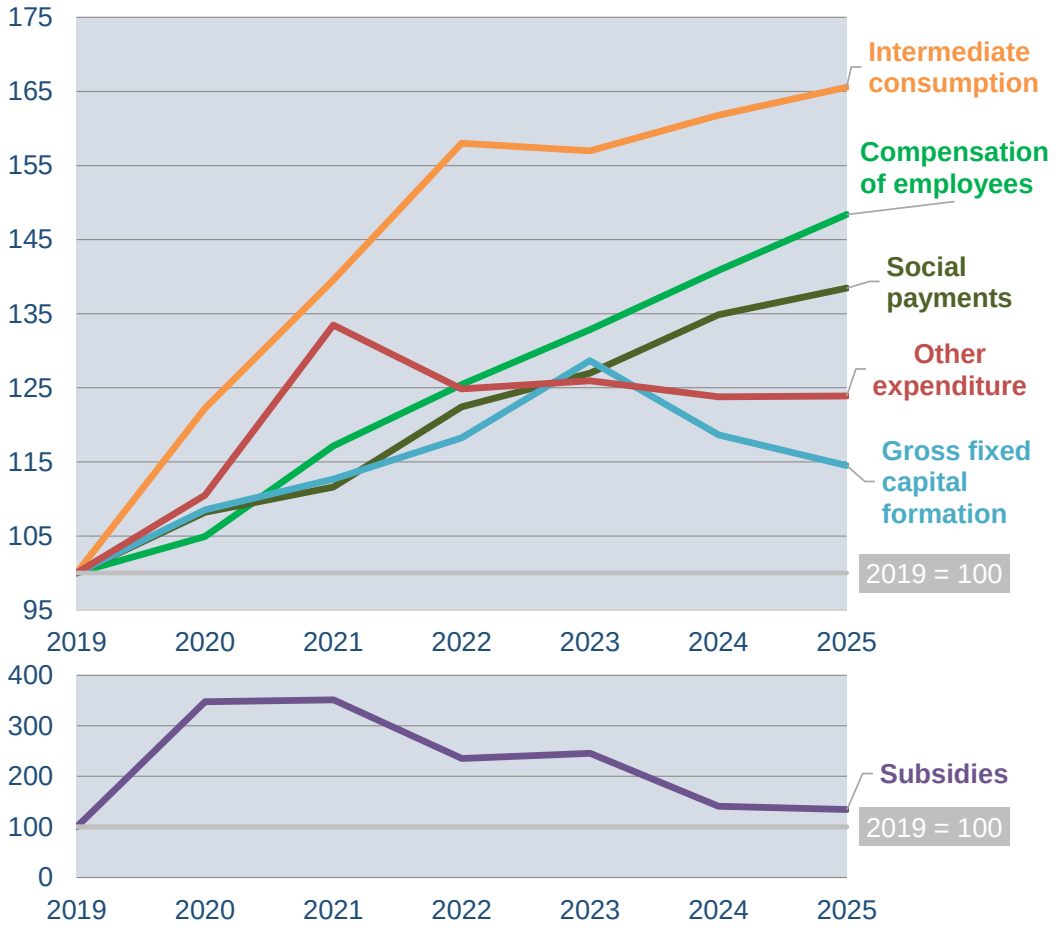
Source: MFE

Under the baseline scenario, the drops in revenue recorded in 2020 are mostly expected to be recovered by 2021, with further revenue increases anticipated thereafter. The pattern for social contributions is different as this source was not much impacted in 2020 and is expected to maintain a smooth upward trajectory throughout the forecast horizon. On the other hand, other revenue is also expected to hover around the same level across the forecast horizon but below pre-pandemic levels in 2025. Current taxes on income and wealth are expected to experience the highest increase over the forecast horizon, rising by around 43.3% when compared to 2019.

Taxes on production and imports was the only component which fell short of reaching pre-pandemic levels in 2021. In fact, indirect taxes are expected to increase by 11.6% in 2022, thus surpassing 2019 levels. This is slightly less optimistic than the forecast for current taxes on income and wealth, which is expected to expand slightly more, reaching 26.5% over its level in 2019. The slightly more cautious outlook for indirect taxes is in line with the greater resilience shown by direct taxes as opposed to indirect taxes in 2020. Although the profile for the other revenue is different from the rest, it is expected to hover around the same level throughout the forecast horizon with limited changes throughout.

