Inflation Report
March 2011

Economic Policy Department
March 2011

This document has benefitted from the contribution of the Economics and External Relations Division of the Central Bank of Malta.

The following symbols have been used throughout this document:

. . .	to indicate that data are not available;
0	to indicate that the figure is zero;
-	to indicate that data are not applicable or cannot be determined;
—	to indicate that the figure is negligible;

Figures may not add up due to rounding.

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Foreword

The Economic Policy Department has been requested to prepare a report detailing price developments in Malta over recent months. The Report has been prepared in close collaboration with the Central Bank of Malta and the National Statistics Office. The cut-off date for Retail Price Index data was the 18th of March 2011 while other sections of the report are based on the information available up to the 23rd of February 2011.

The first Inflation Report published in July 2010 reviewed inflationary developments since 2004. This update of the Inflation Report focuses on recent developments in inflation, in particular the developments during the last quarter of 2010 and the first months of 2011. In order to understand further the phenomenon of inflation in a broader economic context, the report presents the developments in asset prices, producer prices and import and export prices. An analysis of the macroeconomic dynamics that might affect inflation follows subsequently. The report reviews international macroeconomic developments in light of their influence on the Maltese economy. An overview of the outlook for domestic inflationary developments concludes the Report.

Review of Inflationary Trends

The headline inflation rate in Malta, as measured on basis of the Retail Price Index, followed a decreasing trend during the first half 2010, from 1.9 per cent in January to 0.7 per cent in June, mainly reflecting developments observed in the food sub-index. During the second half of 2010, the inflation rate was on the rise, from 0.8 per cent in July to 1.5 per cent in December, mainly as a result of the increases recorded in the Water, Electricity, Gas and Fuels sub-index. During the first two months in 2011, headline inflation continued to increase reaching the rate of 1.8 per cent in February. The trends described above reflect the developments in the annual inflation rate that was generally on an upward trend during 2010 – with the exception of the first three months of 2010 – and peaked at the rate of 3.3 per cent in December. During the first two months of 2010, the annual rate of inflation decreased gradually and by February, the rate stood at 2.3 per cent. The Report provides a detailed analysis of the drivers underpinning these trends.

Meanwhile when compared to trends in the european union, the twelve-month moving average inflation rate in Malta, as measured on the basis of the HICP, was on a rising trend since October 2007 and exceeded the Euro Area average since July 2008. During the first two months of 2010 the inflation rate in Malta

remained higher than the average for the Euro Area. In subsequent months the gap has narrowed, converging to the Euro Area benchmark during the months of June to October. Since November, the inflation rate in Malta rose more rapidly than in the Euro Area with positive gap of 0.5 p.p. being recorded in January 2011.

As regards asset prices, both quarterly data on advertised prices compiled by the Central Bank of Malta and the National Statistics Office property index show that growth in residential property prices returned to positive territory in 2010. The MSE share index decreased in the first half of 2010, but was on an upward trend in the later months of 2010.

The Producer Price Index (PPI) portrayed an upward trend during 2010. To a large extent, these developments reflect the trends in the inflation rate of producer prices for energy goods.

The overall terms of trade (includes both goods and services) increased in the first quarter of 2010, but was on a mild downward trend throughout the rest of the year. The index for goods declined during 2010 as the growth in domestic import prices outweighed that registered in exports. In the case of services, after recovering from a sharp decline during the last quarter of the previous year, the terms of trade index fell during the third quarter in 2010, as a decline in export prices outweighed the decline registered in import prices.

Macroeconomic Analysis of Inflation Developments

Malta operated in a situation of a negative output gap during 2010, albeit the spare capacity in the economy has decreased. A recovering global economy was partly responsible for the substantial increase in exports, which spurred the domestic recovery underway. Investment recorded a slight recovery across a range of products (apart from housing investment) pointing towards increasing business confidence. On the other hand, private consumption remained rather weak while Government consumption contracted. Consequently, it is evident that domestic demand pressures were not a major contributor to inflationary pressures in 2010.

Eventhough a decreasing unemployment rate was recorded this remains at relatively high rate. The increase in the labour supply through a higher activity rate and the positive performance recorded by investment meant that potential output growth increased slightly from the level recorded in the previous year. The Report notes evidence of slack remaining in the economy. Supply side

policies remain important to ensure that there are no productive capacity constraints in the future.

Following positive growth developments in 2010, cost dynamics were more favourable with nominal unit labour cost declining by 2.3 per cent during the first three quarters of 2010 whereas in the same period of 2009, an increase of 5.7 per cent was registered. This decline reflects higher output per labour input coupled with a decline in compensation per capita. As a consequence, profit margins also improved and this helped stimulate labour demand. The contribution of administered prices to overall inflation was rather high in relation to overall inflation in 2010, amounting for around half of the inflation rate. Furthermore, the rather modest increases in the price level in Malta's major trading partners during 2010 are indicative of limited pressure from imported inflation.

Outlook for Inflationary Pressures

Global economic growth is currently recovering; nevertheless, the outlook remains subject to downside risks. Growth projections for Malta's main trading partners for 2011 are generally expected to decelerate or remain roughly in line with growth registered during the previous year. Nevertheless, over the short-term, inflationary pressures for Malta's main trading partners are expected to be tilted to the upside due to high oil and food prices. Over the medium term, risks to inflation in the Euro Area are also on the upside in view of higher than expected commodity prices, indirect taxes, administered price increases and stronger domestic price pressures.

Following the strong recovery experienced in 2010, growth in the Maltese economy is expected to remain robust in 2011, albeit less upbeat when compared to the previous year. The domestic economic environment, characterised by the still negative output gap, weak consumption growth as well as a relatively high unemployment rate, should keep a subdued level of inflationary pressures. Additionally, water and electricity rates are also expected to remain stable given Government's efforts to minimise uncertainty from frequent price changes. On the other hand, there are a number of upside risks in connection to international developments. In particular, the increases in oil and food prices on international markets, pose a temporary, albeit important upside risk to inflation in the local economy.

1. Review of Inflationary Trends

1. Review of Inflationary Trends

1.1 Consumer Price Inflation

1.1.1 Inflation Developments

During 2010, the inflation rate in Malta, as measured by the 12 month moving average in the Retail Price Index (RPI) stood 1.5 per cent, down from 2.1 per cent recorded in the previous year. The inflation rate, as measured on an annual basis was on a downward trend during the first quarter of 2010, declining from 1.1 per cent in January to 0.3 per cent in March. In the subsequent months, the inflation rate was generally on an upward trend. A particular sharp increase was registered during the last quarter with the inflation rate reaching 3.3 per cent in December. The main sub-indices contributing to these developments in inflation during 2010 were Water, Electricity, Gas and Fuels, Food, Personal Care and Health, Housing and Recreation and Culture.

This section will provide an analysis of the latest developments in domestic inflation rate as measured on the basis of the RPI, focusing on developments which occurred in the last quarter of 2010 and the first two months in 2011, as the latest data for 2011 which was available by the cut-off date for publication refers to the month of February.

The overall rate of inflation, as measured by the twelve-month moving average, increased during the last quarter of 2010 reaching the rate of 1.5 per cent in December from 1.0 per cent in October. This upward trend reflected the developments in the annual rate of inflation that rose sharply from 1.7 per cent to 3.3 per cent during the same months. Subsequently, in the first months of 2011, although the annual inflation rate of inflation deccellerated, the twelve-month moving average continued on an upward path reaching 1.8 per cent in February. This resulted as the annual inflation rate during the early months of 2011 exceeded the rates experienced during the corresponding months of 2010. Chart 1.1 illustrates the trend observed in the RPI inflation between the period January 2009 and February 2011.

As shown in Chart 1.2, the acceleration in inflation in the last quarter of 2010 mainly reflects developments in transport and communication and food sub-indices. Another important contributor to this trend was the lower negative contribution by the clothing and footwear sub-index. Meanwhile, the drop in the annual inflation rate between December 2010 and February 2011 mainly reflected decreasing contributions from the water, electricity, gas and fuels

Chart 1.1

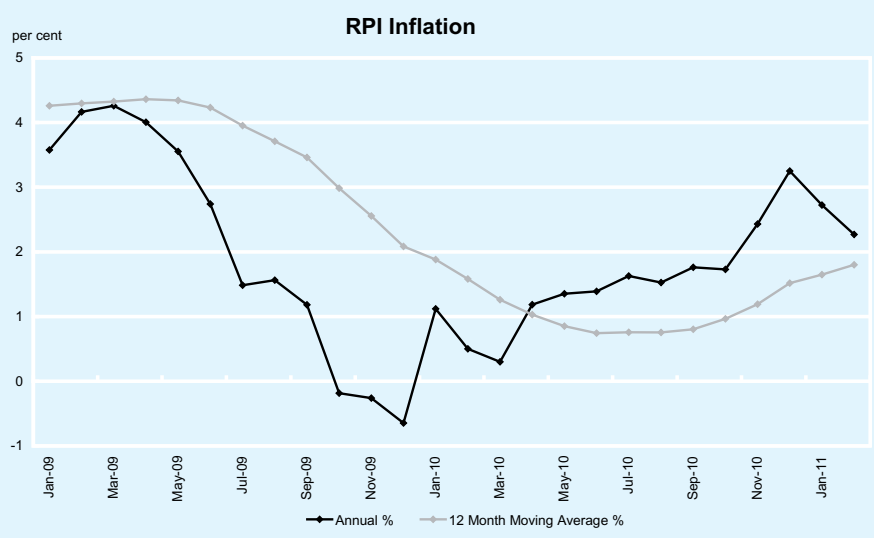
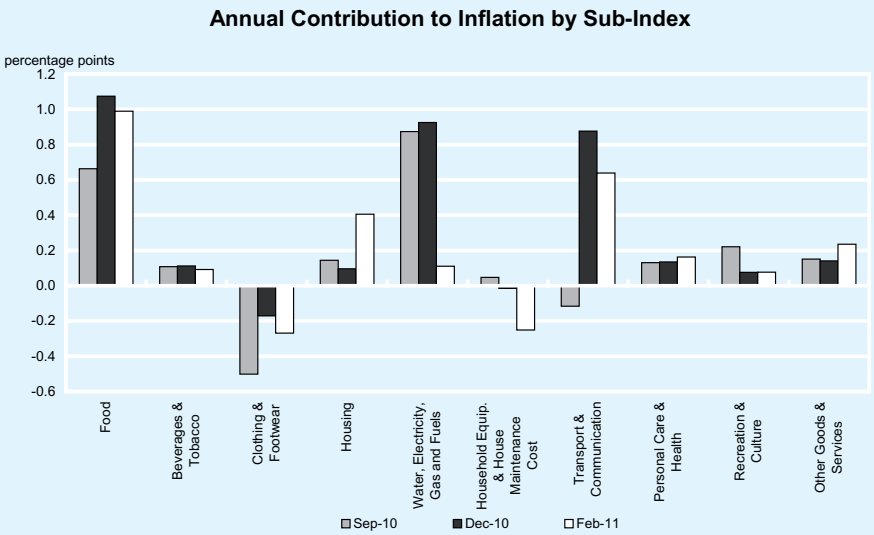


Chart 1.2



and transport and communication sub-indices as well as a larger negative contribution from the household equipment and maintenance cost sub-index. These developments offset the noticeable increase in the contribution to the overall inflation from the housing sub-index. A more detailed analysis of these developments is provided in Section 1.1.3. Meanwhile Box 1.1 presents a simulation of the impact of the rise in fuel prices announced in March on the RPI.

1.1.2 Inflation Persistence

Certain items of expenditure are subject to volatile price movements which may affect the headline inflation rate. In order to assess the underlying inflation in an economy, the measure of core inflation is used. In this report, core inflation is in accordance to the measure adopted by the Central Bank of Malta, as outlined in Quarterly Review 2004:2 (Vol. 37: 2).[1]

As shown in Chart 1.3, core inflation was broadly stable at around 1.5 per cent during 2009 and up to the first quarter of 2010. Subsequently, core inflation

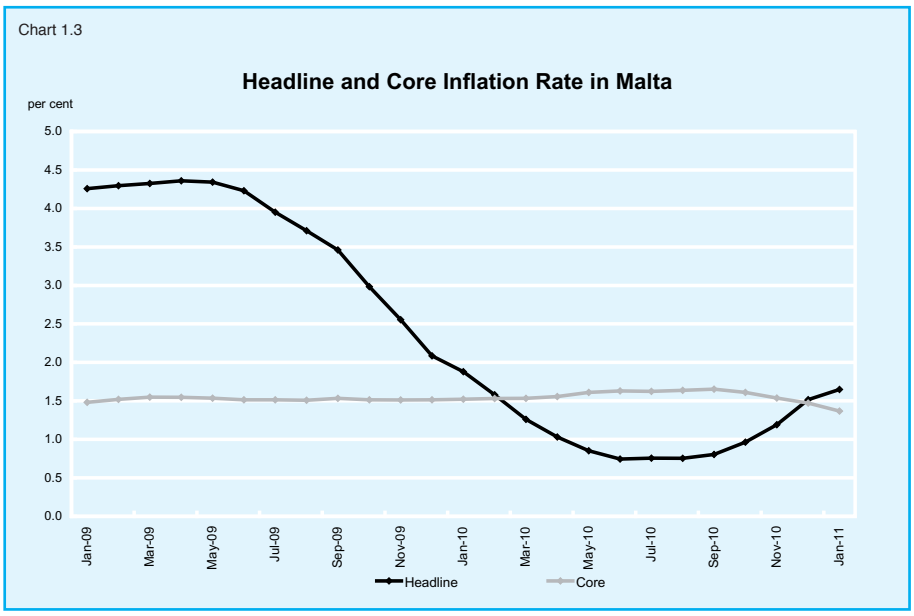
Box 1.1

The Impact of the rise in Fuel Prices on the Retail Price Index

The Economic Policy Department with the assistance of the National Statistics Office is simulating the impact of the rise in fuel prices announced during the months of March and April. This simulation does not represent a forecast of the possible developments in the RPI and was calculated by estimating the impact of the higher fuel prices whilst retaining the rest of the index constant at the levels recorded during February 2011. Hence, this estimate does not capture any potential second-round effects related to the increase in fuel prices as well as any potential upwards and downwards movements in other parts of the Index.

	Index	*Annual Rate*	*12-month MA*
Actual February 2011	*102.13*	*2.27*	*1.79*
Simulated February 2011	*102.33*	*2.64*	*1.82*

As shown in the above Table, after accounting for the rise in fuel prices, the annual inflation rate would rise by 0.3 p.p. to 2.6 per cent relative to the rate of 2.3 per cent recorded in February. The twelve-month moving average is estimated to rise slightly by 0.03 p.p.



has slightly increased to reach 1.7 per cent in September. In the last quarter of 2010 and the first month of 2011, this trend was reversed and core inflation fell to 1.4 per cent in January 2011.[2] During this period, inflationary developments in Malta were conditioned by trends in food and energy-related items thereby explaining the element of stability in core inflation. Consequently, headline inflation exceeded core inflation by a significant gap during 2009, however a negative gap emerged during most of 2010. In January 2011, core inflation was estimated to be below headline inflation. In addition, it is also noteworthy that while the trend in the headline inflation was generally on the rise during the period running up to January 2011, core inflation was on a downward trend.

1.1.3 Contributions to inflation at detailed product level

This sub-section will provide an analysis, at a disaggregated level of the main developments in inflation as well as the main drivers to inflation during the last quarter of 2010 and the first two months of 2011.

