BANK ĊENTRALI TA' MALTA

EUROSISTEMA

CENTRAL BANK OF MALTA

FORTIETH ANNUAL REPORT

AND

STATEMENT OF ACCOUNTS

2007

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Since during the period covered by this Report the Maltese lira was the relevant currency, data presented in tables and charts refer to the Maltese lira alone. Euro equivalents, converted at the official rate of MTL/EUR 0.4293, have been inserted into the text to help the reader. Figures in tables may not add up due to rounding.

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The Mission and Objectives of the Central Bank of Malta

(as from 1 January 2008)

Our Mission

The Central Bank of Malta is an independent institution which seeks to carry out its statutory responsibilities in the public interest. As a member of the Eurosystem, the Bank's primary objective is to maintain price stability, thereby contributing to sustainable economic development.

Our Objectives

We seek to achieve this mission by:-

Promoting price stability in the euro area

The Bank promotes price stability in the euro area through participation by the Governor in the Governing Council of the European Central Bank (ECB). For this purpose the Bank conducts economic analysis and research. The Bank is also responsible for the implementation in Malta of the Governing Council's monetary policy decisions.

Contributing to the stability of the financial system

The Bank contributes to the stability of the financial system through ongoing macro surveillance of the infrastructure, financial institutions and markets and by monitoring and assessing the implications for financial stability of economic and financial developments, both domestically and in the euro area. As part of its early warning system, the Bank analyses data to identify sources of risk and tests the resilience of the financial sector to withstand eventual shocks. This approach is supported by the development of a sound framework for the management of crisis situations and of contingency procedures. Ultimately, in order to safeguard financial stability, the Bank acts as lender of last resort.

Promoting, regulating and overseeing sound and efficient payment and securities settlement systems

The Bank promotes, oversees and regulates the operation of, and the participation in, domestic payment systems as well as any form of cash or security transactions, whether domestic or cross-border. This role relates both to retail and wholesale payment systems, including the instruments used, and involves the establishment of policy and the monitoring of payment and securities settlement developments. In exercising its oversight role, the Bank promotes a competitive, safe and efficient payment services environment.

Supporting the development of financial markets

The Bank promotes and supports the further development of the domestic financial market with the aim of facilitating its smooth and effective integration into the Pan-European market.

Providing and promoting efficient currency services

The Bank issues euro bank notes and coins in accordance with the Treaty establishing the European Community and in line with the Statute of the European System of Central Banks (ESCB) and of the ECB. The Bank is responsible for providing notes and coins to meet demand from the public. The Bank also ensures the authenticity and quality of currency in circulation through the withdrawal of counterfeit and damaged notes and coins.

Optimising the returns on financial assets through prudent investment practices

The Bank holds and manages a portfolio of foreign and domestic financial assets. It seeks to maximise the return on financial assets subject to prudent investment practices. The Bank is also responsible for managing its share of the pooled portion of the ECB's own foreign reserves.

Collecting, compiling, disseminating and publishing statistics

The Bank compiles economic and financial statistics in accordance with international standards. These are provided to the ESCB and other international and domestic users. Statistics are made available through the Bank's regular publications, its website, the publications of the ECB and other international organisations.

Advising the Government generally on financial and economic matters

The Bank acts as an advisor to the Government on financial and economic matters. In offering independent advice, the Bank contributes to sound policy-making. The Bank is able to do this on the strength of its expertise, its reputation and its independent status. The Bank also acts as banker and agent to the Government.

In support of the above objectives, the Bank commits itself:

(a) to actively participate in the Eurosystem, the ESCB and other relevant European Union bodies, including their sub-structures, and in meetings of international organisations; and

(b) to maintain effective support and control functions, which include:

- Motivating and developing skilled staff. To this end the Bank adopts appropriate recruitment and reward strategies and provides its staff with opportunities for training and development.
- Procuring the necessary resource inputs and maintaining the organisation's physical infrastructure in a cost-effective manner to ensure a congenial and secure working environment.
- Maintaining a sound financial control system capable of delivering accurate and timely statutory and management information and designed to ensure that the Bank's needs are effectively met within established budgets.
- Enhancing the flow of information both within and outside the Bank. This is made possible through the sustained development of information and document-handling systems, and of the appropriate information technology infrastructure.
- Maintaining a risk management framework which provides a common methodology for the identification, assessment, reporting, monitoring and treatment of risks. This is complemented by a sound business continuity management programme.
- Operating an independent and objective assurance and consultancy function designed to add value and improve the Bank's operations.

The Bank also seeks to be transparent and publicly accountable. This is achieved through the publication of its financial statements, effective communications and announcements through its website, other publications and regular reporting to Parliament on its policies and operations.

As a member of the Eurosystem, the Bank subscribes to the Eurosystem's Mission, Strategic Intents and Organisational Principles.