The revenue from taxes on production and imports could be more than anticipated, given that tourist numbers (projected by the MFE, at 63.0% of 2019 levels in 2022) are on the cautious side while private consumption has been identified to have upside risks in Chapter 3 of this report. Both these factors point to a potentially higher tax base which may lead to higher revenue from indirect taxes. On the other hand, the risk outlook for the other sources of revenue components (current taxes on income and wealth, social contributions and other revenue) is considered neutral, adequately factoring in macroeconomic developments and discretionary measures. At the same time, the outcome in other revenue is highly dependent on the developments in relation to the residency programme The MFAC notes the planned reductions in revenue from the IIP over the forecast horizon. Thus, the overall risk outlook of the MFAC in relation to total revenue is on the upside.

Chart 5.16: Index for the expenditure components (2019 = 100)



Note: The chart for subsidies is separate from the rest due to a very different scale compared to the other expenditure components.

Source: MFE

On the expenditure front, patterns amongst the individual components are varied. Compensation of employees and social payments are characterised by a close to linear upward trend throughout the forecast horizon. Similarly, the forecast for intermediate consumption is expected to increase linearly up to 2022 and to remain relatively stable in 2023 and increases marginally in the outer years. Gross fixed capital formation is also expected to maintain its upward trajectory up till 2023, but then experience some scaling back in the last two years of the forecast horizon. On the other hand, 'other' expenditure is assumed to fall slightly in 2022 and then remain relatively stable around that level. Such projections are based on the premise that pandemic-related expenditures are scaled down while new expenditure measures relating to the economic effects of the Russia-Ukraine conflict are factored in. In the case of subsidies, these surged in 2020 and remained around the same level in 2021. Throughout the forecast period, subsidies are expected to drop significantly and edge closer to pre-pandemic levels by 2025.

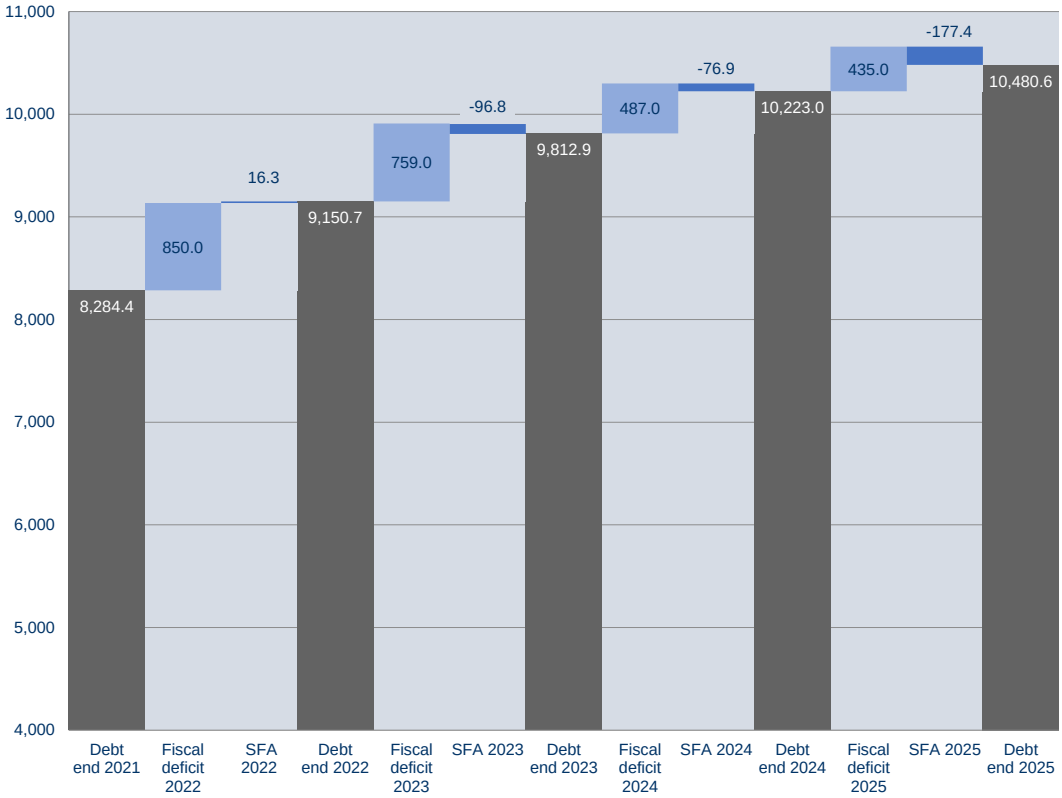
Downside risks appear pertinent in the case of intermediate consumption in 2022, mainly in relation to pandemic-related expenditure, which may be less than planned. However, risks for intermediate consumption tilt on the upside in the medium-term. For the other expenditure component there is a downside risk, specifically in relation to the planned capital transfer to the national airline. On the other hand, the planned expenditure on compensation of employees and social payments both point towards neutral risk as they largely replicate pre-pandemic patterns. Similarly, the outlook for gross fixed capital formation is viewed as neutral but potentially upside in the outer forecast years. In turn, the risk outlook for subsidies remains highly uncertain given that expectations are highly dependent on the developments in the war between Russia and Ukraine and the subsequent longevity of the economic recovery.

