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The Hon Mr Clyde Caruana B.Com. (Hons) Economics, M.A. Economics
Minister for Finance and Employment
30, Maison Demandols,
South Street,
Valletta, VLT 1102.

Dear Minister,

ASSESSMENT OF THE MACROECONOMIC FORECASTS CONTAINED IN THE DRAFT BUDGETARY PLAN 2024

The Malta Fiscal Advisory Council (MFAC) has an obligation under Article 13 of the Fiscal Responsibility Act to endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Ministry for Finance and Employment as part of the Draft Budgetary Plan. Accordingly, the Ministry forwarded to the Council the first draft of the macroeconomic forecasts on 09 October 2023 and the finalised figures on 14 October 2023 (see Appendix 1). These forecasts updated the macroeconomic outlook published by the Ministry and endorsed by the Council on 1 May 2023 as part of the Update of the Stability Programme. The cut-off date for these macroeconomic projections is 26 September 2023.

The Council notes that since the publication of Malta's Update of the Stability Programme in spring 2023, the international environment has remained weak, characterised by a feeble, short-term global growth outlook and rates of inflation which remain high by historical standards. Euro area economic activity grew at a subdued pace in the first half of 2023 (0.7%), despite the unwinding of high energy prices and backlogs in manufacturing orders. The impact of tightening financing conditions and lower foreign demand for the Euro area's production in the context of a stronger euro are dampening growth. At the same time, underlying inflation in the Euro Area remained elevated (first half of 2023 – 7.2%). Overall, the ECB is projecting real GDP growth in the Euro Area to increase by 0.7% in 2023 and 1.0% in 2024. The slowdown in Euro area growth is expected to remain dampened by monetary policy tightening, adverse credit supply conditions which feed through the real economy and by the gradual withdrawal of fiscal support. At the same time, there are a number of risks which would impinge more negatively on economic growth. Inflation could be higher than anticipated if further shocks occur, including those from an intensification of the war in Ukraine and extreme weather-related events, triggering more restrictive monetary policy. Furthermore, financial sector turbulence created by the adaptation of further policy tightening by central banks is a possibility.

In the latest forecast round, the Council reviewed the plausibility of the exogenous assumptions employed by the Ministry for Finance and Employment. Discussions were held with the Ministry's senior officials to examine the drivers underpinning the updated macroeconomic outlook and the factors contributing to the revisions from the previous forecast vintage. The macroeconomic forecasts were further assessed considering the available market information and statistical data and compared to those prepared by independent institutions.

Following the first-half growth rate of 4.4%, the Ministry expects real GDP to grow by 4.1% in 2023, a moderation from the 6.9% growth experienced in 2022. Despite the projected weak global economic growth and strengthening of the Euro, external demand is projected to be the main contributor to growth (5.7 pp.), while domestic demand is anticipated to act as a drag to economic growth. The latter is mainly driven by the projected negative growth in investment (-18.9%), which is primarily due to a base effect arising from 2022 (31.2%) as a result of a one-off spike in machinery and equipment investment. This is also affecting imports, which partly explains the positive contribution from the external sector. The Ministry expects growth to remain at a similar moderate pace in 2024 (4.2%), primarily fueled by domestic demand (3.6 pp.) and, to a lesser extent, by external demand (0.6 pp.). No material impact on growth is expected from inventories in both 2023 and 2024.

In 2023, the Ministry is expecting external demand to be primarily driven by the services sector and, to a lesser extent, by the goods sector. The tourism sector is expected to contribute significantly to growth, as official statistics for the first eight months of the year indicate that this year is going to exceed pre-pandemic levels (tourism expenditure increased by 36.2% between January – August when compared to the same period last year). The professional, scientific and technical activities, administration and support services activities sector is also forecasted to contribute positively. Growth in the goods sector is mainly driven by the manufacturing sector. On the other hand, domestic demand is expected to be mainly driven by increases in private final consumption expenditure (6.1%) on the back of increases in compensation per employee, strong labour market developments and population growth. Government final consumption expenditure is expected to increase by 2.8% following a decline of one per cent (1.0%) during the first half of the year.

Headline inflation is anticipated to remain high (5.7%), core inflation even higher (6.0%), with some deceleration expected in the last few months of the year. The moderation of economic growth, in combination with the buoyant labour market performance, is resulting in declining labour productivity per person employed. With soaring inflation and declining productivity, unit labour costs are anticipated to increase by 4.7%. At the same time, increases in compensation per employee lag the increases in inflation, leading to a fall in real wages. Meanwhile, unit profits are expected to increase by 6.0%.