BOARD OF DIRECTORS*

Michael C. Bonello
Governor

David A. Pullicino
Deputy Governor

Joseph V. Gatt	*Director*
Philomena Meli	*Director*
Charles J. Falzon	*Director*

Executive Management Committee*

Michael C. Bonello
Governor & Chairman

David A. Pullicino
Deputy Governor

Alfred Demarco
Director
Economics and External Relations Division

Godfrey Huber
Director
Finance and Banking Division

René G. Saliba
Director
Financial Markets Division

Herbert Zammit LaFerla
Director
Financial Stability Division

John Agius
Director
Resource Management Division

Audit Committee*

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Chairman

David A. Pullicino
Member

Charles J. Falzon
Member

Monetary Policy Advisory Council*

Michael C. Bonello
Governor & Chairman

David A. Pullicino
Deputy Governor

Joseph V. Gatt
Director

Philomena Meli
Director

Charles J. Falzon
Director

Alfred Demarco
Director
Economics and External Relations Division

René G. Saliba
Director
Financial Markets Division

Herbert Zammit LaFerla
Director
Financial Stability Division

Investments Policy Committee*

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David A. Pullicino
Deputy Governor

Godfrey Huber
Director
Finance and Banking Division

René G. Saliba
Director
Financial Markets Division

Raymond Filletti
Senior Manager
Financial Control Department

Saviour Briffa
Senior Manager
Reserve Management Department

Stephen Attard
Manager
Middle Office

Mario Bugeja
Manager
Investments and Reserves Office

*As at 31 December 2007

THE BOARD OF DIRECTORS

(as at 31 December 2007)

(Left to right) Joseph V. Gatt (Director), Philomena Meli (Director), David A. Pullicino (Deputy Governor), Michael C. Bonello (Governor & Chairman), Stephanie Sciberras (Secretary), Charles J. Falzon (Director).

Joseph V. Gatt was appointed as Director of the Central Bank of Malta for a period of five years with effect from 1 January 2003. He is an economist and a retired banker.

Philomena Meli was appointed as Director of the Central Bank of Malta for a period of five years with effect from 21 January 2003. She is an economist and is presently an adviser on trade policy matters in the General Affairs and International Trade Directorate at the Ministry of Foreign Affairs.

Charles J. Falzon was appointed as Director of the Central Bank of Malta for a period of five years with effect from 7 February 2004. He is an economist and management consultant and is currently a Senior Lecturer in the Faculty of Economics, Management and Accountancy at the University of Malta.

Organisation Chart*

- Governor
  Michael C. Bonello
  - Deputy Governor
    David A. Pullicino
    - Director
      Economics & External Relations Division
      Alfred Demarco
      - Economic Research Department
        - Economic Analysis Office
        - Research Office
        - Statistics Office
      - Library & External Relations Department
        - Library
        - External Relations Office
        - Governors' Secretariat
    - Director
      Finance & Banking Division
      Godfrey Huber
      - Banking & Issues Department
        - Retail Banking Office
        - Payment Systems Office
        - Currency Issue Office
      - Financial Control Department
        - Finance Office
    - Director
      Financial Markets Division
      René G. Saliba
      - Domestic Markets Department
        - Monetary Operations and Collateral Management Office
        - Money & Capital Markets Office
        - Government Debt Analysis Office
      - Reserve Management Department
        - Investments & Reserves Office
        - FX Market Analysis Office
        - Middle Office
    - Director
      Financial Stability Division
      Herbert Zammit LaFerla
      - Financial Stability Department
        - Financial Stability Office
      - Internal Audit & Risk Assessment Department
        - Risk Assessment Office
        - Internal Audit Office
    - Director
      Resource Management Division
      John Agius
      - Resources Department
        - Human Resources Office
        - Administration Office
        - Security Office
      - Information Systems Department
        - IT Services Office
        - Software Development Office
        - Records Management Services Office

*As at 31 December 2007

BANK ĊENTRALI TA' MALTA

Il- Gvernatur

CENTRAL BANK OF MALTA

The Governor

28 March 2008

The Hon Tonio Fenech
Minister of Finance, Economy and Investment
158 Old Mint Street
Valletta VLT 2000

Dear Minister

LETTER OF TRANSMITTAL

In terms of article 21 of the Central Bank of Malta Act (Cap 204), I have the honour to transmit to you, in your capacity as Minister responsible for finance, a copy of the Annual Report of the Bank for the financial year ended 31 December 2007.