The assessment carried out on the individual revenue and expenditure components suggests an overall upside risk outlook vis-à-vis the fiscal balance (possibility of a smaller deficit) in the short-term and a neutral risk outlook for the medium-term. For 2022, this reflects downside risk on the expenditure side of the budget, together with the possible upside risk on the revenue side.

5.5 Assessment of the public debt projections

In 2022, the outstanding level of public debt is expected to rise by €866.3 million, from €8,284.0 million to €9,150.7 million (see Chart 5.17). The increase mainly reflects the financing of the projected €850.0 million fiscal deficit for 2022, but also includes the estimated stock-flow adjustment (SFA). The latter is expected to slightly push up debt by €16.3 million in 2022.[52] Between 2023 and 2025 public debt is expected to keep rising in absolute terms, but the accumulation of debt is expected to get smaller over time. This is due to the planned gradual reduction in the fiscal deficit over the forecast horizon and the downward effect caused by the negative SFA between 2023 and 2025.

Chart 5.17: Drivers of public debt (EUR millions)



Source: MFE

As a result of the projected absolute increase in the outstanding debt and the nominal GDP growth forecast, public debt is expected to rise to 58.6% of GDP in 2022 and

[52] SFA refers to the difference between the change in government debt and the government deficit or surplus for a given period. This arises when transactions impact the fiscal balance (in ESA terms) but not the public debt, or vice-versa. SFA is termed 'positive' when the adjustment raises the stock of debt and 'negative' when it lowers the stock of debt.

59.4% of GDP in 2023, from 57.0% of GDP in 2021. The public debt ratio is thereafter expected to fall to 57.2% of GDP by 2025.

The overall balance for the SFA is significantly reduced across the forecast horizon by the assumed negative ESA adjustments (See Table 5.10). The negative ESA adjustment reflects the discrepancy between the deficit projections in ESA terms and the consolidated fund.[53] In 2022, the downward ESA adjustment is wholly outweighed by the upward push created by changes in the Sinking Fund balances and MGS holdings, euro currency issue, ESA re-routed debt and total consolidation.[54] On the other hand, from 2023 to 2025, the downward ESA adjustment is only partially outweighed, thus resulting in a negative overall balance for the SFA.

Table 5.10: Stock-flow adjustments (EUR millions)

	2022	2023	2024	2025
ESA adjustment	-55.8	-146.8	-139.7	-216.3
Changes in Sinking Fund balances and MGS holdings	25.1	25.1	25.0	25.0
Equity acquisitions	5.0	0.5	0.5	0.5
Euro currency issue	11.9	5.7	6.2	5.3
Movement in Bank Account	0.0	0.0	0.0	0.0
ESA re-routed debt	15.0	5.0	0.0	0.0
Total consolidation	18.0	16.2	32.6	8.5
Other adjustments	-2.9	-2.5	-1.5	-0.4
Total stock-flow adjustment	**16.3**	**-96.8**	**-76.9**	**-177.4**

Source: MFE

The yearly increase in public debt over the period 2022 to 2025 is consistent with the macroeconomic and fiscal scenario, and the estimated SFA. The overall upside risk

[53] The MFE increased the projections for expenditure by EBUs on intermediate consumption and compensation of employees between 2023 and 2025 to create a balance between past trends, expected price and wage developments and consolidation efforts, which reflected into higher deficit projections in ESA terms vis-à-vis the consolidated fund.
[54] ESA re-routed debt includes financial assistance from the European Financial Stability Facility (EFSF). Since the EFSF is acting on behalf of Malta (the guarantor), the lending is rerouted through the government accounts, thus increasing public debt.

vis-à-vis the profile for real GDP (i.e. higher economic activity than anticipated in the baseline scenario) for 2022 compounded with the overall downside risk vis-à-vis the fiscal balance (i.e. lower fiscal deficit than projected in the baseline scenario), in theory, places the possibility to have a lower debt-to-GDP ratio in 2022.[55] The MFAC assesses the balance of risks for the debt-to-GDP ratio in the medium-term to be positive (i.e. a lower debt-to-GDP ratio than projected in the baseline scenario) in view of the possibility to have a lower fiscal deficit in 2022 (due to a base effect) and a more upbeat economic outlook than projected by the MFE.