As already highlighted above, in December 2010, the annual rate of inflation stood at 3.3 per cent. Table 1.1 shows that this was mainly driven by the contribution of fuels, vegetables, electricity charges and air transport services. In contrast, a negative contribution to inflation was mainly noticed in licenses and administrative fees in reflection of more competitive television services packages.

Main Contributors to Inflation in Q4 2010

Table 1.1

	Weight	Contribution to inflation (pp)	
		Sep-10	**Dec-10**
All items	1,000	1.76	3.25
Fuels	3.76	0.27	0.57
Vegetables	1.01	0.36	0.53
Electricity charges	1.43	0.45	0.45
Air transport services	4.90	0.13	0.27
Fresh bread and fresh pastry	1.28	0.06	0.15
Jewellery, watches and clocks	0.57	0.09	0.14
Milk and milk products	1.71	0.13	0.13
Unprocessed potatoes	0.27	0.10	0.12
Gas	0.23	0.06	0.11
Maintenance and repair services of cars	1.69	0.12	0.11
Fruits, fresh or chilled	1.48	-0.13	0.10
Cigarettes	1.89	0.10	0.10
Motor cars	7.62	-0.24	0.08
Cheese	1.08	0.01	0.05
Hygienic articles/Toilet preparations/Make-up articles	2.56	0.04	0.05
Education expenses	1.22	0.12	0.04
Served meals and food	3.02	0.04	0.04
Eggs	0.22	0.01	0.04
Carpets	0.20	-0.03	-0.03
Men's outwear	1.43	-0.17	-0.05
Women's outwear	1.88	-0.15	-0.05
Fish, fresh or chilled	0.60	0.04	-0.06
Telephone and telephone services	2.74	-0.07	-0.07
Licences and administrative fees	1.30	-0.17	-0.18

Source: NSO and EPD Workings

The increase in the annual inflation rate during the last quarter of 2010 is attributable to the developments in a number of items. As shown in Table 1.2, the highest changes in contribution during this period occurred in motor cars, fuels, fruits, vegetables and air transport services sub-indices. In addition, a lower negative contribution to inflation from certain items of clothing also contributed positively to inflation during the last quarter of the year. These developments more than offset the lower contribution to inflation from the prices of various construction works, furniture, fish and education expenses.[3]

In February 2011, the annual rate of inflation stood at 2.27 per cent. Fuels continued to be a major driver to inflation in the first months of 2011. Other items which continued to contribute positively to inflation were various construction work, motor cars, various food items, jewellery, watches and clocks and gas. Conversely, furniture, telephone services, licenses and administrative fees and clothing were among the main items that recorded a negative contribution

Main Contributors to Change in the Inflation Rate in Q4 2010 by Ranking

Table 1.2

	Weight	Contribution to inflation (pp)		Difference (-\+)
		Sep-10	**Dec-10**	
All items	1,000	1.76	3.25	1.49
Motor cars	7.62	-0.24	0.08	0.32
Fuels	3.76	0.27	0.57	0.30
Fruits, fresh or chilled	1.48	-0.13	0.10	0.23
Vegetables	1.01	0.36	0.53	0.17
Air transport services	4.90	0.13	0.27	0.13
Men's outwear	1.43	-0.17	-0.05	0.11
Women's outwear	1.88	-0.15	-0.05	0.09
Fresh bread and fresh pastry	1.28	0.06	0.15	0.09
Gas	0.23	0.06	0.11	0.05
Jewellery, watches and clocks	0.57	0.09	0.14	0.05
Boys' outwear	0.81	-0.07	-0.02	0.05
Cheese	1.08	0.01	0.05	0.04
Men's footwear - with uppers of leather	0.86	0.00	-0.01	-0.02
Non-durable household goods	2.01	0.03	0.01	-0.02
Processed vegetables	0.79	0.01	-0.01	-0.02
Audio visual equipment	1.38	0.02	-0.01	-0.03
Education expenses	1.22	0.12	0.04	-0.08
Fish, fresh or chilled	0.60	0.04	-0.06	-0.10
Furniture	3.32	0.08	-0.02	-0.10
Various construction works	3.95	0.09	-0.02	-0.11

Source: NSO and EPD Workings

during the same month. Table 1.3 shows the main contributors to inflation in February 2011.

Between December 2010 and February 2011, the drop in the annual rate of inflation was almost 1 percentage point. This reflected declines in the contribution of electricity, furniture, vegetables and air transport services. The negative contribution of electricity reflects a base effect in light of the fact that electricity prices during February 2011 were unchanged on an annual basis in comparison to the increase registered during the year to December 2010. On the other hand, as shown in Table 1.4, various construction works registered a significant increase in its contribution to overall inflation rate during this period, followed by various items including motor cars, women's outwear, fish and fuels.

Thus, it is evident that during the last quarter of 2010 and the first months of 2011, main contributors to inflation included energy-related items and higher food prices. Consequently, as described in the previous section, this has led to higher headline inflation when compared to its core measure. Furthermore, higher prices for these necessary items of expenditure were also reflected in weak private consumption in real terms as outlined in Section 2.1.4.

Main Contributors to Inflation Dec 2010 - Feb 2011

Table 1.3

	Weight	Contribution to inflation (pp)	
		Dec-10	**Feb-11**
All items	1,000	3.25	2.27
Fuels	3.76	0.57	0.65
Various construction works	3.95	-0.02	0.52
Vegetables	1.01	0.53	0.21
Motor cars	7.62	0.08	0.21
Milk and milk products	1.71	0.13	0.16
Jewellery, watches and clocks	0.57	0.14	0.16
Fresh bread and fresh pastry	1.28	0.15	0.15
Gas	0.23	0.11	0.12
Fruits, fresh or chilled	1.48	0.10	0.12
Maintenance and repair services of cars	1.69	0.11	0.10
Cigarettes	1.89	0.10	0.10
Unprocessed potatoes	0.27	0.12	0.08
Books and newspapers	1.56	0.03	0.07
Women's outwear	1.88	-0.05	0.06
Medical services	0.78	0.03	0.05
Men's footwear - with uppers of leather	0.86	-0.01	-0.06
Boys' outwear	0.81	-0.02	-0.07
Women's footwear - with uppers of leather	1.13	0.03	-0.09
Girls' outwear	0.97	-0.02	-0.10
Men's outwear	1.43	-0.05	-0.11
Licences and administrative fees	1.30	-0.18	-0.18
Telephone and telephone services	2.74	-0.07	-0.23
Furniture	3.32	-0.02	-0.42

Source: NSO and EPD Workings

1.1.4 Benchmarking Malta's Inflation Rate

As Malta is a member of the Euro Zone, it is important to monitor domestic inflationary developments in the wider context of developments in the European Union (EU). This subsection thus presents a comparison of trends in the inflation rate in Malta on the basis of the Harmonised Index of Consumer Prices (HICP)[4] with developments in the EU and the Euro Area. Chart 1.4 shows plots of the twelve-month moving average inflation for Malta, the EU-27 and the Euro Area (EA) for the period January 2009 to January 2011, the latest month for which HICP statistics were available by the cut-off date.

Malta's inflation rate was on a rising trend since October 2007 and exceeded the EA average since July 2008. In particular, the inflation rate in Malta was around 2.0 p.p. higher than the EA average during most of 2009. Subsequently the gap in the inflation rates narrowed over the period ranging from the last

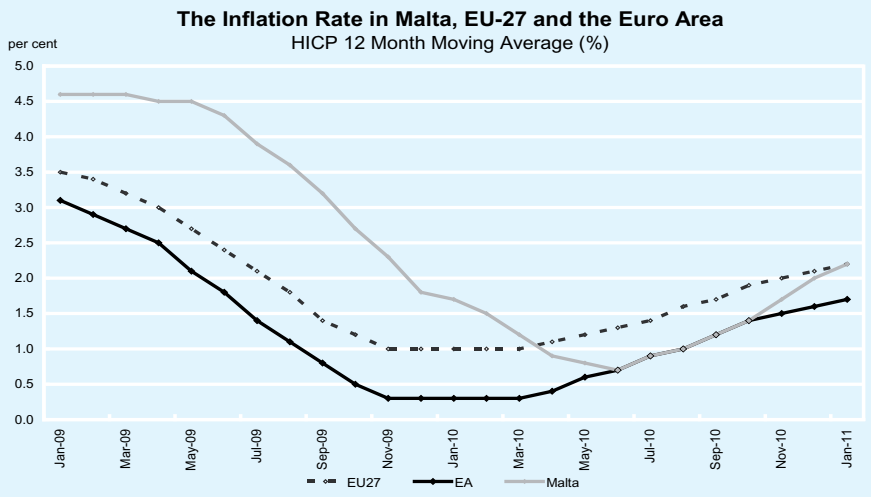
Main Contributors to Change in the Inflation Rate Dec 2010 - Feb 2011 by Ranking

Table 1.4

	Weight	Contribution to inflation (pp)		Difference (-\+)
		Dec-10	**Feb-11**	
All items	1,000	3.25	2.27	-0.98
Various construction works	3.95	-0.02	0.52	0.54
Motor cars	7.62	0.08	0.21	0.13
Women's outwear	1.88	-0.05	0.06	0.12
Fish, fresh or chilled	0.60	-0.06	0.02	0.08
Fuels	3.76	0.57	0.65	0.08
Books and newspapers	1.56	0.03	0.07	0.05
Milk and milk products	1.71	0.13	0.16	0.03
Biscuits and rusks	1.01	0.01	0.04	0.03
Insurance	2.04	0.01	0.04	0.03
Men's footwear - with uppers of leather	0.86	-0.01	-0.06	-0.04
Boys' outwear	0.81	-0.02	-0.07	-0.04
Men's outwear	1.43	-0.05	-0.11	-0.06
Girls' outwear	0.97	-0.02	-0.10	-0.08
Women's footwear - with uppers of leather	1.13	0.03	-0.09	-0.11
Telephone and telephone services	2.74	-0.07	-0.23	-0.16
Air transport services	4.90	0.27	0.00	-0.27
Vegetables	1.01	0.53	0.21	-0.32
Furniture	3.32	-0.02	-0.42	-0.40
Electricity charges	1.43	0.45	0.00	-0.45

Source: NSO and EPD Workings

Chart 1.4



quarter of 2009 to May 2010, with the domestic inflation rate being equal to the EA average during the months of June to October. In subsequent months, the inflation rate in Malta rose more rapidly than in the EA with a positive gap of 0.5 p.p. being recorded in January 2011.

Chart 1.5 depicts the average 2010 inflation rates in Malta, the EU-27 and EA in five main sub-components. Malta's inflation in the energy sub-component (which consists of prices related to electricity, gas and fuels) exceeded by a significant margin that registered in both the EU-27 and the EA. While both European aggregates show an annual average increase of around 7 per cent in this sub-component, Malta's rate reached the rate of almost 19 per cent.

Malta also registered higher annual average inflation rates than both the EU and EA in processed food (including alcohol and tobacco). The average rate for the year 2010 in Malta for processed foods was 2.3 per cent while EU and EA recorded rates of 2.2 and 0.9 per cent respectively. This reflects developments in prices for dairy products, bread, cereals, oils and sugar among others. On the other hand, in 2010, Malta registered a lower average inflation rate than both the EU and EA in unprocessed food and non-energy industrial goods, whereas inflation in services in Malta was similar to that registered in the EA but below that registered in the EU-27. These developments were largely reflected in the comparison of the contribution of these components to the overall inflation rate in Malta relative to the EU-27 and the EA, as shown in Chart 1.6. However,

Chart 1.5

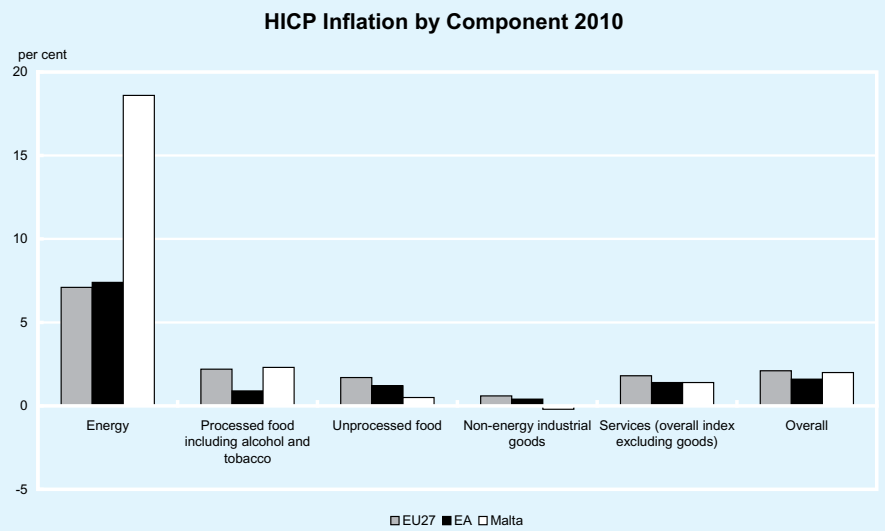
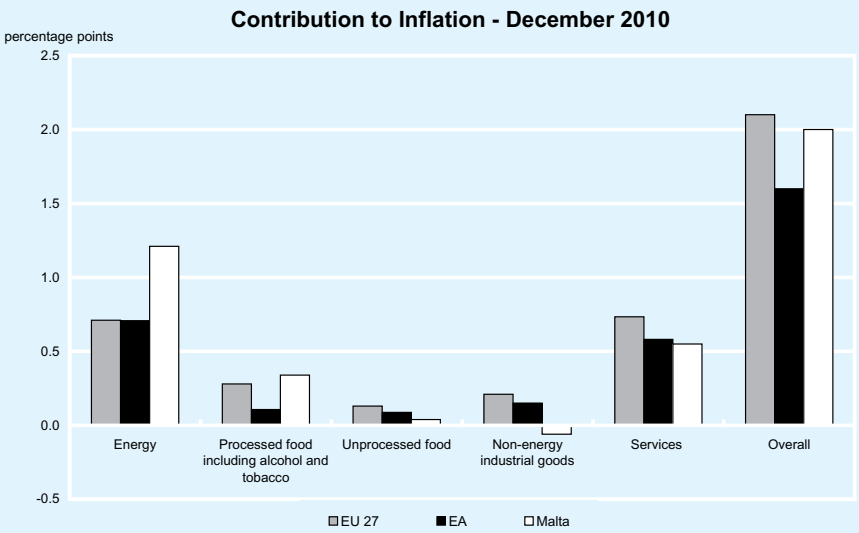


Chart 1.6



one notes that when analysed in terms of contributions to inflation, inflationary developments in the energy component in Malta are only slightly higher than the developments in the EU and the EA, despite the wide differential in inflation rates highlighted above. This is due to the relatively lower weight of energy products in Malta.

Charts 1.7 to 1.12 show plots of the year-on-year change in the HICP at the aggregate and main component classification for Malta, the EU-27 and the EA over the period January 2009 to January 2011. During the first nine months of 2009, the annual inflation rate in Malta was generally higher than that recorded in both the EU and EA, peaking at the rate of 4.0 per cent in April. Between October 2009 and April 2010, the inflation rate in Malta was below the average in the EU and EA. However, it started to exceed the EA benchmark again from May 2010, whilst generally remaining relatively higher than the average inflation rate for the EU as well.

The annual inflation rate for energy in Malta has exceeded the EA average throughout the period being analysed, with the exception of the last quarter of 2009. The gap has been significant during 2010 ranging from 7.7 percentage points in March 2010 to a high of 18.4 percentage points in June 2010. In January 2011, Malta's annual inflation rate in energy stood at 13.3 per cent, compared to around 11-12 per cent in the EU-27 and EA.