Yours sincerely

Michael C Bonello

Contents

ABBREVIATIONS

BIS	Bank for International Settlements
CEBS	Committee of European Banking Supervisors
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EMU	Economic and Monetary Union
ERM II	exchange rate mechanism II
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
ETC	Employment and Training Corporation
EU	European Union
FI	fungibility issue
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
LFS	Labour Force Survey
MBA	Malta Bankers' Association
MIGA	Multilateral Investment Guarantee Agency
MFI	Monetary Financial Institution
MFSA	Malta Financial Services Authority
MSE	Malta Stock Exchange
NACE Rev. 1	Statistical classification of economic activities in the European Community
NECC	National Euro Changeover Committee
NCB	national central banks
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
OECD	Organisation for Economic Co-Operation and Development
OMFI	Other Monetary Financial Institution
OPEC	Organisation of Petroleum Exporting Countries
RPI	Retail Price Index

Governor's Statement

Introduction

During 2007 the Central Bank of Malta's activities became increasingly focused on the logistical preparations for the Bank's approaching role as a member of the Eurosystem and on the achievement of the Maastricht criteria for euro adoption.

On the economic front, this activity culminated first in the positive assessments of Malta's convergence process delivered by the European Commission and the European Central Bank in May. These found the nominal convergence criteria relating to the inflation rate, the long-term interest rate and the deficit to GDP ratio to have been amply met, while the debt to GDP ratio was declining towards the benchmark level at a satisfactory pace. As for the exchange rate criterion, the commitment to maintain the Maltese lira at its central parity rate against the euro throughout the ERM II period was fully met, and the year closed with the Bank's external reserves at their highest level ever.

This opened the way for the EU Council decision in July admitting Malta to membership of EMU and setting the permanent conversion rate for the lira against the euro at its central rate in ERM II. So it was that on 1 January 2008 Malta successfully adopted the euro as its national currency.

Euro area membership is a major milestone for any country for there are clearly long-term benefits associated with belonging to the world's second largest common currency area. There is indeed much evidence that the macroeconomic framework which supports the euro has delivered price stability, job creation and economic growth. For an open economy like Malta's with a heightened vulnerability to external and sector specific shocks, the benefits of the single currency can be expected to be even more significant. From a central bank's perspective, moreover, euro area membership means replacing the manifold risks inherent in managing a small, vulnerable currency such as the Maltese lira with the greater security afforded by a major reserve unit.

The economy in 2007

Malta joined the euro area with GDP growth on a steady recovery path since 2004, reflecting a combination of favourable cyclical conditions on the one hand, and structural reforms, wage moderation and higher productivity, on the other. The economy grew by 3.8% in 2007 in real terms compared with 3.4% in 2006.

Although the impetus to growth in 2007 came mostly from higher private consumption, the reduction in the fiscal deficit together with a smaller current account deficit also pointed to an attenuation of structural imbalances. Meanwhile, the slower rate of growth in investment relative to 2006 was due to a deceleration in investment spending by the private sector.

In the area of public finances, the sustained programme of fiscal consolidation produced a further improvement in 2007. Compared to 2003 when the imbalance was at its peak at almost 10% of GDP, the general government deficit contracted by a full percentage point in 2007 to an estimated 1.6% of GDP, while the public debt ratio continued its decline from the 2004 peak of 73% to 63% in 2007.

Having satisfied the inflation criterion in March, the moving average HICP measure of inflation dipped further during the year to 0.7% in December. During the same month, however, the annual inflation rate stood at 3.1%, well above the 0.8% recorded at the end of 2006. The acceleration ensued mainly from steady increases in food and energy-related prices, largely reflecting international price movements.

The pick-up in the pace of economic activity in 2007 was accompanied by tighter labour market conditions. Overall employment levels were around 2% higher than in 2006, and preliminary data show a further accentuation in 2007 of the excess of job vacancies over placements reported by the Employment and Training Corporation. The average unemployment rate through October 2007 based on administrative records declined to 4.6%, compared to 5% in the same period in 2006, reaching a low of 4.3% in June and July, the lowest rate in several years. The LFS measure of unemployment also followed a downward trend amid evidence of emerging skill bottlenecks in some segments of the labour market.

At the same time, Malta's international competitiveness recorded a small improvement in 2007. While the pace of growth in nominal employee compensation moderated further to 1.5%, the rate of productivity growth also slowed, to around 1.0%. As a result, unit labour costs increased, though by less than in 2006, 0.5% compared with 1.0%. In comparison, unit labour costs in the euro area increased by 1.3%.

The continued strengthening of economic fundamentals registered in 2007, however, was not sufficient to make a significant impact in terms of real convergence with the euro area. Malta's GDP measured on a per capita basis in fact rose by less than one percentage point during the year to 71% of the euro area average.

The way forward

The Central Bank of Malta has been present at every stage of Malta's journey to the euro, providing the conceptual underpinnings for the project as well as policy advice. Now that this objective has been achieved, the Bank reaffirms its view that membership of the euro area does not represent the end of a process. Rather, it marks the beginning of a new phase in which the harmful effects of inappropriate policies and inefficient practices on costs and final prices become more visible. The policy challenge, therefore, is to maximize the benefits of participation in monetary union by introducing further reforms designed to strengthen the country's international competitiveness, and so bridge the remaining income gap with the euro area.