[55] Real GDP growth combined with the GDP deflator determines the value for nominal GDP, which acts as the denominator for the public debt ratio. The downside risk relates to the numerator (the possibility of a smaller fiscal deficit) combined with the denominator (the possibility of higher real GDP).

Chapter 6

Comparison across different fiscal forecasts

6.1 Introduction

The plausibility of the fiscal projections published in the USP 2022 – 2025 can be further appraised by evaluating the similarity or otherwise with respect to the forecasts produced by other reputable institutions. The caveat remains that these forecasts are not necessarily based on the same data sets, mainly as some were prepared at different times. Certain assumptions relating to the pace of macro-economic recovery and the extent to which inflationary pressures remain elevated, may also lead to differences across institutions. Nonetheless, the MFAC considers such comparison as a valid benchmark to support the qualitative assessment in relation to the fiscal projections carried out in Chapter 5. The fiscal outlook presented in the USP is also compared to the previous vintage of fiscal forecasts, thus those published in the DBP, to trace the revisions in the main revenue and expenditure components.

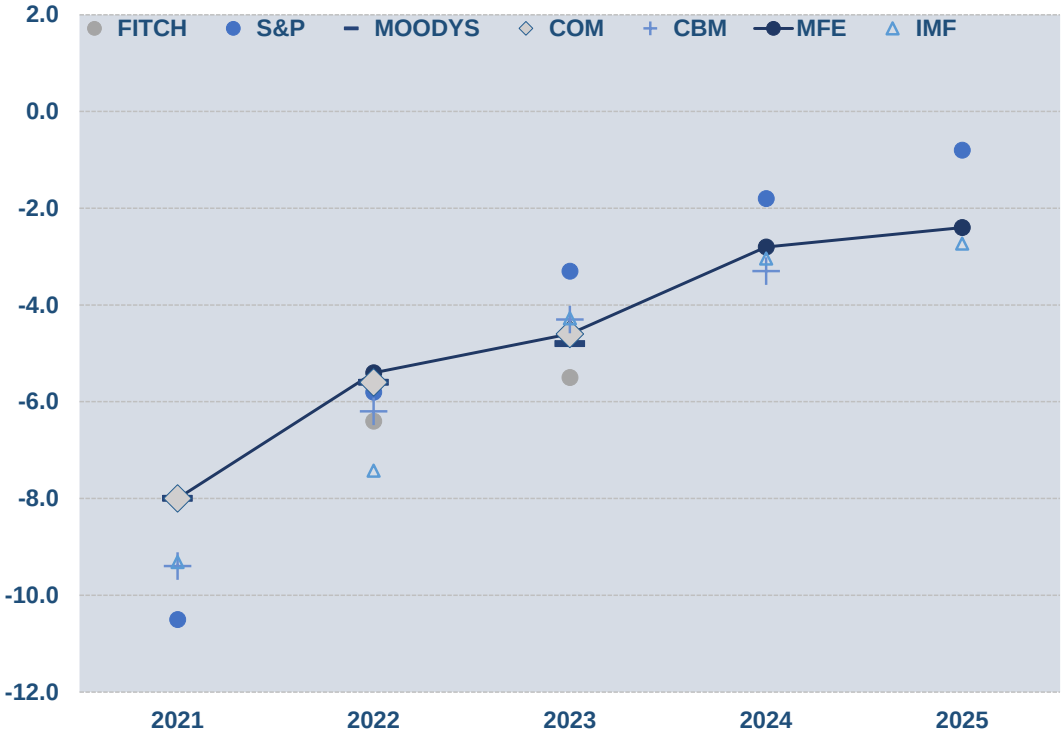
6.2 Fiscal balance

All institutions point towards a fiscal deficit throughout the period 2022 to 2025 (see Chart 6.1). Concomitantly, all institutions envisage a significant correction in the fiscal deficit by the end of their forecast period. However, there are some differences in the pace of the expected correction in the deficit. It should be noted that not all institutions have incorporated the latest fiscal data news release published on 22 April 2022.[56,57] Moreover, some of the institutions did not incorporate the updated policy measures that the government is implementing to curb the impact from the conflict between Russia and Ukraine and its subsequent effects on domestic and international inflationary pressures.