Chart 1.7

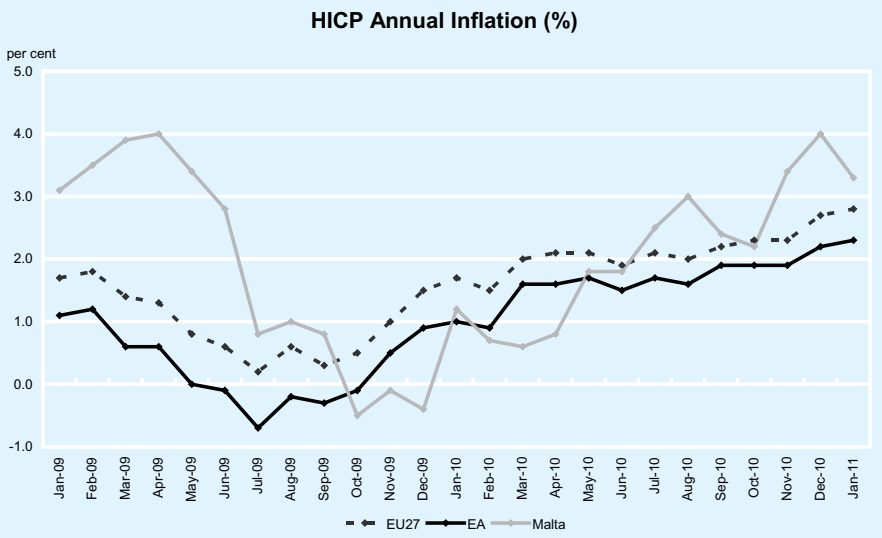


Chart 1.8

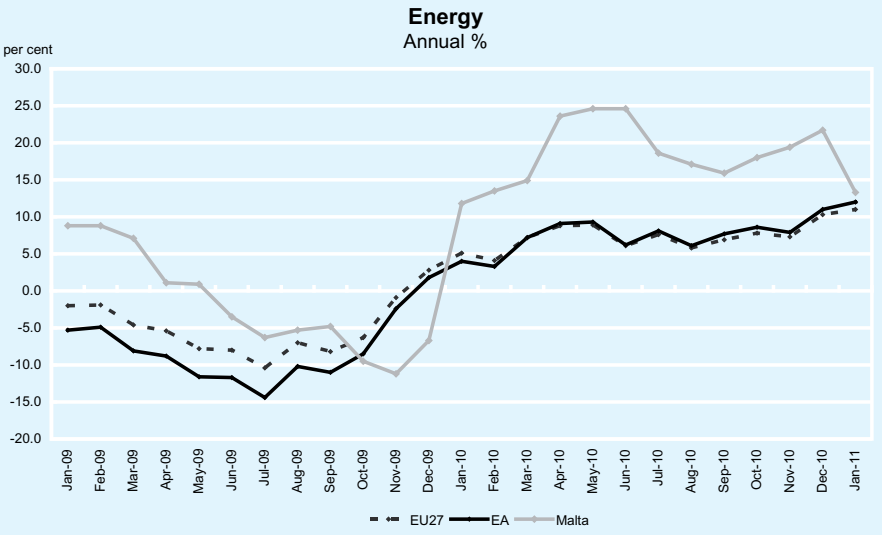


Chart 1.9

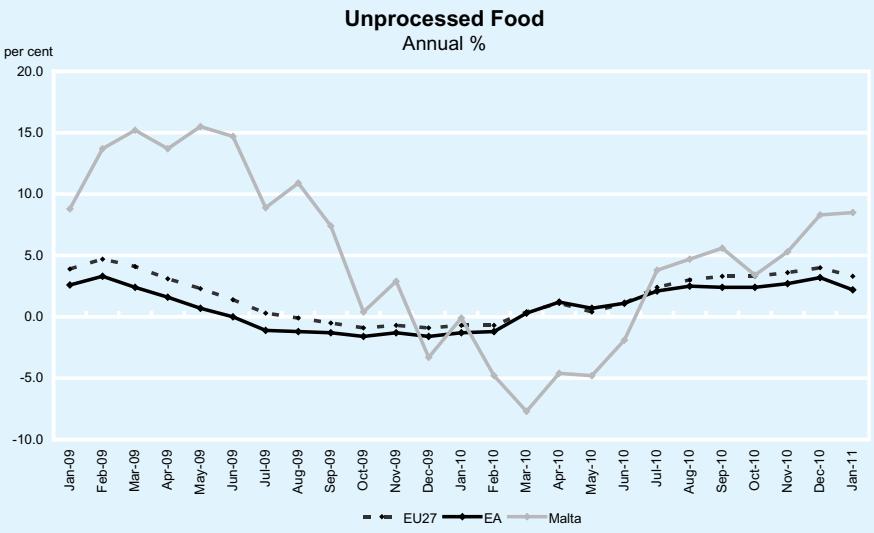


Chart 1.10

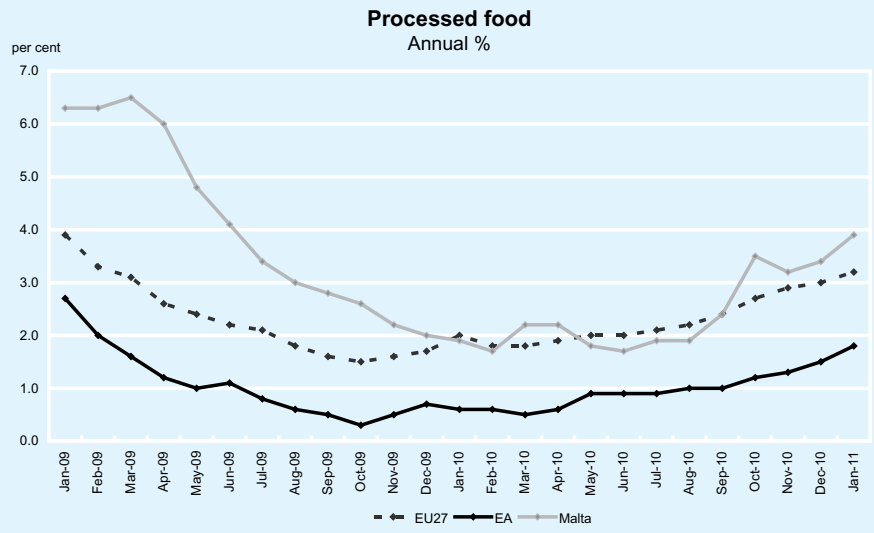


Chart 1.11

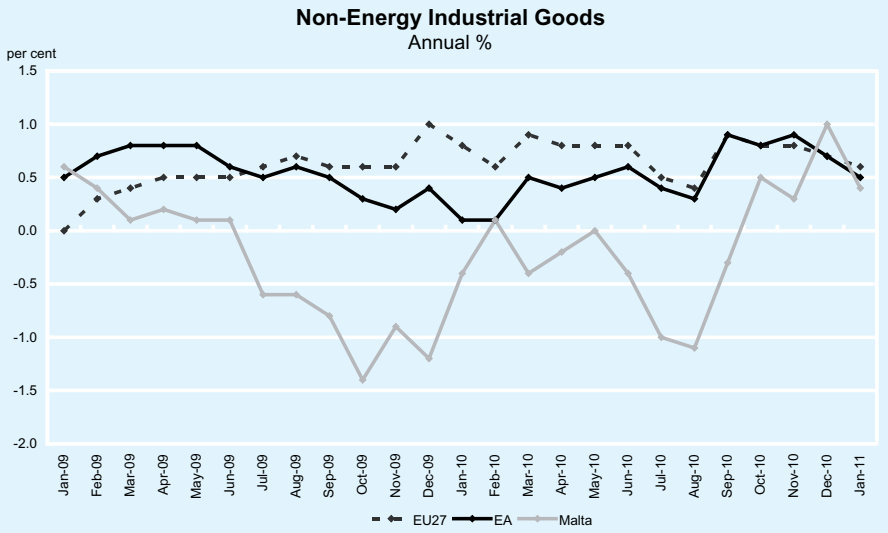
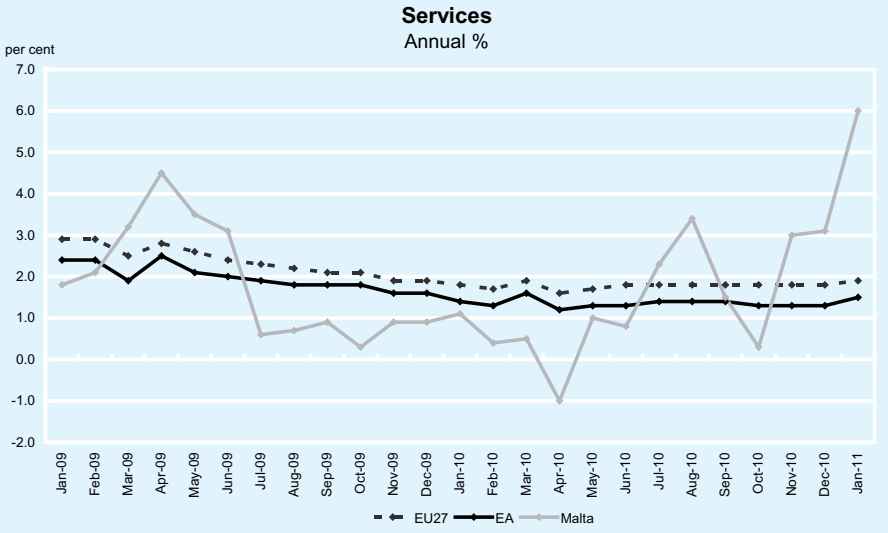


Chart 1.12



Malta has generally registered higher annual inflation rates in unprocessed food than both the EU-27 and the EA throughout the twenty-four months to January 2011, with the exception of the period between December 2009 and June 2010 when Malta registered negative inflation rates. The gap was notable especially in the first half of 2009 when it fluctuated around 10 percentage points. As from the third quarter of 2010, inflation in unprocessed food has picked up more rapidly in Malta when compared to both the EU-27 and the EA, with a widening gap being registered. The negative annual inflation rates recorded during the first half of 2010 have conditioned the annual inflation rate for unprocessed food, such that overall in 2010, the annual rise in prices for unprocessed food was lower than that recorded in the EA and the EU.

The annual inflation rate in processed food in Malta exceeded the European benchmarks by a significant degree in the first half of 2009 but converged to the EU-27 average and remained close to this rate at around 2 per cent during the first three quarters of 2010. However, Malta's rate remained higher than that registered in the EA, which ranged between 0.5 per cent and 1 per cent during this period. As from September 2010, the annual inflation rate in processed food in Malta as well as the EU-27 and the EA followed a gradual upward trend though, the increase in prices in Malta was faster. Indeed, Malta's annual inflation rate in processed food exceeded the EU-27 rate in the last quarter of 2010 and, at around 3 per cent, was almost double the rate registered in the EA. In January 2011, inflation in processed food picked up more rapidly in Malta when compared to both the EU-27 and EA averages. During the month, Malta's rate was 0.7 and 2.1 p.p. above the EU-27 and EA rates, respectively.

On the other hand, Malta's annual inflation rate in non-energy industrial goods was in general below that registered in both the EU-27 and the EA. Malta generally registered negative annual inflation rates in this sub-component during the period under review, whereas both the EU-27 and the EA registered positive rates below 1 per cent. Malta's annual inflation rate in non-energy industrial goods turned positive as from October 2010 and has broadly converged to the European benchmarks since then.

The annual inflation rate in services in Malta has been lower than that registered in both the EU-27 and the EA throughout the period from July 2009 to June 2010. Subsequently, domestic inflation was quite volatile, whereas the European benchmarks remained relatively stable between 1 and 2 per cent. In the last two months of 2010, domestic inflation in services increased significantly to around 3 per cent and accelerated further to 6 per cent in January 2011. In particular, the annual inflation rate recorded in January 2011 reflected higher prices for

accommodation services. As these developments were not registered in the EU-27 and EA, a widening gap in the inflation rates resulted.

Concluding, whilst domestic annual inflation rates tend to be more volatile than the comparable European benchmarks, certain clear developments emerge. In particular, the convergence of the headline inflation rate with the rates recorded in the EU and EA during the last quarter of 2009 and the first half of 2010 appears to have been shortlived. Indeed, subsequently Malta's annual inflation rate has been consistently higher than that registered in the EA and in general a positive differential was also registered with the EU-27 rate. The gap widened significantly as from November 2010. Of note is the generally persistently higher domestic inflation when compared to both the EU-27 and the EA in the energy as well as in the unprocessed food sub-components. Furthermore, the average inflation rate in processed food in Malta has been consistently higher than that registered in the EA during the period under review, whilst it converged to the EU-27 rate during the first three quarters of 2009. On the other hand, Malta's annual inflation rates tended to be lower than the European benchmarks as regards non-energy industrial goods and services. Nevertheless, developments in these sub-components also need to be monitored closely due to the diverging trends registered as from the last quarter of 2010. In particular, a widening gap between the annual domestic inflation rate in services and that registered in the EU-27 and EA has been observed.

1.2 Developments in Other Prices

Developments in asset prices, producer prices and import and export prices can be related to the developments in consumer price inflation, which were outlined in the previous section. This sub-section presents an overview of developments in these other prices.

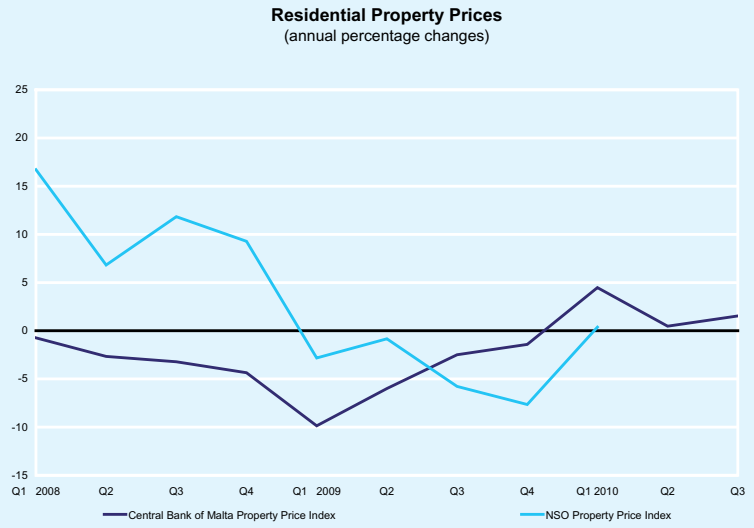
1.2.1 Asset Prices

Residential Property Prices

Developments in house prices could theoretically be linked to consumer price inflation. In particular, certain HICP components, such as house maintenance costs, could be influenced by developments in the property market. Moreover, rising house prices could also lead to a wealth effect, boosting consumer demand and thus potentially resulting in inflationary pressures.

Chart 1.13 shows the latest available data on residential property prices as

Chart 1.13



Source: Central Bank of Malta, NSO.