A first condition for meeting this challenge is to ensure that fiscal policy remains supportive of macroeconomic stability. Not only would any slippage in the pace of fiscal consolidation breach the terms of Malta's commitment under the Stability and Growth Pact, but it would also delay the planned reduction in the debt ratio to below 60% in 2009. Such developments would negatively impact investor confidence.

Moreover, given the policy constraints typical of a monetary union, fiscal policy is the only short-term countercyclical instrument available at the national level. For this reason too, therefore, the early achievement of a balanced budget is a desirable objective. This consideration assumes greater weight at a time when demand in Malta's major export markets is slowing down.

The room for manoeuvre of fiscal policy, furthermore, should be broadened primarily by placing more emphasis on expenditure restraint, particularly in view of rising cost pressures caused by ageing-related factors such as pensions and health care. This approach would also eventually create space for further lightening the burden of taxation.

Apart from improving the long-term sustainability of public finances, expenditure cuts would allow more resources to be channelled into growth-enhancing activities, thereby helping to boost productivity. The latter should indeed be a priority goal because a consistent improvement in productivity is still needed to restore Malta's competitiveness vis-à-vis the euro area back to where it was at the start of the decade.

In recent years, the economy made efficiency gains largely as a result of privatisation and trade liberalisation. As these processes are almost completed, however, progress in strengthening productivity further will have to be made elsewhere. In this regard, a critical condition for increasing competitiveness in a monetary union is to ensure that wage increases are matched by productivity gains and that product and labour markets are sufficiently flexible. It is particularly important to avoid upward pressures on costs as a result of rigid labour market policies and practices at a time when some skill shortages are emerging.

The above policy imperatives assume greater relevance for Malta's open economy when growth prospects in our main export markets are weakening. There is the added risk, moreover, that lower demand levels in these markets will not be accompanied by commensurate declines in international commodity prices, including oil. In such circumstances, the risk of higher inflation may well limit the ability of monetary policy at the euro area level to address concerns related to slow growth.

While it is clear, therefore, that membership of the euro area will strengthen the economy's ability to face external shocks, it must be recognized that the euro is but one of several conditions necessary to achieve the needed improvement in Malta's international competitiveness. Going forward, the policy debate must be conducted in a longer-term perspective and focus on measures that would promote efficiency and innovation, encourage entrepreneurship and investment, and thus generate a faster rate of growth. Another, no less important consideration is that there is no other way to preserve, let alone improve, a social model that has reduced income inequality and secured wide access to education, health and pensions.

Bank policies and operations

During the past year the Central Bank of Malta was heavily involved in the preparations for the advent of the euro on both the policy and institutional levels. In the area of monetary policy, the Bank continued to orient its stance to support the exchange rate peg, which remained unchanged throughout the year at the central parity rate in ERM II. Thus the Bank responded to the premature conversion of Maltese liri into euro by increasing its central intervention rate by a quarter of a percentage point in January and again in May. Official interest rates then remained unchanged until the end of December, when the central intervention rate was lowered to 4.0% to bring it in line with the ECB's minimum bid rate ahead of entry into the euro area in January 2008.

On an institutional level, the Bank contributed to the euro adoption process in different ways. I continued to serve as a member of the Steering Committee for Euro Adoption, while the Deputy Governor represented the Bank on the National Euro Changeover Committee. In the meantime, the Bank undertook further work to ensure that the Central Bank of Malta Act would be compatible with the relevant provisions of the EC Treaty and with the Statutes of the ESCB and the ECB. The House of Representatives duly enacted the necessary amendments in February and in March.

At the end of the year, the Board of Directors approved changes to the Bank's Mission Statement to reflect the Mission Statement of the Eurosystem and the primacy accorded to price stability, the Bank's independence and the resultant obligations of transparency and public accountability.

All along, the Bank continued to strengthen its relations with the ECB and the other national central banks which, collectively, make up the ESCB. To this end, I continued to attend the quarterly meetings of the General Council of the ECB, while Bank officials participated in the work of the ESCB committees and working groups. Following the ECOFIN Council decision in July to allow Malta to adopt the euro, the Bank was accorded observer status in the Governing Council and all Eurosystem committees and working groups.

In the area of currency logistics, the Bank entered into an agreement in January with the *Monnaie de Paris*, the French state mint, for the production of euro coins with the Maltese national side. Minting of the coins began soon after the confirmation of the euro adoption date, and the first deliveries were made in September. In addition, the Bank was responsible for procuring euro banknotes and co-ordinating the distribution of both notes and coins to the banks ahead of the euro adoption date. The currency changeover also entailed work on the Bank's premises, the construction of a new coin depot and the implementation of extensive security arrangements.

Preparatory work was also undertaken in the area of payment and securities settlement systems. Here the Bank continued to develop the related infrastructure to enhance its efficiency and thus ensure a smooth transition to the single currency. Also in this context, Malta formed part of the first wave of countries that joined TARGET2, the new payment system of the Eurosystem, in November.