[56] The Quarterly Accounts for General Government NSO News Release NR067/2022 is available here.
[57] The discrepancy is shown in Chart 6.1, whereby those institutions that did not have the updated fiscal statistics when producing their forecasts, had a higher fiscal deficit-to-GDP ratio than the MFE's, which uses the latest news release.

Energy and commodity prices, in particular wheat and grains, have intensified inflationary pressures from supply chain disruptions and the recovery from the pandemic.

Chart 6.1: Fiscal balance estimates by institution (% of GDP) [58]



Source: MFE, COM, CBM, IMF, FITCH, MOODY'S, S&P

Despite such differences, all institutions envisage an improvement in the fiscal balance in 2022 compared to 2021. Moreover, most institutions are forecasting a similar improvement in the fiscal balance, ranging from 1.9pp to 2.6pp in 2022. This range excludes the forecast of S&P, which is expecting a larger improvement, albeit that it was expecting a larger fiscal deficit for 2021 than the rest of the institutions.[59,60] Turning on to 2023, all institutions are again anticipating an improvement in the fiscal balance over 2022. However, most institutions expect the change in the deficit in 2023 to be less than that expected between 2022 and 2021, thus indicating a slowdown in the pace of improvement in 2023. Overall, the figures by the COM and those by Moody's

[58] The credit rating agency SCOPE, noted that they 'expect the deficit to gradually narrow to below 3.0% of GDP by 2026'.
[59] The forecast by S&P is close to those of most institutions in 2022, but since the base in 2021 was of a larger fiscal deficit than the rest, this implies a larger improvement in the balance for 2022. The publication by S&P was released on 14 March 2022, which pre-dated actual fiscal data on the last quarter of 2021.
[60] The forecasts by the CBM and the IMF were also issued before the release of the actual data for the last quarter of 2021.

are closest to those forecasted by the MFE. For 2024 and 2025, all institutions producing such medium-term forecasts are envisaging further improvements in the deficit over both years. Similar to the forecast by the MFE, the expectation is that the improvement is larger in 2024 than in 2025.

The USP targets a deficit of €850.0 million in 2022, which is practically the same deficit figure as indicated in the DBP (see Table 6.1). However, the deficit in the DBP was factoring in a much larger improvement for 2022 as the deficit forecast for 2021 at the time of the DBP was €378.7 million worse than the actual turnout (used in the USP). The USP's updated forecast factors in both a better macroeconomic turnout and the need for more fiscal support than previously anticipated, mainly due to the significant pressures being created by rising prices and the external geopolitical tensions. Indeed, both the revenue and the expenditure figures were revised significantly. The revenue target was raised by €344.5 million, whereas the planned expenditure for 2022 was scaled up by €343.8 million. Such revisions thus largely cancel off each other.

Higher budgets were allocated across all expenditure components except for gross fixed capital formation. The largest revision was in subsidies (+€204.0 million), mostly due to the new information about the planned energy support and the commodity prices and supply security measures, which were not previously anticipated. The budget for intermediate consumption was also raised by €117.6 million, mostly reflecting higher health-related expenditure. In turn, the planned spending on gross fixed capital formation was revised downwards by €104.8 million, which more than offsets the €85.5 million additional expenditure listed as 'other expenditure'. Updated calculations also led to upward revisions in compensation of employees and social payments, which were, however less strong, respectively up by €38.7 million and €2.8 million.

In turn, the upward revision in total revenue is largely attributable to the €316.2 million higher yield expected from current taxes on income and wealth. Part of this revision is due to a better outturn for 2021, as this source of income contributed to almost €190.0 million more in revenue than expected in the DBP, mostly explained by a higher outturn for gross operating surplus. The rest of the components are expected to be closer to those anticipated in the DBP. The €38.7 million increase in the forecast for social contributions and an additional €51.8 million classified under 'other revenue', offset the downward revision in taxes on production and imports of €62.2 million due to the more subdued expected economic developments.