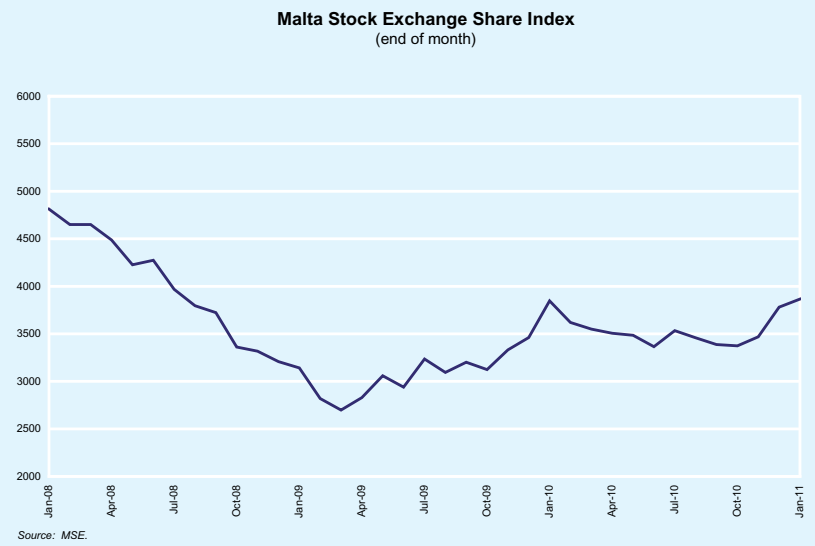
measured by both the NSO and the Central Bank of Malta. The National Statistics Office (NSO) property price index went down by an average of 4.3 per cent in 2009. However, during the first quarter in 2010, property prices recovered and recorded a marginal increase of 0.4 per cent.

Quarterly data on advertised prices compiled by the Central Bank of Malta also shows that growth in residential property prices returned to positive territory in 2010. Indeed, after registering negative annual rates for two consecutive years, in the first quarter of 2010, a growth rate of 4.5 per cent was recorded. In the remaining quarters in 2010 as shown in the Chart, the series continued to show positive improvements.

Different indications from these two measures of residential property prices reflect a number of methodological factors, including differences in sources and methods. Recently, however, both measures indicate a positive rate of growth in property prices, after a stream of negative rates being recorded in 2009.

The increase in property prices is still subdued and thus one would not expect any impact on inflationary pressures to date. However, it is also worth noting that in Section 1.1.3 it was highlighted that the contribution to inflation of construction works is increasing.

Chart 1.14



Equity Prices

Since March 2009, the Malta Stock Exchange (MSE) share index started to increase gradually after a relatively long period of decline. In fact, it rose by around 43 per cent between March 2009 and January 2011. The biggest change was observed during 2009 and January 2010, where the index climbed up from 3141.45 in January 2009 to 3846.91 in January 2010. Subsequently, in the first half of 2010, the index lost part of this recovery but was relatively stable in the following months. In December, the index rose sharply and reached 3865.79 in January 2011. This recovery may reflect an increase in confidence in domestic financial markets after an uncertain period.

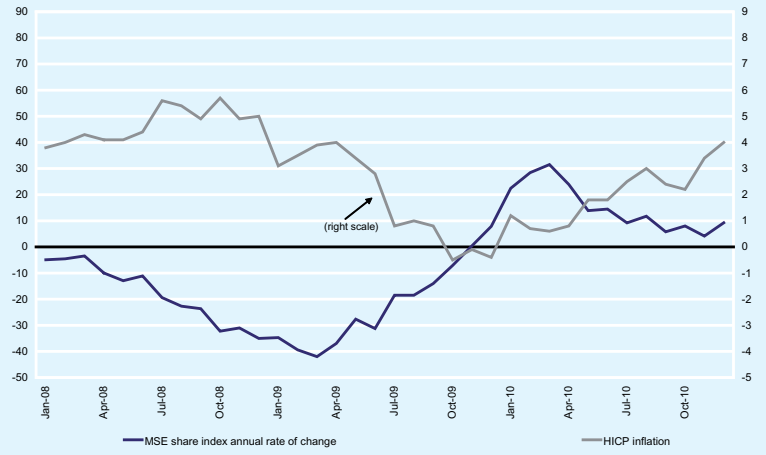
Developments in equity prices can also influence household wealth and thus impact consumer demand, and possibly also inflationary trends. However, as can be seen from Chart 1.15, since the beginning of 2010, as the MSE annual rate of change followed a downward trend, HICP inflation rate has increased gradually. Thus, over the period as a whole, there is no evidence of a robust, contemporaneous relationship between the two variables.

1.2.2 Industrial Producer Prices

The Producer Price Index (PPI), which measures the gross monthly change in the selling prices received by domestic producers for their output, portrayed an upward trend during 2010. Following a strong decline of 8.8 per cent in the

Chart 1.15

MSE Share Index and HICP
(annual percentage rate of change)

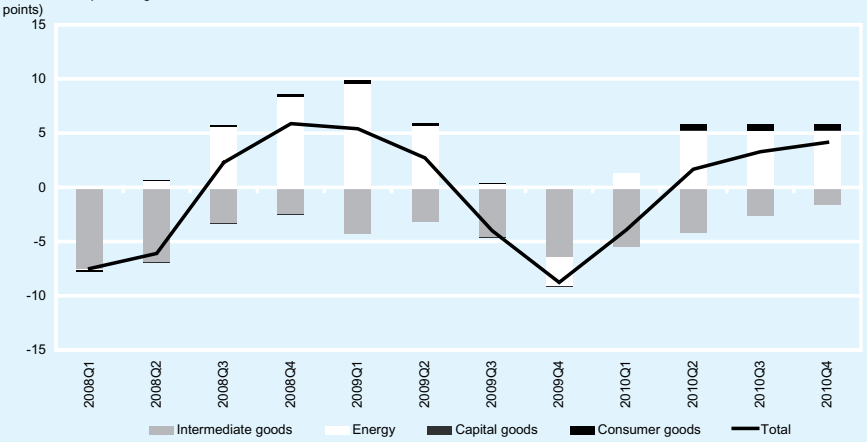


Source: MSE, Eurostat.

Chart 1.16

Industrial Producer Prices
by Main Industrial Grouping

(annual percentage change; contribution in percentage points)

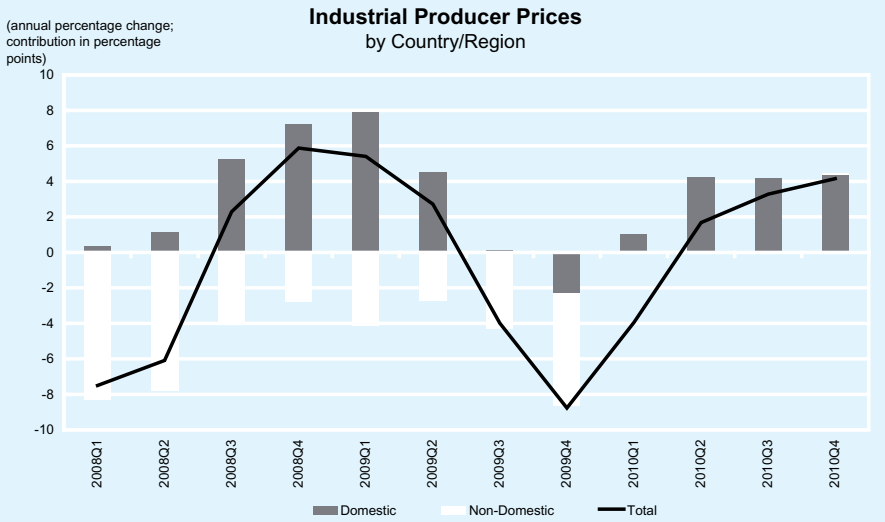


last quarter of 2009, the PPI continued to fall during the first quarter in 2010, but by a smaller magnitude of 4.0 per cent. The PPI then registered steady improvements with positive growth being recorded throughout the remaining quarterly periods, as can be seen in Chart 1.16.

To a large extent, the noted developments reflect significant growth in the annual inflation of producer prices for energy goods. The contribution of this category to the overall PPI stood at 5.3 percentage points during the last three quarters of 2010. On the other hand, intermediate goods continued to sustain deflationary pressure on the overall industrial producer price, though at a decreasing rate. Meanwhile, both consumer and capital goods have had relatively negligible impacts on the aggregate PPI, reflecting marginal changes in their prices.

Overall, the developments during 2010 are indicative of inflationary pressures that are facing producers which according to economic theory would eventually flow through to consumer prices. Developments in the PPI indicate that no substantial pressure on consumer prices emanates from domestically produced consumer goods. However, higher energy prices have a direct effect on consumer prices but also an indirect effect as higher energy prices faced by producers would, depending on degree of pass through, eventually be expected to affect consumer prices. A comparison of developments in the PPI and HICP shows significant divergence between the two indices. Mainly, three reasons exist to explain these differences. First is the fact that the PPI targets the output of domestic producers and therefore excludes developments in the prices of

Chart 1.17

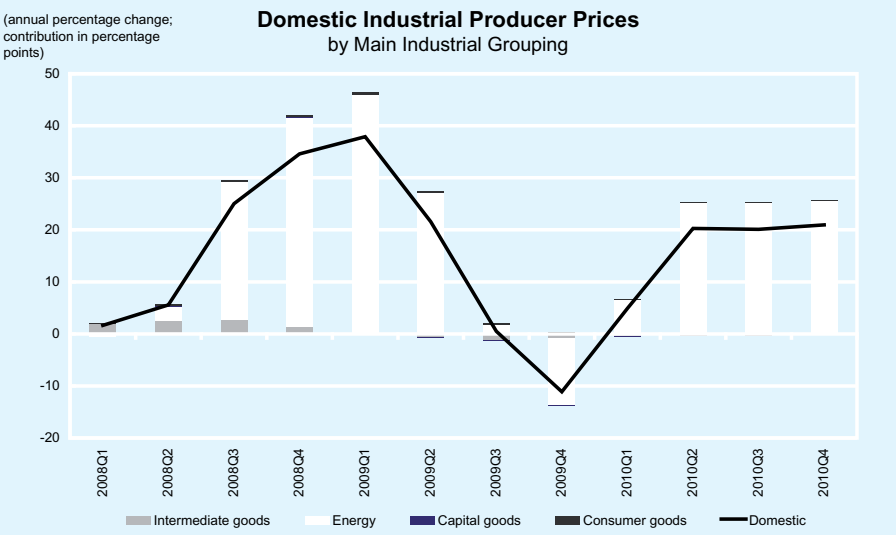


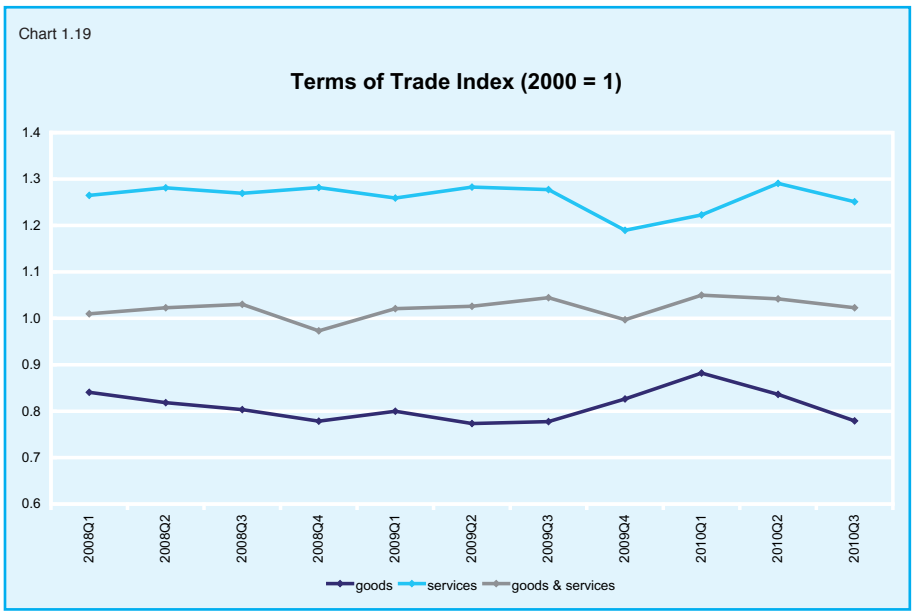
consumer imports. Second is the exclusion of excise taxes from the PPI. Both these variables are taken into consideration in the HICP. Thirdly, a substantial proportion of domestically produced goods is directly exported abroad and therefore has no impact on prices faced by domestic consumers. This point is in fact reflected in Chart 1.17 showing diverging trends in domestic and non-domestic producer prices.

Domestic producer prices measure the average selling price of locally-produced goods sold on the domestic market. On the other hand, the non-domestic producer prices reflect developments in the selling prices of goods resulting from domestic economic activity but sold outside the domestic market. As can be noticed in Chart 1.17, the domestic sector was the major contributor to developments in the PPI in 2010. In fact, its contribution increased from 1.0 percentage point in the first quarter to 4.4 percentage points during the last quarter. On the other hand, contributions from the non-domestic sector during the same year were negligible.

At a more disaggregated level, Chart 1.18 shows that in recent years the main drivers of the developments observed in the domestic PPI have been energy prices. In fact, the contribution of the energy grouping to the domestic PPI was around 6.5 percentage points during the first quarter of 2010, increasing to 25.2 percentage points during the last three quarters in the same year. Moreover, during the last quarter in 2010, price developments for intermediate and consumer goods made a contribution of 0.4 and 0.1 percentage points,

Chart 1.18





respectively. Other industrial groupings have had a negligible impact on the trend followed by the domestic producer price index, reflecting relatively unchanged producer prices.

Overall, it can be concluded that during the year 2010, the inflationary pressures noted in the overall producer price index are mainly a reflection of price developments in the energy category.

1.2.3 Terms of Trade

The purchasing power of a country is reflected in its terms of trade, which measures the volume of imports that can be bought with one unit of exports. Chart 1.19 shows that, during 2008 until the third quarter of 2009, the index for goods in general showed a declining trend. In addition, whilst recovering sharply during the subsequent two quarters, it fell again in the second and third quarter of 2010. In the case of services, the index was broadly stable during 2008 and the first three quarters of 2009, but registered a sharp decline in the last quarter of the year. Subsequently, the services terms of trade index recovered during the first six months of 2010. However in the third quarter, the index fell as the decline in exports prices exceeded that in imports prices.

The overall terms of trade declined in the last quarter in 2008. It reversed its direction during 2009, but decreased again in the last quarter. Subsequently,

it increased in the first quarter of 2010 remaining and followed a gradual downward trend throughout the remaining quarters.

Footnotes:

[1] The estimate of Core Inflation excludes the Food, Beverages and Tobacco, Water, Electricity, Gas and Fuels, Transport & Communications and Clothing & Footwear sub-indices on basis of their volatility.

[2] Estimates of Core Inflation are available up to the month of January 2011.

[3] Various construction works index mentioned refers to various internal works on property like plastering, installation of windows and doors, tiling and painting.

[4] For comparability purposes the analysis in this sub-section is based on the Harmonised Index of Consumer Prices (HICP), an index calculated according to rules specified in a series of European Union Regulations that were developed by the EU statistical office - Eurostat - in conjunction with the EU Member States. A comparison of the RPI and the HICP can be found in Box 1.2 of the Inflation Report, July 2010

2. Macroeconomic Analysis of Inflation Developments

2. Macroeconomic Analysis of Inflation Developments

Developments in demand, supply pressures and credit can be important factors determining inflation over the short to medium term. Thus, this Section analyses macroeconomic developments in the Maltese economy with a view to assess the repercussions on domestic inflation. Supply factors will also be examined as these can influence costs of production, thus affecting inflation.