A substantial part of the Bank's communications strategy during the year was related to the euro changeover. The Bank and the ECB undertook an extensive publicity campaign, focusing on the appearance of euro notes and coins and their security features. The joint campaign was launched at the end of September in the presence of the ECB President, Mr Jean-Claude Trichet.

The euro changeover also necessitated additional work on the Bank's core information technology systems. At the same time, the Bank continued to ensure that it would be able to fulfill all its statistical data collection and transmission obligations as a member of the Eurosystem. The Bank also brought its accounting framework into line with the ECB's reporting guidelines.

The Bank's operating profit for the year amounted to Lm12.3 million (EUR 28.7 million), as against Lm11.2 million (EUR 26.0 million) in 2006.

On behalf of the Board of Directors, I would like to thank the Bank's staff for their dedication and hard work during a particularly challenging period. Without their contribution, the achievements described elsewhere in this Report would not have been possible.

Michael C. Bonello

Part I

FINANCIAL AND
ECONOMIC DEVELOPMENTS

1. The International Environment

The world economy

In 2007 the global economy was resilient in the face of turbulent financial market conditions, triggered by the distress in US high-risk credit markets. While real GDP growth slowed down in many major economies, emerging markets continued to perform robustly, on the strength of both domestic and foreign demand (see Table 1.1).

Although inflation rates were moderate for the year as a whole, the last quarter saw the resurgence of concerns over price stability, as inflation rates picked up mainly on account of higher commodity prices. The coincidence of the downside threat to growth from financial market tension and the risk posed by inflationary pressures heightened the challenge faced by policy makers.

Following weaker growth in the first half of the year, mainly as a result of lower residential investment, the US economy picked up in the second half as the depreciation of the dollar spurred growth in net exports. For 2007 as a whole, however, GDP growth eased to 2.2% from 2.9% in 2006, although the unemployment rate remained unchanged at 4.6%. Though the average inflation rate for the year fell to 2.8% from 3.2% in 2006, food and energy prices accelerated towards the end of the year.

In the euro area, underlying economic fundamentals remained favourable, with real GDP slowing only marginally to 2.7% in 2007 from 2.8% in 2006. At the same time, conditions in the labour market tightened further with the jobless rate falling to 7.4% from 8.3% in 2006. Despite the steady fall in unemployment and the boost to households' income, concerns over inflation and financial market uncertainty led to only modest growth in consumer spending in 2007. At 2.1%, the average inflation rate was 0.1 percentage points lower than in 2006. Yet, as in many other major economies, prices rose more rapidly towards the end of the year.

In the UK, the acceleration of GDP growth to 3.1% from 2.9% in 2006 was mainly attributable to higher consumption expenditure and capital investment. At 2.3%, the average inflation rate in 2007 was the same as in 2006. However, price developments during the year differed from those in the US and the euro area. Inflation exceeded the official 2% target in the first half of the year, peaking at 3.1% in March. In the second half of the year, the inflation rate decelerated as utility prices eased, before edging up to 2.1% by December. Meanwhile, unemployment hovered around 5.3%, unchanged from the average rate registered in the preceding year.

Growth in Japan slowed down to 2.1% in 2007 from

Table 1.1
INTERNATIONAL ECONOMIC INDICATORS
Annual percentage changes

	Real GDP			Consumer prices		
	2005	2006	2007	2005	2006	2007
United States	3.1	2.9	2.2	3.4	3.2	2.8
Euro area	1.5	2.8	2.7	2.2	2.2	2.1
United Kingdom	1.8	2.9	3.1	2.1	2.3	2.3
Japan	1.9	2.4	2.1	-0.3	0.3	0.0
China	10.4	11.1	11.4	1.8	1.5	4.8

Sources: Eurostat; Bureau of Labor Statistics, US; Statistics Bureau, Japan; National Bureau of Statistics, China.

2.4% in the previous year, largely because of weaker public-sector and residential investment. Consumer prices fell or were flat until the last quarter of the year, when they rose slightly. Unemployment edged down further, falling by 0.2 percentage points to 3.9%.

Interest rates

In the US, the federal funds rate target was unchanged at 5.25% through August, even as the Federal Reserve indicated its concern over the inflation rate (see Chart 1.1). In August, the Federal Reserve responded to heightened instability in the financial markets by cutting the discount rate by half a percentage point, while leaving the federal funds rate unchanged. In September, the latter was cut by 50 basis points, while in October and December it was lowered by a quarter of a percentage point on each of two occasions in a further effort to avert an economic slowdown. Thus, at the end of the year the target rate stood at 4.25%.

In order to counter inflationary pressures associated with vigorous money and credit growth, the ECB increased the minimum bid rate on its main refinancing operations in March and again in June, on each occasion raising it by 25 basis points to 4.0%.