Table 6.1: Fiscal balance forecasts by institution (EUR millions)

	2022				2023		
	MFIN DBP	MFIN USP	COM SPR	CBM AR	MFIN USP	COM SPR	CBM AR
Total Revenue	**5,611.3**	**5,955.8**	**5,967.8**	**5,545.8**	**6,288.0**	**6,342.6**	**6,069.4**
Taxes on production & imports	1,862.3	1,800.1	1,787.1	1,719.8	1,967.4	1,963.6	1,911.3
Current taxes on income & wealth	1,995.5	2,311.7	2,280.1	1,938.9	2,383.4	2,356.9	2,083.3
Social contributions	912.2	950.9	950.3	911.5	991.4	987.7	951.6
Other *	841.3	893.1	950.2	975.6	945.8	1,034.4	1,123.2
Total expenditure	**6,462.0**	**6,805.8**	**6,839.2**	**6,510.7**	**7,047.0**	**7,111.5**	**6,789.8**
Compensation of employees	1,855.7	1,894.4	1,895.2	1,860.3	2,006.6	2,008.9	1,970.3
Intermediate consumption	1,421.6	1,539.2	1,541.3	1,405.5	1,529.1	1,553.0	1,450.7
Social payments	1,521.3	1,524.1	1,525.1	1,505.9	1,580.9	1,594.7	1,587.2
Gross fixed capital formation	742.4	637.6	638.8	730.1	693.6	693.2	749.1
Subsidies	254.8	458.8	460.2	274.0	478.7	479.5	252.7
Other **	666.2	751.7	778.5	617.9	758.1	782.2	698.1
Fiscal balance	**-850.7**	**-850.0**	**-871.5**	**-964.9**	**-759.0**	**-768.9**	**-720.4**
Gross debt	**9,373.7**	**9,150.7**	**9,107.0**	**9,430.7**	**9,812.9**	**9,884.0**	**10,195.7**

* Includes capital taxes, property income and 'other' revenue.

** Includes interest payments, capital transfers payable and 'other' expenditure.

Source: MFE, COM

Turning on to a more detailed comparison across institutions, the COM's revenue and expenditure forecasts for 2022 and 2023 are higher, but relatively close to the estimates by the MFE. For 2022, the COM produced slightly lower estimates for both indirect and direct taxes, but these were more than offset by the higher revenue expected from the 'other revenue' category. On the other hand, the COM's estimate for social contributions is entirely in line with the USP. The same narrative is expected for 2023, with the COM's estimated revenue from the main sources (indirect taxes and direct taxes) being slightly lower than the MFE's estimates. Again, their combined

effect, along with a marginally lower social contributions estimate, is overshadowed by the COM's higher expected revenue from 'other' sources.

On the expenditure front, the COM's estimates for 2022 are practically the same as those of the MFE, with marginal differences of less than €2.0 million for almost all categories. The only exception is the 'other expenditure' category, for which the COM is estimating €26.8 million more in outlays. Some larger differences are forecasted for 2023. The forecast for compensation of employees is again practically the same as that of the MFE, though marginally higher by the COM. With respect to social payments, the COM is factoring in €13.8 million in additional expenditure. For intermediate consumption, the COM is projecting an increase of €23.9 million from the previous year, whilst the MFE is assuming a reduction of €10.1 million. There is practically no difference in the forecast for investment and for subsidies in 2023, whilst 'other expenditure' is again contributing to higher expenditure in the case of the COM than the MFE's targets.

Overall, such discrepancies are not significantly large and result in similar fiscal balance estimates between the COM and the MFE. The variance is €21.5 million in 2022, reduced to €9.9 million in 2023, where in both cases, the COM's fiscal balance is marginally more negative than the MFE's.

On the other hand, the revenue and expenditure discrepancies between the CBM's forecasts and those by the MFE are rather significant. However, these forecasts are less comparable to those of the COM, as such differences are in part due to the different timing of the forecasts, as the Central Bank's economic projections were finalised on 11 February 2022 and thus pre-date both the release of national accounts on 1 March 2022, the fiscal data news release of 22 April 2022, as well as the rise in geopolitical tensions in Europe. Indeed, both the revenue and expenditure forecasts are much lower than those of the MFE and the COM. Nonetheless, the expected trajectory for most revenue components is similar, with most revenue estimates increasing in 2023 with similar margins. Increments in compensation for employees and social payments also observe a similar trajectory to those of the MFE. However, the main differences in expenditure relate to additional subsidies relating to price measures and information on other expenditures, which were not yet in place to be included in the forecast, whilst investment was still planned as higher than the MFE's forecast. Overall, the forecast for 2022 is of a higher deficit by the CBM, with the