2.1 The Impact of Demand and Supply Factors

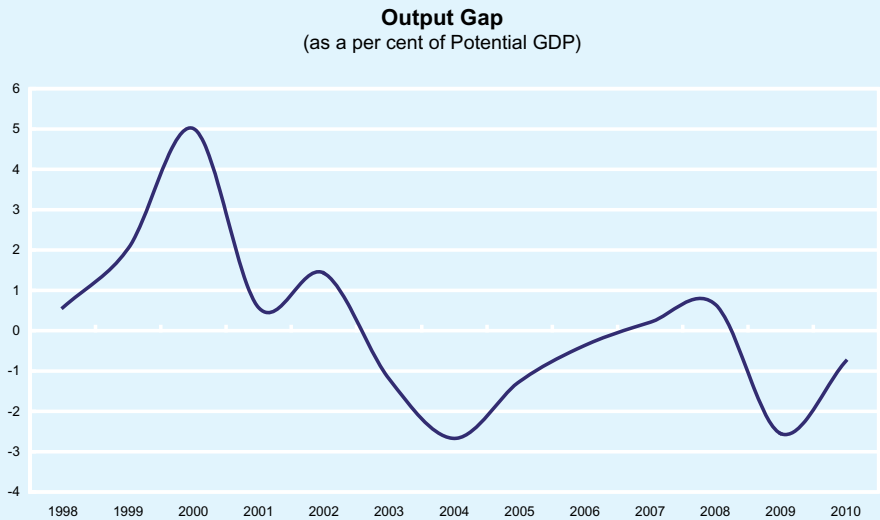
2.1.1 Inflation and Demand Conditions

During a period where the demand for an economy's output exceeds the potential aggregate supply, upward pressures on inflation would be expected. In view of supply constraints, it would be particularly difficult for firms to satisfy the increasing demand without increasing the prices charged to consumers, especially in the short run. In particular, an excess demand for labour resources could also materialise, generating upward pressures on wages and subjecting firms to higher labour costs of production.

Economists typically use the concept of the output gap in order to determine whether excess demand pressures are present in an economy. The output gap measures how much actual GDP/output exceeds or otherwise a notional estimated measure of potential GDP/output. Potential output is defined as the output that could be produced by the economy if all the factors of production were fully employed. A positive output gap is thereby typically associated with excess demand pressures tending to drive inflation upwards, other things (supply side shocks and expectations) remaining equal. A negative output gap is associated with deficient demand for an economy's output often tending to result in lower inflationary pressures and possibly even deflation.

A sharp turnaround in the output gap was registered in 2010[1], albeit the output gap still remained in negative territory. As shown in Chart 2.1, the output produced in 2010 was still below its potential level. Although at the current juncture, inflationary pressures generated by demand conditions would not be expected to be significant, the spare capacity available in the economy was decreasing at a sustained pace, thereby pointing towards the importance of focusing on the supply side to be able to meet higher demand.

Chart 2.1



An analysis of selected components of aggregate demand which are deemed relevant for current developments in inflation follows. Beforehand, credit developments are reviewed, as these can be a relevant factor explaining the performance of specific demand components.

2.1.2 Credit Developments

Growth in domestic credit can be an important source of excess aggregate demand, thus creating inflationary pressures. Table 2.1 and Chart 2.2 show developments in credit to residents of Malta. Credit to domestic residents rose by 5.8 per cent in 2010, as opposed to 9.4 per cent during 2009. Increases were registered in credit to private non-financial corporations, households, and general Government. The deceleration in credit growth was influenced by the increasing tendency of non-financial corporations to resort to the capital market to raise funds.

Credit to general Government increased by 8.5 per cent during the year, driven by a rise in bank holdings of Malta Government Stocks. This represents a marked slowdown from 2009, where credit expanded by 19.1 per cent. The deceleration reflected a decrease in the amount of Treasury bills issued by Government.

Credit to other residents of Malta, mainly households and non-financial corporations, expanded by 5.1 per cent during 2010, down from 7.2 per cent

Credit to Residents [1]

Table 2.1 annual percentage changes

	2009	2010			
	Dec	Mar	Jun	Sep	Dec
Total Credit	9.4	10.0	7.8	7.3	5.8
Credit to general Government	19.1	19.8	12.0	10.6	8.5
Credit to other Residents	7.2	7.7	6.8	6.4	5.1

[1] Credit includes, besides lending, claims in the form of debt securities and shares and other equity.

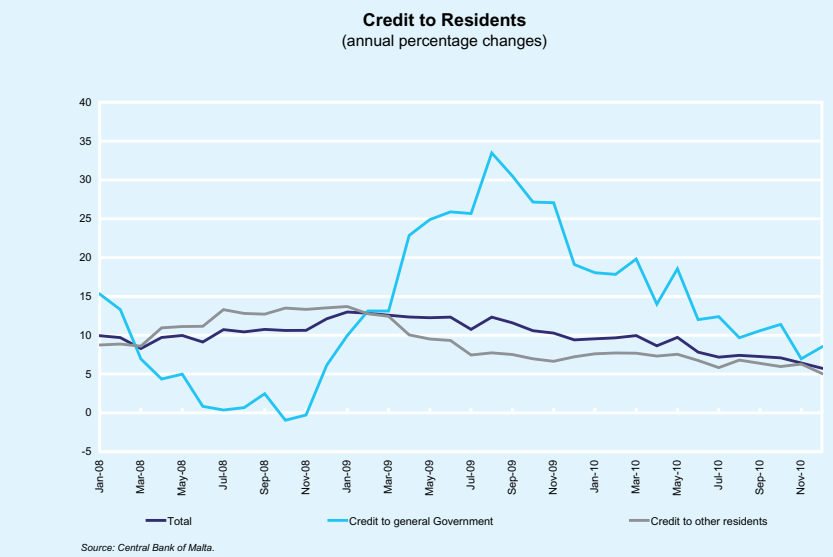
Source: Central Bank of Malta.

in 2009. In particular, loans, which account for almost all credit outstanding, increased at a slower pace during the year, with their growth rate dropping to 5.1 per cent from 7.1 per cent at the end of 2009.

Table 2.2 reveals credit and loan growth by economic activity. It is to be noted that a reclassification was carried out with data following NACE rev. 2 as from June 2010. Data for the sectors comprising construction, real estate activities and other activities faced the major changes, such that it is not possible to make comparisons involving statistics before June 2010 for these economic sectors.

Loan growth during the year was mostly due to a rise in borrowings by the non-

Chart 2.2



Credit to Other Residents [1]

Table 2.2 annual percentage changes

	2009	2010			
	Dec	Mar	Jun	Sep	Dec
Total Credit	7.2	7.7	6.8	6.4	5.1
Credit to the non-bank private sector	6.6	7.9	6.4	6.7	5.4
Credit to the non-bank public sector	13.8	5.8	10.6	3.5	1.4
Total Loans	7.1	7.5	6.4	6.1	5.1
Electricity, gas & water supply	29.7	15.0	21.6	11.3	16.2
Transport, storage & communication	11.8	13.4	7.9	16.8	6.6
Manufacturing	-13.0	1.2	-2.2	-4.8	-4.4
Construction	0.4	2.1	52.9	51.4	52.0
Hotels & restaurants	6.2	5.4	-8.9	-6.4	-8.1
Wholesale & retail trade; repairs	1.3	6.3	5.9	5.9	7.6
Real estate activities [2]	10.9	8.0	-57.1	-59.5	-62.0
Households & individuals	9.8	9.6	8.1	8.1	6.9
Other activities[3]	-5.3	-5.0	85.0	101.0	104.4

[1] Credit to other residents consists mainly of loans and holdings of securities, including equities, issued by the non-bank private sector and public non-financial companies, and financial derivatives. Interbank claims are excluded. As from June 2010, the statistical classification of loans by economic activity is based on NACE rev. 2.

[2] Excluding loans to unincorporated bodies such as partnerships, sole proprietors and non-profit institutions. Loans to such bodies are classified by their main activity.

[3] Includes loans to agriculture & fishing, mining & quarrying, public administration, education, health & social work, financial and insurance activities (including interbank loans), professional, scientific and technical activities, administrative and support service activities, arts, entertainment and recreation, other Services activities and extra-territorial bodies & organisations.

Source: Central Bank of Malta.

bank private sector. In particular, household mortgages increased significantly during the year and remained the largest single category of bank borrowing by residents. At the same time, growth in loans to the non-bank public sector decelerated to 1.4 per cent from 13.8 per cent a year earlier following some debt repayment by one public corporation.

There was negative annual growth in loans provided to hotels and restaurants since June 2010, while the manufacturing sector faced a reduction in loans practically throughout the whole period from the end of 2009 to the end of 2010. Loans to households and individuals maintained their upward trend, albeit a slight decrease in growth was recorded over the period under study.

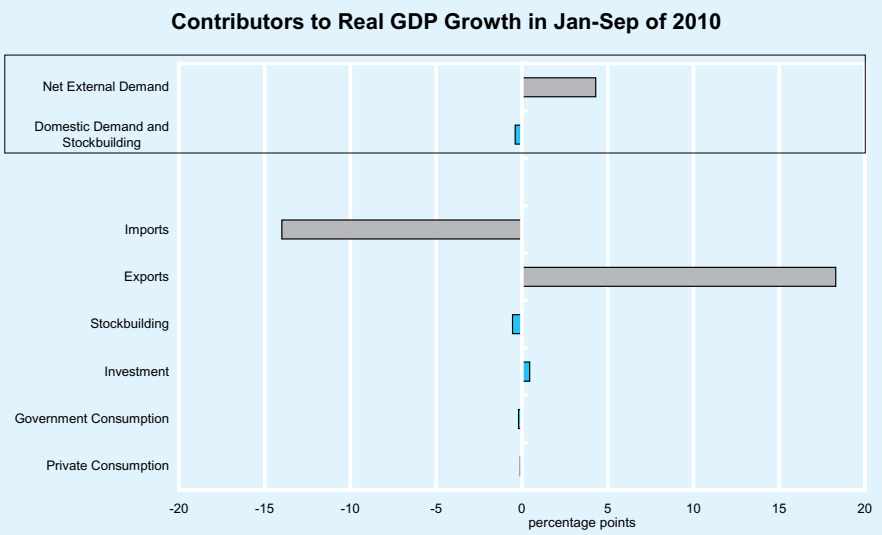
The results of the quarterly Bank Lending Survey carried out by the Central Bank of Malta show that conditions applied by the banks to the supply of credit to enterprises and households remained unchanged during 2010. However, a slight decline in demand for loans, particularly by households, was observed in all four quarters.

2.1.3 Real GDP Growth[2]

Real demand increased by 3.9 per cent during the first three quarters of 2010, when compared to the corresponding period of 2009. The annual rate of growth of real GDP was on a slightly downward trend, decreasing from 4.2 per cent during the first quarter of 2010 to 3.6 per cent during the third quarter of 2010. This data shows a relatively strong recovery which is establishing itself, starting from the fourth quarter of 2009 following a recession which lasted three quarters. Implied inflation from the national accounts deflators hovered around 3.6 per cent in January-September 2010, increasing from 2.7 per cent in the same period of the previous year. Chart 2.3 plots the contributions to real demand growth in the first nine months of 2010, while details of real GDP components can be seen in Table 2.3.

Turning to more recent quarterly developments, the improvement in real aggregate demand in the third quarter of 2010 was attributable to net external demand, which contributed around 4.1 percentage points to growth. This reflected an increase in exports which outpaced the increase in imports. On the other hand, domestic demand conditions shaved off 0.5 percentage points from growth mainly due to decreased private and Government consumption. Box 2.1 provides a preliminary review of GDP developments in 2010.

Chart 2.3



Expenditure Components of Real GDP

Table 2.3 annual percentage changes

	2008	2009				2010		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Final Consumption	2.8	0.3	-2.1	-1.2	0.9	0.5	0.8	-2.2
Private Final Consumption [a]	2.0	-0.2	-2.8	-1.0	2.3	1.2	0.2	-1.7
Government Consumption	5.3	2.0	0.2	-1.8	-3.9	-1.7	2.7	-3.8
Gross Capital Formation	-40.3	-23.3	-52.1	-9.9	27.9	25.7	-43.5	13.7
Gross Fixed Capital Formation	-45.8	-33.1	-22.1	2.3	-6.2	5.6	0.4	3.7
Changes in inventories [b]	2.6	1.4	-10.0	-1.6	4.8	3.6	-5.5	1.3
Acquisitions less disposals of valuables [b]	-0.3	0.3	0.0	0.2	0.0	-0.2	-0.2	-0.4
Net Trade [b]	8.2	2.0	11.8	-0.3	-3.8	-0.4	9.0	4.1
Exports of Goods and Services	-8.5	-17.0	-8.8	-3.8	-4.2	26.9	23.8	16.7
Imports of Goods and Services	-15.5	-17.9	-19.5	-3.6	0.1	25.7	12.9	12.7
GDP	1.0	-2.4	-3.8	-2.5	0.9	4.2	4.0	3.6

[a] Includes NPISH Final Consumption

[b] Percentage point contributions to growth of Real GDP

Source: NSO

Box 2.1

Latest Real GDP Estimates for 2010

The National Statistics Office has released the GDP statistics for the complete year 2010, such that a brief overview of the main developments will be presented in this box.

Real GDP growth of 3.7 per cent was registered in 2010, with net external demand still providing the major influence as exports increased by around 17.2 per cent in real terms. Private final consumption was weak, being partly offset by a slight increase in Government consumption. Meanwhile, investment continued to recover although it still stands at much lower levels than observed before the onset of the crisis.

Following a slight downward trend in real GDP growth over the first three quarters of 2010, growth picked up again to reach around 4.0 per cent in the fourth quarter. However, this was mainly generated from domestic demand, with Government consumption providing a positive contribution and investment recording a relatively strong rate of growth. Private consumption continued to be weak while a gradual downward trend in real export growth could be discerned since the second quarter of 2010.

Thus, whilst noting the stronger contribution of domestic demand during the forth quarter, on the basis of this preliminary preview one may conclude that, as stated in this Report, demand pressures were not an important driver of inflationary pressures in Malta during 2010.

2.1.4 Private Consumption[3]

Real private final consumption decreased by just above 0.1 per cent in the first three quarters of 2010, subtracting around the same percentage points from real GDP growth during the period. To note is that expenditure on transport decreased, which should be contrasted to the increases registered in the comparable periods of the previous two years. This category includes purchases of new vehicles, costs related to transport operations and transport services. Statistics indicate a decrease in the number of newly licensed motor vehicles during the first three quarters of 2010.

In the third quarter of 2010, private consumption contracted by 1.7 per cent. This followed weak private consumption growth registered during the first two quarters of 2010 showing that private consumption did not cause inflationary pressures in 2010. Such a development is noteworthy and deserves monitoring. This could signal an adjustment of consumption patterns in the light of higher local utility and fuel prices and a changing global economic environment marked by the increasing risk of rising inflation.

2.1.5 Investment[4]

Investment is important for both the expenditure side and the production side of the economy. In the short run, changes in investment as an expenditure component affect directly the output produced in the economy. As the majority of investment goods (excluding construction) are imported by Malta, is not expected that investment demand will generally result in domestic inflationary pressures. Due to the small size of the local economy, domestic demand conditions could potentially exert pressures on prices of investment goods only in cases where there are domestic intermediaries in the value chain. From the supply perspective, investment activity is also an important input in the production process as it boosts the stock of capital, helping to increase the aggregate supply of the economy.

Following significant declines during both 2008 and 2009, a modest rebound in investment was registered since the first quarter of 2010, as private sector firms have been resuming their investment projects possibly in view of the improving economic prospects. The increase in investment was quite broad-based, with investment in construction (excluding housing) also registering increases since the first quarter of 2010. However, this rebound was not shared by investment in housing, which continued to register declines during January-September 2010.