The Bank of England lifted the official rate paid on commercial bank reserves by 0.25 percentage points on three occasions during 2007, to counter upside risks to price stability. In December, however, the Bank reversed its stance and cut the rate by a quarter of a point to 5.50%, amid signs of an economic slowdown and the deterioration in the financial markets.

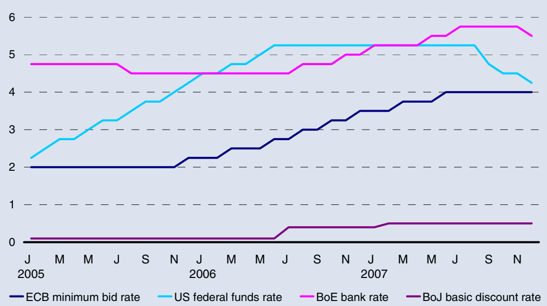
In February, the Bank of Japan raised its benchmark short-term interest rate, the uncollateralized overnight call rate, to 0.50%, despite the absence of inflationary pressures, citing prospects of an improving economic situation. The official discount rate was also raised, from 0.40% to 0.75%. The benchmark rate remained unchanged for the rest of the year.

Long-term yields in the US rose until June but generally fell for the remainder of the year, as market risk aversion increased in the wake of the financial market turmoil (see Chart 1.2). Ten-year bond yields in the euro area followed a similar course, increasing over the first half of the year, but subsequently declining to end 2007 nearly half a percentage point lower. In December, the differential between euro area and US bond yields turned negative for the first time in three years, as yields in the US fell at a faster pace. Developments in the UK broadly mirrored those of the US and the euro area. In Japan, long-term yields remained below 2%.

Currency markets

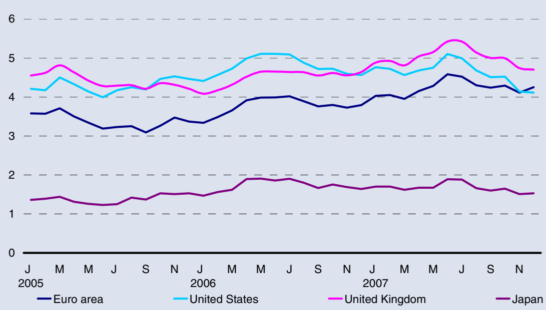
During 2007 foreign exchange markets were characterised by the continued depreciation of the US dollar (see Chart 1.3). Concerns regarding the housing sector and the high-risk end of the mortgage market contributed to a negative outlook for the US economy, resulting in a decline in the value of the dollar vis-à-vis the euro, the pound sterling and the Japanese yen (see Table 1.2).

Chart 1.1
OFFICIAL INTEREST RATES
(percentages per annum, end of month)



Sources: ECB; Federal Reserve; Bank of England; Bank of Japan.

Chart 1.2
LONG-TERM INTEREST RATES*
(percentages per annum, monthly averages)



* Long-term interest rates refer to yields on ten-year government bonds.
Source: Reuters.

Table 1.2
EXCHANGE RATES AGAINST THE US DOLLAR

	USD/EUR	USD/GBP	JPY/USD
Closing rate for 2007	1.4721	2.0074	112.04
Closing rate for 2006	1.3179	1.9629	118.86
Appreciation (+)/depreciation (-) vs the US dollar (%)	11.7	2.3	5.7
Lowest rate during 2007	1.2907	1.9212	124.02
	(12 Jan.)	(05 Mar.)	(22 June)
Highest rate during 2007	1.4868	2.1067	107.96
	(27 Nov.)	(08 Nov.)	(23 Nov.)

Source: Reuters.

In the early months of the year, the US dollar appreciated against the euro and sterling, as market expectations of an easing of the Federal Reserve's monetary policy stance diminished. The dollar, however, changed course and depreciated sharply for most of the remainder of the year, reflecting a more negative outlook for the US economy and the anticipation of a reduction in the federal funds target rate. Concerns related to financial market turmoil added to pressure on the US dollar after July.

Movements in the JPY/USD and the JPY/EUR rates during 2007 were mainly influenced by carry trade activity. At the beginning of the year, the euro and the US dollar strengthened against the yen but lost ground in March as the decline in investor's sentiment led to the unwinding of carry trade positions. In the second quarter, however, the dollar and the euro appreciated as investors borrowed in the low-yielding yen to invest the funds in other higher-yielding currencies. Later in the year, heightened volatility in financial markets led once again to the unwinding of carry trades, leading to a depreciation of the dollar and the euro. The US and the euro area currencies, however, registered gains in December mainly due to a less risk-averse environment.