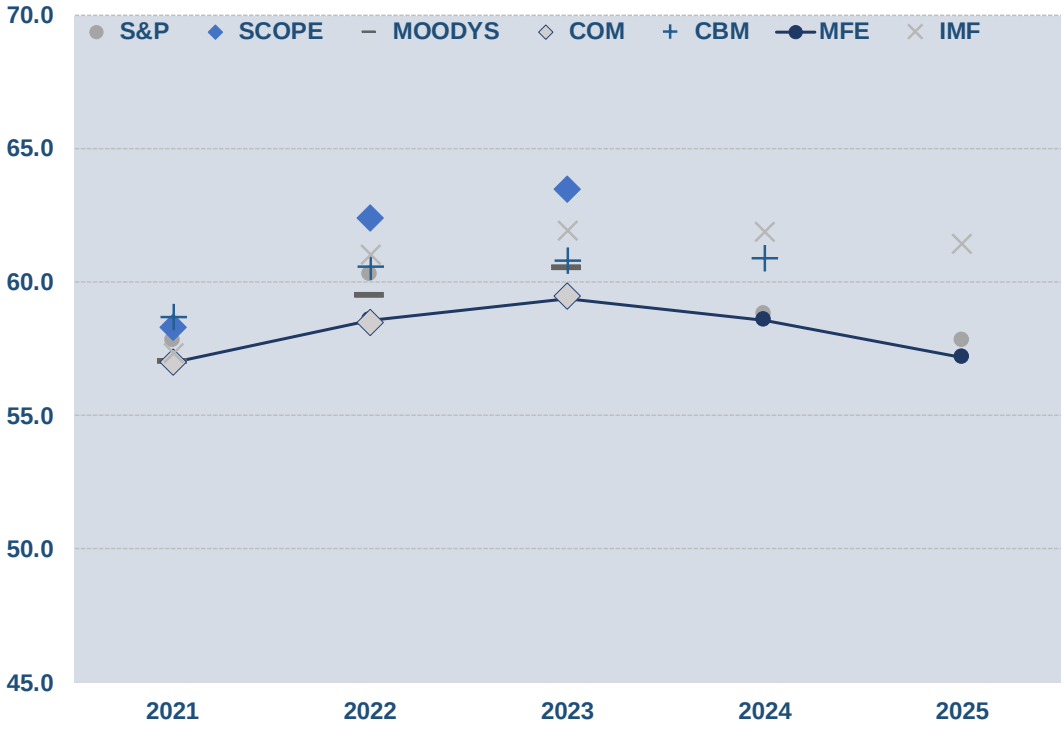
discrepancy being much less in 2023. All forecasts anticipate an improvement in the fiscal balance across both years.

6.3 Public debt

The USP reduced the debt target by €223.0 million for 2022 compared to the DBP, to €9,150.7 million. The fiscal deficit for the year has been retained between forecast rounds and the revision in the debt level mainly reflects a base effect, since official data turned out lower than what had been previously anticipated by the MFE for 2021. This effect was only partially outweighed by the larger stock flow adjustment assumed for 2022. The 2022 debt estimate by the COM is €43.7 million lower than that of the MFE. The variations by the COM mainly stem from the lower assumed SFA for the year which outweighs the slightly higher fiscal deficit expected for the year. On the other hand, the debt projection for 2022 by the CBM is €280.0 million higher than indicated in the USP. This discrepancy is the result of a higher assumed fiscal deficit combined with the upward push created by the larger SFA, as well as the discrepancy relating to the outstanding debt in 2021 (see differences in availability of data as described in the previous section).

All institutions expect a rise in the debt-to-GDP ratio in 2022, though to varying degrees (see Chart 6.2). The forecast by the MFE appears to be somewhat more favourable throughout the forecast horizon as the debt ratio is expected to remain below the 60.0% threshold. Nonetheless, the debt forecast patterns are very similar across all institution's forecasts. Indeed, almost all institutions expect the debt ratio to peak in 2023 except for S&P, which expects debt-to-GDP to peak in 2022. Thereafter, the institutions which extend their forecast beyond 2023 (MFE, COM, CBM and S&P) anticipate that debt-to-GDP will either fall slightly or stabilise at the 2023 level. Divergences in the outlook for the public debt are driven by the cumulative nature of public debt (which is a stock variable), whereby differences over time tend to amplify. This trajectory is also impacted by the differences in the estimate for nominal GDP over the period 2022 to 2025, which acts as the denominator for the public debt ratio.