The Council notes that the real GDP growth outlook for 2024 has been revised downwards to 4.2% relative to the forecast of 4.5% projected by the Ministry in April of this year. This revision is attributed to a downward revision in net exports contribution (from 1.2 pp. to 0.6 pp.), which was partly offset by an upward revision in domestic demand contribution (from 3.2 pp. to 3.6 pp.). Indeed, export growth has been revised downwards from 5.2% to 3.9%, mainly on the back of updated exogenous assumptions reflecting weaker global economic growth and a stronger euro vis-à-vis the British Pound. On the other hand, the Ministry is anticipating stronger increases in private final consumption expenditure in 2024 driven by stronger labour market developments (stronger employment growth and a lower unemployment rate) and higher wages per employee relative to the April forecasts vintage (from 3.9% to 4.5%). Investment is anticipated to increase by 5.5% in real terms relative to the 3.8% growth anticipated in April, mainly because of a stronger base effect in 2023. Headline inflation in 2024 has been revised slightly upwards from April's forecast vintage to 3.7%. Labour productivity has been revised downwards to negative territory, meaning that the Ministry is anticipating labour productivity to record two years of declining rates. Unit labour costs are anticipated to increase by 4.6% in 2024.

The Council notes that the outlook presented by the Ministry for Finance and Employment for 2023 and 2024 adequately factors in the macroeconomic information available to date. The outlook for GDP growth across the forecast horizon broadly matches the profile indicated in the forecasts published by independent institutions by the date of this letter, save for the IMF which are anticipating a slowdown in 2024. The Council is satisfied with the background information and clarifications provided by the Ministry, which were required to assess and verify the internal consistency of the forecasts. The MFAC notes that in view of the current circumstances in the global economy, the macroeconomic outlook remains subject to considerable uncertainty and very sensitive to the assumptions employed.

Based on the information available to the Malta Fiscal Advisory Council by the date of this letter, the Council considers that the macroeconomic forecasts for 2023 and 2024 prepared by the Ministry for Finance and Employment as part of the Draft Budgetary Plan 2024 lie within its endorsable range. Nonetheless, whilst the Council considers that the balance of risk for 2023 is upside, there are downside risks to the expected growth for 2024.

According to its assessment, the upside risk for 2023 is primarily due to the first half data, which stands higher than the overall projection for the year and the statistical base effect emanating from the second half of the year in 2022. On the other hand, for 2024, the Council believes that growth could turn out weaker than expected, especially from the external side. The increases in unit labour costs and the higher inflation rate projected by the Ministry relative to our European counterparts could impinge negatively on Malta's competitive position. Concomitantly, some of the key services sectors in the economy may be reaching market saturation. The potential impact from the introduction of the global tax harmonisation on multinationals regime also constitutes a possible further risk factor to export growth.

Furthermore, the Council is concerned with the growth composition for 2024, as growth is mostly emanating from domestic demand increases, mainly from private consumption expenditure. The Council would like to emphasize the importance of export-led growth and the need to improve competitiveness through labour productivity increases for sustainable medium-term economic growth. In this context, and in view of the fact that fiscal rules will become binding again at the start of 2024, the Council would also like to stress that fiscal consolidation is required and that it should not be achieved by curtailing productive public investment.

Finally, the Council would like to understand better the reasons why the Ministry for Finance and Employment is projecting a negative output gap which widens in 2023 relative to 2022 and broadly remains so for 2024. This is not congruent with a relatively high core inflation.

A detailed assessment of the macroeconomic forecasts carried out by the MFAC supporting the endorsement decision will be published in the Council's forthcoming report.

Yours sincerely,

Moira Catania

Moira Catania
Chairperson

Appendix 1: Main macroeconomic indicators

	2022	**2023**	**2024**
Real GDP components chain-linked volumes, reference year 2015			
Private final consumption expenditure (including NPISH) *(y-o-y %)*	9.5	6.1	4.5
General government final consumption expenditure *(y-o-y %)*	2.3	2.8	2.8
Gross fixed capital formation *(y-o-y %)*	31.2	-18.9	5.5
Exports of goods and services *(y-o-y %)*	6.8	2.6	3.9
Imports of goods and services *(y-o-y %)*	10.1	-0.9	3.9
Real GDP *(y-o-y %)*	**6.9**	**4.1**	**4.2**
Contribution to real GDP growth:			
Domestic demand (pp)	10.7	-1.6	3.6
Inventories (pp)	-0.1	0.0	0.0
Net exports (pp)	-3.7	5.7	0.6
Nominal GDP *(y-o-y %)*	**12.6**	**9.7**	**7.4**
Inflation rate *(based on the HICP) (%)*	6.1	5.7	3.7
Employment growth *(FTEs) (%)*	6.4	4.7	4.4
Unemployment rate *(based on the LFS) (%)*	2.9	2.7	2.7

Note: GDP growth rates for 2022 are based on the provisional values as published by the National Statistics Office on 04 September 2023 (News Release 158/2023), while figures for 2023 and 2024 represent the forecasts prepared by the Ministry for Finance and Employment.

Source: Ministry for Finance and Employment