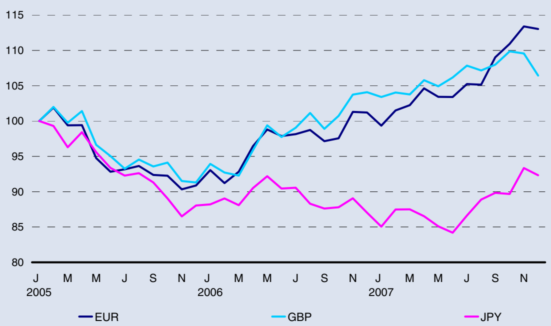
Along with the appreciation against the dollar and the yen, the euro also firmed vis-à-vis the pound sterling, gaining 9.2% during 2007. For most of the year, the euro fluctuated within a narrow range against sterling before strengthening sharply in the final four months of the year, as the tension in the sub-prime mortgage market spread to the British financial sector. Moreover, expectations of further easing in the Bank of England's monetary policy stance also contributed to the depreciation of sterling.

Commodities

Oil

Oil prices followed a generally upward path during 2007, prompted by rising demand, particularly from emerging economies such as China and India, and concerns about supply disruptions, especially in Nigeria and the Middle East. During the year the

Chart 1.3
EXCHANGE RATE MOVEMENTS AGAINST THE US DOLLAR
(index of end-of-month rates, Jan. 2005=100)



Source: Reuters.

Chart 1.4
OIL*
(US dollars per barrel, end of week)

*Brent crude
Source: Reuters.

price of Brent crude rose by 61.2% (see Chart 1.4). The deepening crisis in US financial markets and a bleaker economic outlook for the US prompted an easing of oil prices in the late summer months. Renewed geopolitical tensions and low inventory data in the US, however, led to further upward pressure, with the price of Brent crude reaching an all-time high of USD 96.57 per barrel towards the end of December.

Gold

High oil prices and the weak US dollar were the major factors behind the surge in the price of gold during 2007 (see Chart 1.5). Having commenced the year on a weak note, the price of gold embarked on an upward trend, reflecting rising oil prices, a weaker US dollar and the renewed attractiveness of the metal's safe haven attributes at a time of geopolitical tension. In May and June the price of gold retreated as the US dollar stabilised and gained some ground. In addition, the metal was negatively affected by expectations of higher interest rates since the latter would raise the opportunity cost of holding gold. In August, however, the price of the metal resumed its upward trend spurred by a lower dollar and record high oil prices. Prices were further boosted by the tension in financial markets in late summer. As a result, the price of gold rose to USD 743.70 at the end of September. It continued to rise over the last quarter of 2007 to end the year at USD 833.20 per ounce. Over the year, the price of gold gained 30.9% in US dollar terms.

Chart 1.5
COMMODITY PRICES
(end of week)

Source: Reuters.

Other commodities

The Reuters Commodity Index, which excludes gold and oil products, remained on an upward course in 2007, rising by a further 16.3% (see Chart 1.5).[1] The increase was spurred by higher prices for raw materials and food. The rise in food prices was mainly driven by higher energy prices, low inventory levels and supply cuts resulting from drought conditions in various producing countries. Strong demand for crops in emerging markets and for biofuel production also contributed to the rise in food prices.

[1] The Reuters Commodity Index is a weighted index of the prices of seventeen commodities that include food, beverages, vegetable oils, agricultural raw materials and metals, but exclude oil and gold.

2. Monetary and Financial Developments

Responding to a tightening of monetary conditions overseas, particularly in the euro area, the Central Bank of Malta raised its central intervention rate by 25 basis points twice during 2007, in January and May. As a result, the rate went up from 3.75% in December 2006 to 4.25% in May. At the end of December, just before the adoption of the euro, the Bank lowered the rate to 4.00%, bringing it in line with the minimum bid rate on the main refinancing operations set by the ECB. During the year, money market interest rates moved in line with official rates. In the capital market, yields on 5- and 10-year government bonds rose considerably, broadly in line with movements in euro area rates. The MSE share index ended December marginally higher than a year earlier.

Monetary growth accelerated in 2007, following moderate expansion during the previous two years. This was attributable to a significant rise in domestic credit, primarily in the form of loans to the non-bank private sector and, to a lesser extent, to an increase in the net foreign assets of the banking system.

The monetary base[1]

The monetary base (M0) expanded by Lm83.1 million (EUR 193.6 million), or 12.2%, during 2007 as a sharp rise in bank deposits with the Central Bank of Malta outweighed a sizeable drop in currency in issue (see Table 2.1).[2] The former was mainly attributable to an increase in minimum reserve deposits in November,

Table 2.1
THE MONETARY BASE AND ITS SOURCES
Lm millions

			Change	
	2006	2007	Amount	%
Currency in issue	504.0	291.0	-213.0	-42.3
Bank deposits with the Central Bank of Malta[1]	177.0	473.1	296.1	+
Monetary base (M0)	**680.9**	**764.1**	**83.1**	**12.2**
Central Bank of Malta assets				
Foreign assets	949.2	1,084.9	135.7	14.3
Claims on government	30.3	87.4	57.1	+
Fixed and other assets	57.0	60.4	3.4	5.9
less:				
Remaining liabilities				
Private sector deposits	12.1	27.3	15.2	+
Government deposits	106.6	166.2	59.7	56.0
SDR allocations	5.5	5.2	-0.3	-5.9
Foreign liabilities	0.0	0.0	0.0	+
Other liabilities	153.7	188.4	34.7	22.6
Capital and reserves	77.7	81.5	3.8	4.9

+ indicates a value exceeding +/- 100%

[1] Excluding term deposits, which are shown with "other liabilities".