Although caution still needs to be applied when interpreting this investment

activity pick-up, this trend reversal is encouraging considering the significant decreases recorded in 2008 and 2009. Through the build-up of capital, the possibility for supply bottlenecks and any potential build-up of inflationary pressures from an increasing demand could be reduced.

2.1.6 Government Spending and the Fiscal Stance

Real Government consumption decreased by 0.9 per cent during the period January-September 2010, shaving off 0.2 percentage points from output growth. A relatively sharp decline of 3.8 per cent was registered during the third quarter of 2010. The Government is following a fiscal consolidation strategy based on restraint in public expenditure. Such a strategy would avoid the need for further taxes and the unnecessary increase in the national debt. Moreover, the budget deficit is planned to be decreased gradually over the period from 2011 to 2013 with the aim to ensure economic and financial stability, credibility and investor confidence.

2.1.7 The International Economy and Export Performance

External demand conditions can affect domestic inflation in a direct and indirect manner. Foreign demand can influence producer and export prices, and possibly other domestic prices, depending on the degree of inter-linkages between certain exporters and their domestic suppliers as well as the size of these suppliers and their market shares in the local economy. Indirectly, export performance also affects domestic income and thereby influences domestic demand. In this context and given the high degree of openness of the Maltese economy, it is relevant to monitor international developments when analysing inflationary pressures.

The global economy has grown strongly in 2010, with the IMF's projections for world GDP growth being revised upwards significantly since April 2009, to a rate of around 4.8 per cent. The IMF projection for growth in 2011 has remained broadly unchanged at around 4.2 per cent.

According to the JPMorgan Global Manufacturing and Services Purchasing Managers Index (PMI), global GDP growth accelerated during the latter part of the year. Rates of expansion in output and new orders gathered pace in the manufacturing and service sectors, adding balance and sustainability to the recovery. Growth in the services sector has outpaced that in the manufacturing sector in November and December, with the trend likely to continue in 2011.

2.1.7.1 Recent Economic Developments in Malta's main Trading Partners

A general recovery appears to be underway in Malta's main trading partners, although it is not as robust as global growth figures. Germany registered strong growth but the recovery in other countries is not well established. Particularly, Italy and France registered declining growth during certain quarters of 2010. Moreover, indicators are tending to illustrate some slowing in GDP growth in Germany and across the Euro Area as a whole in the third quarter of 2010.

Table 2.4 shows the growth in consumption, investment and inventories in Malta's main trading partners, which is a better measure of the potential demand for Maltese exports than GDP growth. In general, domestic demand conditions in the major trading partners appeared to be quite strong in the first three quarters of 2010, having recovered from the negative territory recorded during 2008 and 2009, albeit the performance differs between EU Member States. This has led to a substantial increase in demand for Maltese exports in the first three quarters of 2010, with exports of goods and services increasing by 18.0 per cent in nominal terms and by 22.0 per cent in real terms.

It has to be noted that the positive growth outlook is subject to a number of downside risks. Considering the sovereign debt crisis in the Euro Area, as a number of Member States are implementing significant fiscal consolidations, it is expected that demand conditions remain weak. Furthermore, the looming prospect of increasing global inflationary pressures (with oil and commodity prices being quite important to the production process) and geopolitical tensions in a number of countries within the Arab world (which also include some major oil exporting countries) also involve potential risks to the economic outlook.

Domestic Demand in Malta's Main Trading Partners

Table 2.4 percentage changes on the previous quarter

	Averages		2010		
	2007	2008-2009	Q1	Q2	Q3
EU-27	0.7	-0.6	0.9	1.0	0.4
Euro Area	0.5	-0.5	0.9	0.9	0.2
Germany	0.4	-0.3	1.9	2.1	0.4
France	0.6	-0.2	-0.4	0.9	0.7
Italy	-0.1	-0.5	0.4	-0.1	0.8
UK	0.8	-0.9	1.2	0.9	0.8

Source: Eurostat

2.1.8 Conclusion

A recovering global economy has helped Malta register impressive growth in exports, which has in turn generated the domestic recovery underway. Investment has picked up across a range of products indicating an increasing business confidence. However, housing investment still decreased possibly due to the existing excess supply in the property market. Despite the overall improvement in economic activity, private consumption remained weak. Thus, while the negative output gap is closing, the weak private consumption and contraction in Government consumption indicate that domestic demand was not a major contributor to inflationary pressures in 2010. In this context, it is relevant to assess developments in supply side factors and their contribution to domestic inflationary trends over the period under review.

2.2 Potential Output Growth and Inflation

Population and labour supply developments are factors affecting the potential output capability of an economy and could have implications on potential output growth as well as inflationary prospects. Given the economic importance of labour input, an analysis of labour market conditions is provided in this Section. The contributors to potential output growth are also analysed. It should also be borne in mind that the recovery of investment, albeit modest up to now, would contribute to enhance the productive capacity of the economy.

2.2.1 Inflation and the Labour Market

In analysing the labour market it is important to review developments in the labour supply and labour demand which actually refers to the number of vacancies issued on the market although it is frequently measured by employment. The evolution in the working age population, which is in turn dependant on demographic trends, is a major factor affecting the labour supply. In turn, individual decisions as to whether to participate in the labour market and in which area of the labour market to participate following the undertaking of the necessary skill and knowledge upgrading, are central to determining the labour supply and its composition. Labour demand is a derived demand, as it tends to be mainly based on the growth of the individual firm. This is mainly related to economic growth, as firms seek more workers as higher output is produced.

The labour market tends to settle in a position where some degree of unemployment is inevitable. Some frictional and structural unemployment would tend to be present as people take time to search for, locate and settle in

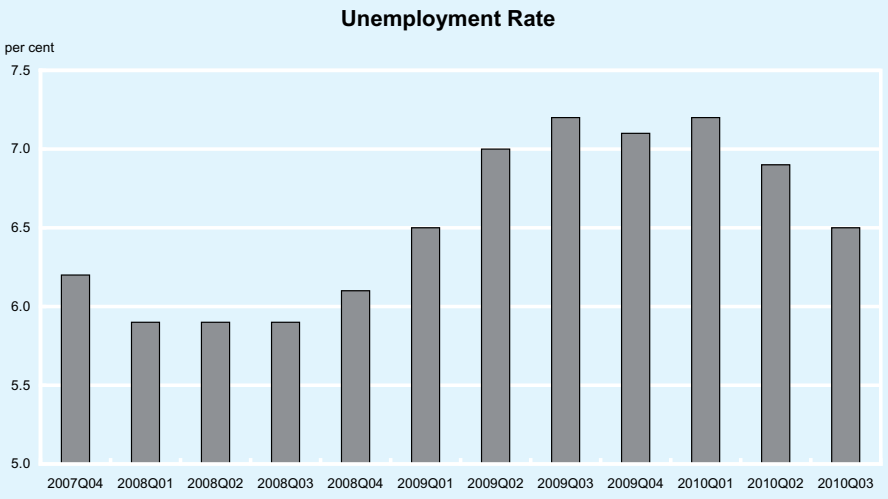
new jobs while certain skill mismatches could result, leading to the undertaking of the necessary retraining. Structural unemployment is likely to be more common during periods of economic restructuring. This level of unemployment is known as the natural rate of unemployment and is associated with stable inflationary pressures.

As an economy enters a recessionary period, an increase in unemployment would be expected due to deficient demand for the firms' products. Downward pressures on wages and inflation would tend to materialise as unemployment would exceed the natural rate. On the other hand, the opposite tends to occur as an economy is overheating (growing at high economic growth rates above potential output growth), with unemployment being below the natural rate.

Data treating the labour market was obtained from the Labour Force Survey, except when indicated otherwise. The unemployment rate[5] established a downward trend after the first quarter of 2010, being recorded at 6.5 per cent during the third quarter of 2010. As illustrated in Chart 2.4, this might be indicative of the diminishing spare capacity in the economy and thereby consistent with the sustained decline in the negative output gap. However, although the long-term unemployment rate did not increase during this period, it remained at elevated levels compared to rates established over the period from 2006.

Labour demand as measured by employment growth[6] registered a turnaround

Chart 2.4



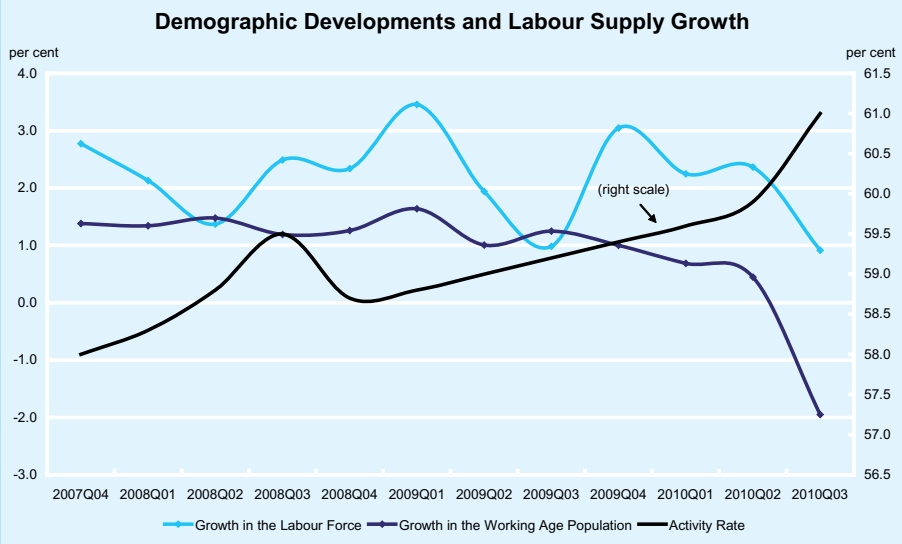
Note: Eurostat seasonally adjusted series

during January-September 2010, with a growth rate of 2.6 per cent at the end of the third quarter of 2010 as compared to a decline of 1.5 per cent at the end of the same period of 2009. The growth in employment was in contrast to declines registered during most of 2009, albeit growth was not as substantial as that registered during the corresponding periods of 2007 and 2008.

Labour supply as measured by the labour force and being composed of the employed and unemployed populations, continued to register growth during January-September 2010. The activity rate also continued on its upward trend, reaching 61.0 per cent at the end of the period under review as compared to 59.2 per cent registered at the end of the same period of 2009. This occurred as the labour force increased by 0.9 per cent when compared to the decline of around 2.0 per cent registered in the working age population. Chart 2.5 highlights these developments.

Female activity continued to increase, reaching 43.6 per cent in the third quarter of 2010, but is still low by EU standards. This was mainly responsible for the increase in the activity rate coupled with developments in the male activity rate that increased from 76.8 per cent to 77.7 per cent. Raising the activity rate - particularly through policies that provide the required incentives to enable the take-up of employment opportunities while balancing family and working needs - remains paramount in preventing labour supply constraints from becoming a source of inflation. Increasing activity rates also enable the Maltese economy to grow in size as the new providers of labour benefit from a source of income

Chart 2.5



which would thereby facilitate the required consumption and saving.

The reduction in the unemployment rate was the result of an increase in labour demand that outpaced the growth in the labour supply. The latter is encouraging, in that the productive potential made possible through the utilisation of labour as a factor of production increased even as a decline in the working age population materialised. Although the spare capacity in the labour market and the economy might have decreased, labour demand growth is still not as strong as observed before the crisis and the activity rate was on an upward trend. This might suggest that the labour market was not tight enough to cause inflationary pressures in 2010.

When analysing the relationship between inflation and unemployment, it is important to distinguish between structural and cyclical unemployment. An increase in unemployment may indeed still be accompanied by upward wage and inflationary pressures if this results mainly from a rise in structural unemployment. This is due to the increasing difficulty firms would need to contend with in order to find the suitable persons to fill in emerging vacancies due to skill and ability mismatches.

While the unemployment rate decreased during the period under study, this mostly resulted from the reduction in the short-term unemployment rate, as longer term unemployment rates remained roughly unchanged. Thus, it is important to continue to invest in the education system and the provision of training and lifelong learning programmes so that the labour supply has the necessary skills required by domestic economic operators.

2.2.2 Potential Output Growth

Potential output growth registered in 2010[7] was roughly at the same level of the previous year, but as actual output growth recovered from the decline recorded in 2009, the negative output gap closed significantly. Labour and capital provided roughly equal contributions to potential output growth, as the potential labour input increased mainly due to an increase in the trend participation rate while the potential capital input increased through a higher investment ratio. However, the investment ratio still stands at relatively low levels compared to the pre-crisis period, such that a strengthening of investment is required to enhance the productive potential of the economy. Total factor productivity was also a very important contributor to potential output growth in 2010, maintaining its importance from the previous year.

2.2.3 Conclusion

Spare capacity may be decreasing in the Maltese economy due to the increase in aggregate demand, albeit this was mainly the result of higher export activity. The labour market is becoming relatively tighter, albeit the increase in the labour supply through a higher activity rate is encouraging. Investment in the capital stock returned to a period of growth. These factors have contributed to an increase in the productive potential of the economy, in conjunction with total factor productivity increases.

There appears to be some slack remaining in the economy as evidenced by the negative output gap and an unemployment rate which is still higher than the lowest levels ever recorded, such that it is unlikely that there were inflationary pressures coming from aggregate supply constraints during 2010. However, the slack is closing quite quickly, pointing towards the increasing importance of supply side policies to ensure that there are no productive capacity constraints in the future.

While the downward trend in investment has been reversed, it is of utmost importance to ensure an increase in the investment ratio since it is still relatively low. This would enable a higher productive capacity of the economy which is important to avoid supply bottlenecks, especially considering the significant growth in export activity registered. Increases in the activity rates of males and especially females should be facilitated through the appropriate policies while the reform in the education system should be continued to ensure that the labour force possesses the skills required by the growing sectors of the economy.

2.3 Costs

Developments in the price level can be viewed also from a cost-push perspective. Changes in the cost structure of production, including but not limited to cost of inputs, are ultimately reflected in the final price of a domestically produced good or service. It thus follows that an increase in input prices is normally expected to raise the price level, albeit the extent of change in the final price is subject to various forces including future expectations and the structure of the market.

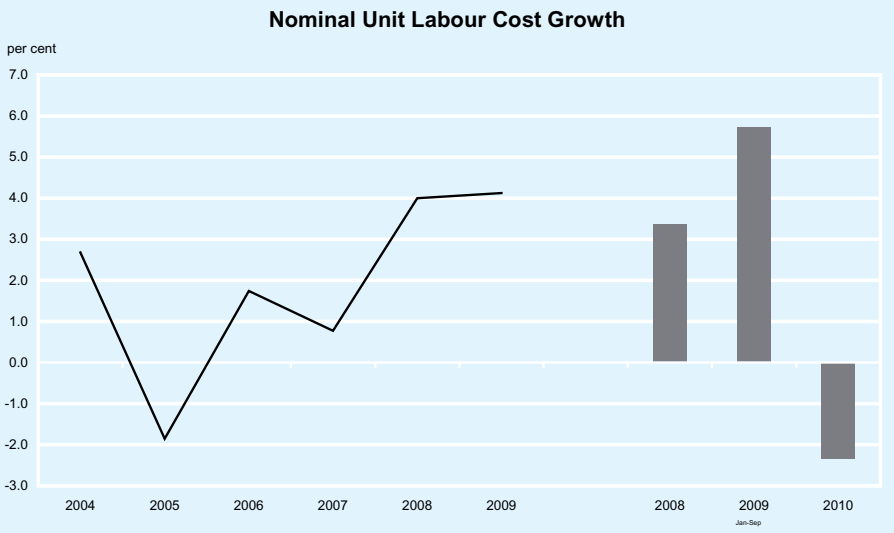
This sub-section looks at the developments of the most important variables associated in the production process, namely labour costs (wages) and profits as well as the effect of imported inflation. The extent of the impact of government-induced inflation is also covered.