Chart 6.2: Public debt estimates by institution (% of GDP)



Source: MFE, COM, CBM, IMF, MOODY's, S&P, SCOPE

6.4 Assessment

The fiscal revisions for 2022 carried out by MFE have maintained the fiscal deficit at the same level as the DBP. Notwithstanding, total revenue has been revised upwards, mainly increasing through higher current taxes on income and wealth. At the same time, expenditure has also been revised upwards mainly due to higher expected costs in intermediate consumption and subsidies. The new set of fiscal forecasts for the outer years build on the premise that the fiscal deficit will be reduced significantly and is expected to fall below 3.0% by 2024 and 2025. The fact that all other independently produced forecasts show a correction in the fiscal deficit in all forecast years, though to varying degrees, offers comfort that, based on the information available to date, the USP scenario appears plausible and there is broad consensus around it. On the other hand, certain differences, for instance in the debt-to-GDP ratios can be largely explained by the fact that those which were produced last (MFE, COM and MOODY's) factored in more timely information, which was unavailable when the other sets of forecasts were produced. Notwithstanding some differences in magnitude, the path for the gross debt-to-GDP ratio identified by the other institutions fits closely the debt trajectory assumed by MFE.

Chapter 7
Conclusion

The USP is based on the scenario that in 2022 Malta's real GDP is expected to continue building momentum and increase by 4.4% on the back of a strong recovery registered a year earlier. Moderate growth is anticipated in 2023 at 3.9%, slightly below that of potential output, before slightly easing to 3.7% and 3.5% in 2024 and 2025, respectively.

The expansionary fiscal stance taken by the Government over the past two years was crucial to ensure that the Maltese economy remains afloat while at the same time, providing the necessary support and safeguards to sustain jobs and livelihoods. Supportive fiscal policy enabled the Government to combat the economic challenges brought about by the pandemic whilst concomitantly, enabling timely and adequate healthcare (including the COVID-19 vaccination programme) to mitigate and address the adverse health effects brought about by the pandemic. This fiscal support and stimulus resulted in a deficit in the general government balance equivalent to 9.5% of GDP in 2020 and 8.0% of GDP in 2021. Despite these deficit levels, the fiscal space built in previous years enabled the Government to maintain a debt-to-GDP ratio below the Maastricht reference value of 60.0%.

The need for a supportive budgetary policy remains as the conflict between Russia and Ukraine has slowed down the global recovery from the pandemic. Energy and commodity prices, in particular wheat and grains, have intensified inflationary pressures from global supply chain disruptions and the recovery from the pandemic. Being a small open economy, Malta is highly susceptible to these external shocks. Once again, the Government has intervened to shield households and businesses from the increases in the international price of oil and ensure stability in the price of cereals (including wheat) as well as security of supply. This comes on top of the measures aimed at mitigating the impact of the pandemic, including the extension of the Wage Supplement Scheme.

The fiscal revisions for 2022 carried out by MFE have maintained the fiscal deficit at the same level as the DBP. Notwithstanding, total revenue has been revised upwards, mainly increasing through higher current taxes on income and wealth. At the same time, expenditure has also been revised upwards mainly due to higher expected costs

in intermediate consumption and subsidies mainly reflecting the new energy support measures. The new set of fiscal forecasts for the outer years build on the premise that the fiscal deficit will be reduced significantly. The MFAC favourably notes that the general government balance is expected to fall below 3.0% by 2024 and 2025 and that the debt ratio is expected to remain below the 60.0% threshold throughout the forecast horizon. It is noteworthy that the projected fiscal developments benefit from the flexibility granted by the activation of the general escape clause.[61]

Both the macroeconomic and the fiscal forecasts are considered to lie within the endorsable range of the MFAC. While acknowledging the uncertainty that prevails in relation to the evolution of the pandemic, the conflict between Russia and Ukraine and the subsequent effects of supply chain disruptions and increased global prices and the key assumptions, the MFAC's risk assessment suggests a broadly positive risk outlook vis-à-vis the profile for real GDP growth over the forecast horizon. For 2022, the MFAC considers that both the fiscal balance and public debt could possibly be lower than expected by the MFE in the baseline scenario. For the outer years, the MFAC opines a neutral outlook for the fiscal balance and the possibility of a lower public debt-to-GDP ratio.

The MFAC reminds that when economic conditions allow, fiscal policies should again be aimed at achieving a prudent medium-term fiscal position, and ensuring debt sustainability, while enhancing investment. It is important to be adequately prepared for the time when the general escape clause will eventually be revoked, and the fiscal rules thus become binding again. Rebuilding fiscal space would be useful to counteract any future adverse shocks and enhance the economy's overall resilience. The fiscal space, which was available pre-pandemic, because of the stream of fiscal surpluses and the low level of public debt, proved very valuable by making possible the implementation of aggressive fiscal support measures.

[61] The Commission's communication on the fiscal policy guidance for 2023 is available here.

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