2.3.1 Labour Costs

An increase in nominal unit labour costs, driven either by a nominal increase in cost per unit of labour that exceeds the increase in productivity or by a fall in output accompanied by a more contained decline in labour input, will generally increase the pressure to increase the price of the final product. Developments in nominal unit labour costs in Malta are shown in Chart 2.6.

Nominal unit labour costs registered a decline of 1.9 per cent in 2005, however it increased by an average of 2.7 per cent during 2006-2009 with rates of 4.0 per cent and 4.1 per cent in 2008 and 2009 respectively. These relatively high increases in nominal labour cost during these years are attributable to a fall in output per employee following the decline in international demand as a result of the global recession. Chart 2.6 also compares the change in nominal unit labour cost for the period January-September. As can be observed, during January-September 2009, nominal unit labour cost increased by 5.7 per cent while for the same period of 2010 a decline of 2.3 per cent was registered. This decline for the first three quarters of 2010 reflects an increase in productivity coupled with a decline of 0.2 per cent in compensation per capita. Indeed, while total employment increase by 1.8 per cent in the first three quarter of 2010, compensation of employees increased at a slower pace at 1.6 per cent. These developments in the first three quarters of 2010 point towards a decline in nominal unit labour cost reflecting adjustments in the labour market and a strong recovery in output.

Chart 2.6



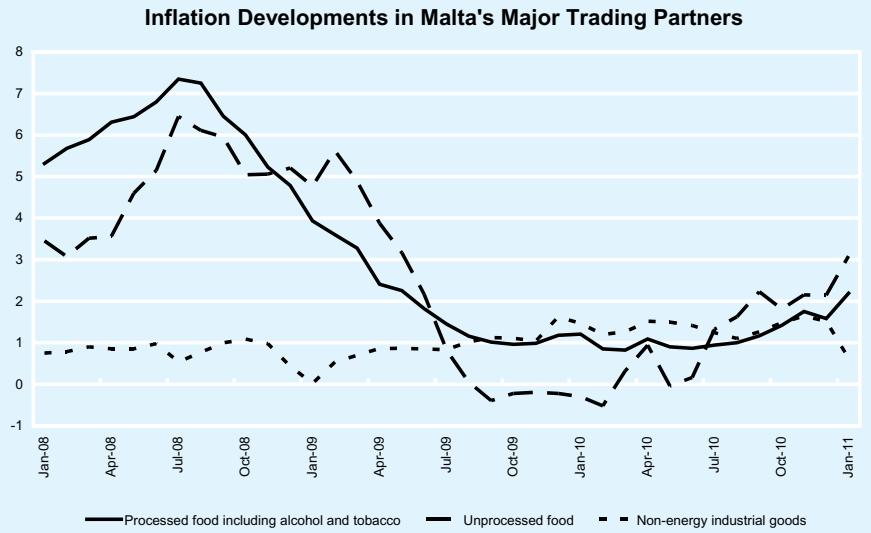
2.3.2 Inflationary Developments in Malta's Trading Partners

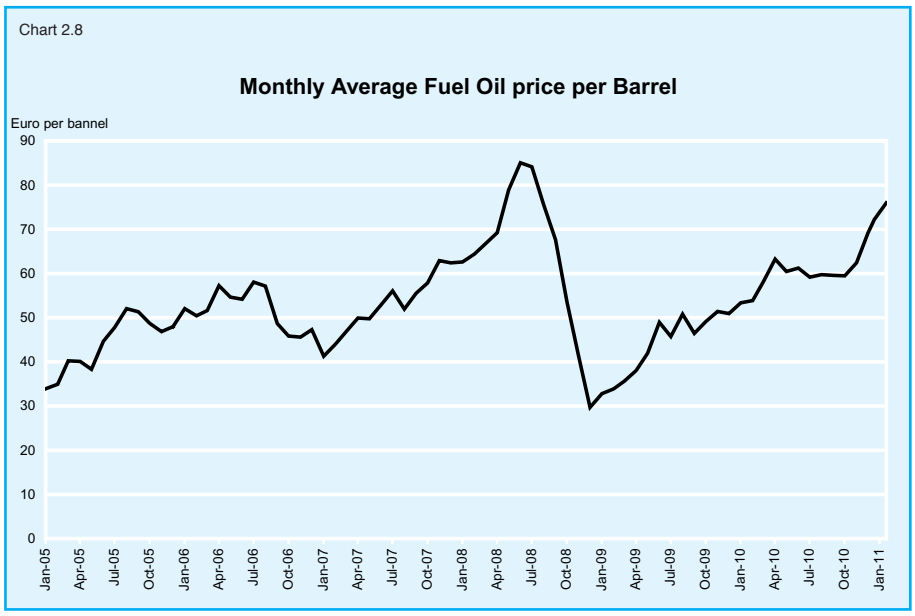
The high degree of openness of the Maltese economy accentuates its exposure to developments in the international market, especially those in major trading patterns. The impact of higher prices abroad are passed to the local economy mainly through imported raw material as well as imported final consumer products and services. This section looks at the contribution of imported inflation by analysing headline indicators for consumer inflation in Malta's major trading partners and also to recent changes in international oil prices. Furthermore, developments in exchange rates movements are also considered.

Chart 2.7 presents recent developments of indicators measuring annual inflation in Malta's major trading partners, constructed by using the trade share as weights.

The index measuring price trends in processed food (including alcohol and tobacco) displayed annual increase of 1.1 per cent during 2010. Following a period characterised by relative stability in terms of increases since the second half of 2009, the rate of increase accelerated during the last quarter of 2010. Price movements in unprocessed food were rather volatile, but still displayed an upward trend since the second quarter of 2010, mainly attributable to higher inflation in Germany and in the UK. Non-energy industrial goods displayed more price stability, registering an annual average rise of 1.4 per cent in 2010, underpinned by a general increase in prices in all major trading partners.

Chart 2.7





Equally important in terms of their impact on imported inflation are movements of the international price of crude oil as well as movements in the exchange rates. Developments in the monthly average fuel oil price per barrel are displayed in Chart 2.8 As can be observed, following a sharp decline in the price of oil in the first quarter of 2009, the monthly average fuel oil price increased steadily since then, reaching €69.18 per barrel in December 2010 or equivalently $91.45 per barrel. During the month of January, the monthly average fuel, oil prices continued to rise and reached $96.5 per barrel. This reflected stronger demand from Asia, particularly China and was compounded by the uncertainty created by the ongoing political unrest in a number of oil-producing countries in the Middle East and North Africa.

During the first half of 2010, the Euro lost some of its value when compared with both the US dollar and the Sterling. Indeed in June 2010, every Euro was equivalent to 1.22 US dollar and to 0.83 British Pound, down from 1.42 US dollar and 0.88 British Pound in January 2010. However, subsequently, the Euro appreciated steadily up to October 2010 but thereafter declined again to reach an average of 1.32 US Dollar and 0.85 British Sterling during December 2010. These developments in the exchange rate, point towards relatively more expensive imports during the period April-August of 2010 when the exchange rate depreciated slightly. Exchange rate movements are shown in Chart 2.9.

Chart 2.9

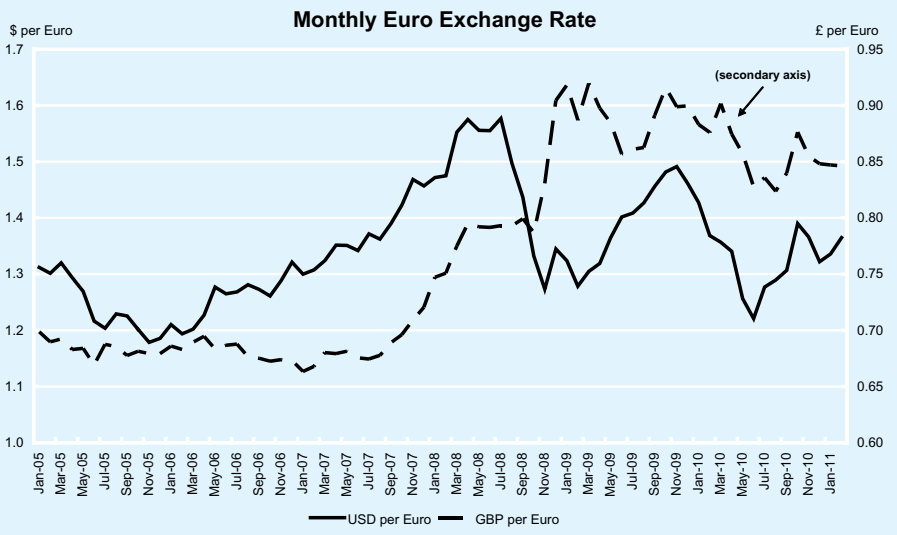
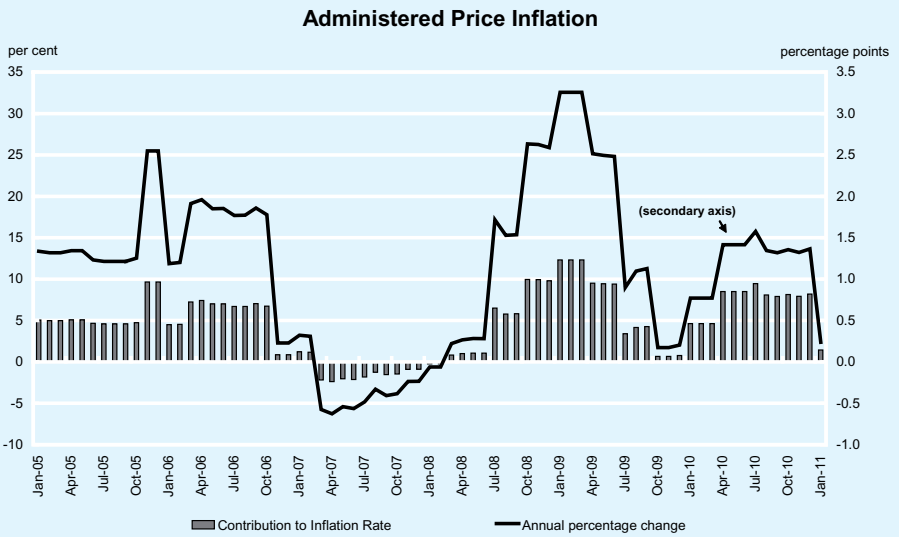


Chart 2.10



2.3.3 Administered Price Inflation

Government decisions can alter the price level, through changes in fees, administration costs, as well as the price of commodities and services supplied by the Government both directly and indirectly. The index of administered prices released by Eurostat shows a significant increase during 2010. Indeed, in December 2009, the annual inflation in administered prices stood at 2.2 per cent, rising to 7.7 per cent in 2010, with a peak of 15.7 per cent in July 2010. Thereafter, it decline slightly to around 13.0 per cent. Consequently, the contribution of administered prices to overall inflation was rather high in relation to overall inflation, amounting to around 50 per cent of the inflation rate. These increases in administrative prices were mainly due to increases in the price of electricity and gas, that recorded an average increase of 30 per cent and 37 per cent, respectively during first three quarters of 2010. Chart 2.10 shows the annual percentage change in administered prices.

2.3.4 Profit Margin

When faced with increasing costs of production, one of the possible actions that might be taken by the producer is to absorb some of the increase in costs. This is often reflected in a decline in profit margin, defined as the ratio of Gross Operating Surplus to Output. However, the extent to which this can take place depends on many factors and can have adverse consequence in the long-run: without an adequate return over an extended period of time, a business will not be in a position to invest in its operations. Consequently, a lower rate of investments, limits the productive capacity of enterprises and in the absence of other compensating factors, it might also have implications for price developments.

As illustrated in Table 2.5, profit margins decreased during the first half of 2009 mirroring a contraction in GDP for the same period. Nevertheless, during the

Growth Rates in Value Added

Table 2.5

	2009Q1	2009Q2	2009Q3	2009Q4	2010Q1	2010Q2	2010Q3
Real GDP (%growth)	-2.4	-3.8	-2.5	0.9	4.2	4.0	3.6
Profit Margin (pp.growth)	-0.8	-1.3	0.2	0.6	1.6	2.2	1.7
Compensation per employee (% growth)	4.5	2.6	1.6	1.0	-2.3	1.1	0.7
Employment (exc. Self-employed) (% growth)	0.6	-0.5	-2.2	-1.3	1.8	1.0	2.7

Source: NSO

same period, compensation per employee still registered positive increases, giving rise to higher labour unit cost. However, the trends changed during the first three quarter of 2010, where profit margins turned positive while compensation per employee slowed down. Indeed, profit margins increased by 1.8 percentage points during January-September 2010 compared with the same period of 2009, while compensation per employee declined slightly by 0.3 per cent in the first three quarters of 2010 over the corresponding period of 2009. Employment growth was negative during 2009 in line with the contraction in GDP and profit margins. Employment recovered during 2010, increasing by 1.8 per cent during the first three quarters of 2010.

These developments confirm the finding that the majority of Maltese firms, being price takers, made adjustments to the cyclical changes through their profit margins, however, increases in the final price of goods and services were noted when economic activity recovered.

2.3.5 Conclusion

The local economy in 2010 was characterised by a steady recovery with sustained growth in output. This growth in output as well as a marginal decline in compensation per capita helped to moderate labour cost. Accordingly, profit margins recovered during the first three quarters of 2010. This has to be viewed also in relation to the developments during 2009, where lower demand led to negative growth in both profit margins and employment. Furthermore, the rather modest increases in the price level in Malta's major trading partners during 2010 could be indicative of limited pressure from imported inflation. However, the price of oil continued to increase as the price of crude oil increased from roughly €50 per barrel in January 2010 to almost €70 per barrel in December 2010. This exerted upward inflationary pressures on the local economy especially in energy-sensitive sectors. Indeed, both the price of gas and electricity registered significant increases during 2010 although the increase in administrative prices was more moderate than in 2009. Thus concluding, the costs contributing to inflation during 2010 were energy-related since the contribution of labour costs and inflation in trading partners remained rather limited.

Footnotes:

[1] EU Commission Autumn 2010 Forecasts using the Output Gap estimation program were utilised for the section treating the output gap. Actual output growth for 2010 was estimated at 3.1 per cent, while potential output growth of 1.2 per cent was estimated for the same year.

[2] Sections 2.1.3 to 2.1.5 are based on National Accounts Gross Domestic Product data issued in December 2010 and covering the period until the third quarter of 2010.

[3] While aggregate real consumption data is available and was utilised, disaggregated data by expenditure category is only available on a nominal basis.

[4] While aggregate real investment data is available and was utilised, disaggregated data by product type is only available on a nominal basis.

[5] The seasonally adjusted unemployment rate was utilised in order to enable comparisons across different quarters.

[6] Employment growth according to the National Accounts definition was used.

[7] This refers to the EU Commission Autumn 2010 Forecasts using the Output Gap estimation program mentioned earlier.

3. Outlook for Inflationary Pressures

3. Outlook for Inflationary Pressures

Prices reflect the interaction of demand and supply for goods and services in the real economy. The macroeconomic outlook as well as the developments in prices of commodities and other industrial inputs also reflect themselves in movements in inflation. The following overview presents recent developments and the short-to-medium term outlook for the main components of demand together with other indicators, in order to gain some insight into the domestic inflationary outlook.

3.1 International Macroeconomic Developments

As highlighted in Section 2.1.7, global economic activity expanded during the course of 2010 with growth during the second half of the year being better than previously expected, according to the IMF World Economic Outlook Update of January 2011. The better-than-expected performance during the second half of 2010 was mainly the result of stronger than anticipated private consumption in both the US and Japanese economies, and was partly driven by stimulus measures. Nevertheless, growth is advancing at different paces in advanced economies with respect to emerging and developing economies. In fact, growth in advanced economies remained relatively subdued in 2010. On the other hand, growth in emerging and developing economies was buoyant in 2010 and remained robust during the second half of the year supported by private demand, continued accommodative fiscal and monetary policies as well as capital inflows.

The positive impact of the ongoing global economic recovery on demand for EU and Euro Area exports has continued to support economic activity. According to the European Commission's Autumn Forecast of November 2010, exports of goods and services in the EU and Euro Area increased by 10.2 and 10.7 per cent respectively in 2010. A decelleration to 6.4 and 6.1 per cent respectively, is expected in 2011. Indeed, growth in private investment is expected to rebalance growth towards domestic demand . Investment is expected to contribute positively to growth in both areas during 2011 and is forecasted to grow by 2.8 per cent in the EU and by 2.2 per cent in the Euro Area when compared to a contraction registered in both areas last year. Additionally, albeit remaining subdued, private sector domestic demand is expected to continue contributing positively to growth, supported by accommodative monetary policy and measures adopted to improve the functioning of the financial system. Balance sheet adjustments across various sectors are also expected to have a dampening effect on economic growth. Table 3.1 displays the various

Demand Components in the EU and the Euro Area

Table 3.1

	2009	2010	2011	2012
Final Demand				
Euro Area	-6.5	3.5	2.5	3.0
EU	-6.7	3.7	2.8	3.2
Private Consumption Expenditure				
Euro Area	-1.1	0.6	0.9	1.4
EU	-1.7	0.7	1.2	1.6
Government Consumption Expenditure				
Euro Area	2.4	1.0	-0.1	0.2
EU	2.0	1.2	-0.2	0.0
Total Investment				
Euro Area	-11.4	-0.8	2.2	3.6
EU	-12.1	-0.6	2.8	4.2
Exports of Goods and Services				
Euro Area	-13.2	10.7	6.1	6.3
EU	-12.5	10.2	6.4	6.6
Imports of Goods and Services				
Euro Area	-12.0	8.7	5.1	5.9
EU	-12.4	8.9	5.4	6.1

Source: European Commission

components of demand in real terms.

According to the European Commission's Interim Forecast of February 2011, in 2011, growth in the EU and Euro Area is expected to remain largely in line with that registered in the previous year, supported by the global economy and EU business sentiment and reaching 1.8 and 1.6 per cent for both areas respectively. In 2012, growth in the EU and Euro Area is expected to be 0.2 percentage points higher when compared to the forecast for 2011, thus reaching 2.0 and 1.8 per cent in both areas respectively. Nevertheless, downside risks to economic growth remain as possible further tensions relating to sovereign debt markets in the Euro Area periphery cannot be ruled out and these could potentially spread to other Euro Area countries. Additionally, renewed upward price pressures in oil and other commodity markets, as well as the possibility of a reversal of capital flows in countries with widening current account deficits also weigh on the downside risks to the outlook.

Notwithstanding the ongoing economic recovery experienced in 2010, the

labour market remained weak in the EU. In fact, employment contracted by 0.6 per cent in 2010 while the rate of unemployment stood at 9.6 per cent. The weakness in the labour market reflects in part the lag between developments in employment and output. The situation is therefore expected to improve over the forecast horizon and, according to the European Commission's Autumn Forecast of November 2010, employment is anticipated to grow by 0.4 per cent in 2011 and to pick up further to 0.7 per cent in 2012. The unemployment rate in the EU is expected to improve only marginally by 0.1 percentage point in 2011 when compared to 2010, while it is forecast to decline to 9.1 per cent in 2012. A number of key indicators are presented in Table 3.2.

Over the short term, inflation is expected to be relatively high in the EU and Euro Area, and inflation rates could also temporarily increase further over the coming months driven by energy and commodity prices (as outlined in the next

Key Indicators

Table 3.2

	2009	2010	2011	2012
Output (percentage change)				
EU	-4.2	1.8	1.8	2.0
Euro Area	-4.1	1.7	1.6	1.8
Germany	-4.7	3.6	2.4	2.0
France	-2.6	1.6	1.7	1.8
Italy	-5.0	1.1	1.1	1.4
Spain	-3.7	-0.1	0.8	1.7
UK	-5.0	1.4	2.0	2.5
Japan	-5.2	3.5	1.3	1.7
US	-2.7	2.7	2.1	2.5
Advanced Economies	-3.4	3.0	2.5	2.5
Emerging and Developing Economies	2.6	7.1	6.5	6.5
Consumer Prices (percentage change)				
EU	1.0	2.1	2.5	1.8
Euro Area	0.3	1.6	2.2	1.7
Germany	0.2	1.2	2.2	2.0
France	0.1	1.7	2.0	1.6
Italy	0.8	1.6	2.2	1.9
Spain	-0.2	1.8	2.4	1.4
UK	2.2	3.3	3.4	1.4
Japan	-1.4	-0.9	-0.7	0.0
US	-0.4	1.6	1.1	1.5
Advanced Economies	0.1	1.5	1.6	1.6
Emerging and Developing Economies	5.2	6.3	6.0	4.8
Labour Market (EU)				
Employment (percentage change)	-1.9	-0.6	0.4	0.7
Unemployment Rate	8.9	9.6	9.5	9.1

Data Source: IMF, European Commission

section). Nevertheless, remaining slack in labour markets, as well as subdued growth in private consumption, indicate that underlying inflationary pressures should remain relatively subdued and that therefore inflationary pressures are expected to moderate towards the turn of the year. As a result, in 2011, inflation in the EU is expected to increase to 2.5 per cent when compared to 2.1 per cent registered in the previous year before declining to 1.8 per cent in 2012 according to the European Commission's Interim Forecast of February 2011. In the Euro Area, inflation is expected to increase by 0.6 percentage points reaching 2.2 per cent in 2011 before declining to 1.7 per cent in the subsequent year. Inflation in the German economy is expected to reach 2.2 per cent and 2.0 per cent in 2011 and 2012 respectively when compared to 1.2 per cent registered in 2010. In Italy, inflation is forecasted to increase to 2.2 per cent in 2011 from a base of 1.6 per cent last year before declining to 1.9 per cent in 2012. Inflation in the French economy is expected to increase by 0.3 percentage points in 2011, reaching 2.0 per cent before declining to 1.6 per cent in the following year. In the UK, inflation is expected to increase only marginally by 0.1 percentage point in 2011 compared to 3.3 per cent registered in 2010, before subsequently declining to 1.4 per cent in 2012 as a result of spare capacity weighing down on prices, as well as expected exchange rate and commodity price developments which should have beneficial base effect.

In the global scene, the performance of inflation differs as a result of contrasting inflationary pressures affecting emerging and developing economies, and developed economies. In advanced economies, while input prices have been increasing on the back of higher food and energy prices, internal inflationary pressures remain relatively subdued. In fact consumer prices in advanced economies are expected to remain stable at a growth rate of 1.6 per cent during both 2011 and 2012 when compared to a rate of 1.5 per cent registered in 2010. On the other hand, inflation rates in emerging and developing economies have been increasing on account of the combined effect of strong economic activity as well as increasing food and energy prices. In 2010, consumer prices in emerging and developing economies grew by 6.3 per cent. In these economies, inflation is expected to remain at a relatively high 6.0 per cent in 2011 before declining further to 4.8 per cent in the subsequent year.

3.2 Exchange Rates and Commodities

According to the European Commission Autumn 2010 Forecast, the value of the Euro vis-à-vis the US Dollar is expected to average 1.39 during 2011 and 2012, thus representing only a mild appreciation in terms of the US Dollar when compared to an average value of 1.33 US Dollars per Euro registered in 2010.

Chart 2.12 in Section 2 shows past movements in the exchange rate of the euro with respect to the US Dollar and the UK Sterling.According to the European Commission Autumn 2010 Forecast, the value of the Euro in terms of the British Pound is expected to average 0.86 Sterling per Euro, during both 2011 and 2012, thus remaining unchanged when compared to the average value recorded in 2010.

As shown in Chart 3.1, during 2010 the IMF Commodity Price Index was on a general uptrend, with the most pronounced increase occurring in the last quarter of the year. These developments were mainly characterised by increases in the food price index, followed by the increases in the metals price index which persisted throughout the second half of 2010. Additionally, higher crude oil prices during the last quarter of 2010 also contributed heavily to the increase in the IMF Commodity Price Index. Overall, the total IMF Commodity Price Index ended 2010 19.7 per cent higher when compared to the beginning of the year. Over the period June-December 2010, the IMF Food and Metal Price Indices increased by 29.6 per cent and 28.1 per cent respectively. The IMF Food and Metal Price Indices continued to increase in January 2011 registering an increase of 3.6 and 25.9 per cent respectively over the previous month while over the same comparative period, the average price of crude oil as measured by the IMF increased by 3.0 per cent. Consequently, in January of 2011, the IMF's overall index continued its upward trend, registering a further increase of 6.6 per cent over the previous month, mainly driven by the increase in the metal price component, followed by the increase in the price of crude oil.

Chart 3.1

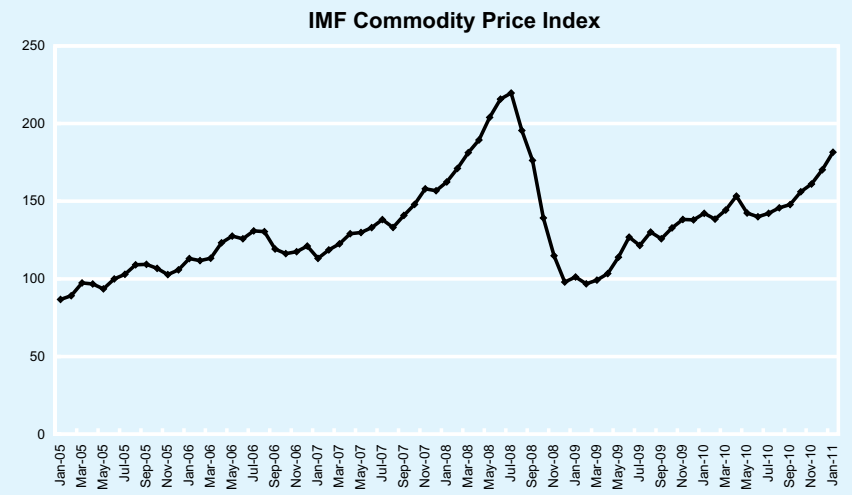
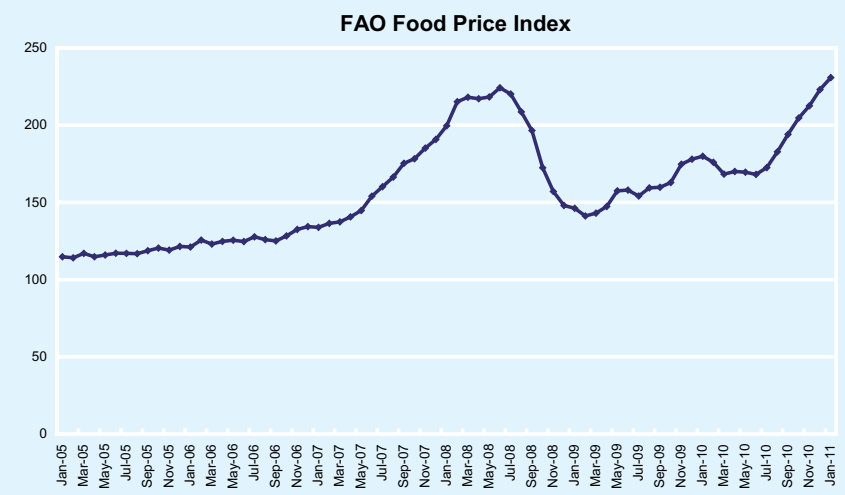


Chart 3.2 illustrates the FAO Food Price Index which is a measure of international prices of a food basket composed of cereals, oilseeds, dairy products, meat, and sugar. The FAO Food Price Index has experienced a considerable increase throughout the second half of 2010 and into 2011. In fact, during January 2011, the index reached a value of 230.7, representing an increase of 37.3 per cent when compared to the level registered in June 2010 and thus returning to the mid-2008 peak level. The most notable increases were registered in the sugar, oils and cereals components of the Index which respectively increased by 86.8, 64.9, and 61.9 per cent over the same comparable period. The increase in food prices during this period is a result of a combination of both robust demand as well as supply shortages caused by adverse weather conditions.

Chart 2.8 in Section 2.3.1 shows the developments in the brent average monthly price of fuel oil per barrel. During January 2011, the average monthly price of crude oil reached $96.5, representing an increase of 24.0 per cent when compared to September 2010. A slightly lower increase of 21.3 per cent to €72.3 per barrel was registered in Euro terms. Given strong demand, as well as recent political unrest in various Middle Eastern and North African countries, the pressures on the price of crude oil are expected to remain on the upside. According to the IMF World Economic Outlook Update of January 2011, and based on future markets, the price of crude oil is forecasted to average $89.5 and $89.75 per barrel in 2011 and 2012 respectively thus indicating that oil prices are expected to remain relatively high over the forecast horizon.

Chart 3.2



Commodity prices, in general, have experienced a considerable increase during 2010 in response to strong global demand, as well as to supply side shocks. The upward trend in commodity prices has continued in January of 2011 and upward pressures on commodity prices are also expected to persist in the rest of 2011, mainly as a result of continued strong demand and a slow response of supply growth.

3.3 Outlook for Inflationary Developments in Malta

The degree of uncertainty linked with the aforementioned factors affecting short to medium term inflationary developments and expectations necessitates that caution to be applied when considering the conclusions of this Section.

Albeit downside risks to the growth outlook remain, the global economy is currently progressing along the recovery. On the whole, while continuing to recover, growth in Malta's main trading partners for 2011 is expected to remain either roughly in line with growth registered last year or to decelerate. Inflationary pressures in Malta's main trading partners are expected to be tilted to the upside in the short-term, as a result of high oil and food prices. Over the medium term, risks to inflation in the Euro Area are also on the upside in view of higher than expected commodity prices, indirect taxes, administered price increases and stronger domestic price pressures.

As outlined earlier in Chapter 2, the Maltese economy experienced a strong recovery during 2010. During 2011, growth is expected to expand further though growth might proceed at a slower pace than in 2010. In view of the still negative output gap, weak consumption growth and relatively high unemployment rates, it is unlikely that inflationary pressures will build up in the domestic economy as a result of demand factors. Water and electricity rates in Malta are expected to remain stable during the current year in line with Government's policy of keeping unchanged utilities' prices so as to minimise as much as possible uncertainty derived from frequent changes in prices. Thus, inflationary pressures from this cost component are not expected in 2011. On the other hand, there are significant risks to inflation developments in Malta associated with the rise in international commodity and fuel prices - in a context marked by significant political turmoil in the neighbouring Maghreb economies. This poses an important upside risk to inflation in Malta, which is particularly significant in view of the important direct and indirect effects associated with shocks in food and fuel prices.