Source: Central Bank of Malta.

[1] Information on the monetary base and its sources is derived from the Bank's financial statements, which are compiled in accordance with accounting principles as laid down in International Financial Reporting Standards (IFRS). These data may differ from those on monetary aggregates and their counterparts, which are produced in line with international standards on the compilation of monetary statistics.

[2] M0 is a measure of the Central Bank of Malta's monetary liabilities and consists of currency in issue and bank deposits with the Bank, excluding term deposits.

when all credit institutions established in Malta became obliged to hold such deposits with the Bank. In contrast, the shift out of currency holdings into bank deposits ahead of the euro changeover dampened growth in the monetary base.

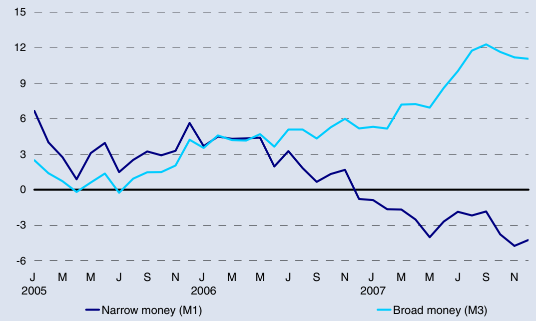
During 2007 growth in the monetary base was matched predominantly by an increase in the Bank's foreign assets and, to a lesser degree, by an expansion in its holdings of government securities. However, growth in M0 was dampened by a rise in government deposits with the Bank and an increase in its other liabilities. The latter mirrored the increased absorption of liquidity from the banking system through term deposits.

Monetary aggregates

The annual rate of growth of broad money (M3) more than doubled in 2007, rising from 5.2% in 2006 to 11.1% (see Chart 2.1). This pick-up was driven by a greater demand for bank deposits which, in turn, stemmed from several factors, particularly rising deposit interest rates and the changeover to the euro.

After a small fall in 2006, narrow money (M1), which accounts for almost half of M3, contracted by 4.2% during 2007 (see Table 2.2). This was attributable to

Chart 2.1
MONETARY AGGREGATES
(annual percentage changes)



Source: Central Bank of Malta.

a sizeable drop in currency in circulation, which outpaced a rise in deposits withdrawable on demand. The former shrank by 45.2%, reflecting lower demand for cash in the face of the euro changeover and the greater opportunity cost of holding currency in an environment of rising interest rates. In contrast, deposits withdrawable on demand grew by 12.3% during the year, mainly on account of higher Maltese lira balances belonging to households and an increase in corporate foreign currency deposits.

During 2007 intermediate money (M2) expanded by 11.1% as the drop in M1 was offset by a surge in deposits with an agreed maturity of up to two years, which climbed by 27.1%. An increase in Maltese lira denominated deposits belonging to households

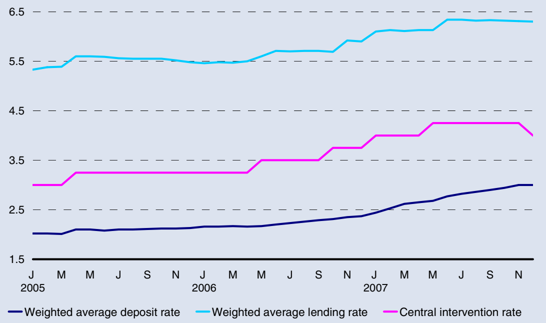
Table 2.2
MONETARY AGGREGATES
Lm millions

	Annual percentage changes			Amount outstanding	Change
	2005	2006	2007	2007	2007
Narrow money (M1)	**5.6**	**-0.8**	**-4.2**	**1,586.4**	**-70.4**
Currency in circulation	2.7	-4.2	-45.2	262.0	-215.8
Deposits withdrawable on demand	7.0	0.7	12.3	1,324.5	145.4
Intermediate money (M2)	**4.2**	**5.2**	**11.1**	**3,552.6**	**353.6**
Narrow money (M1)	5.6	-0.8	-4.2	1,586.4	-70.4
Deposits redeemable at notice up to 3 months	4.7	-2.0	46.8	45.2	14.4
Deposits with agreed maturity up to 2 years	2.5	12.8	27.1	1,920.9	409.5
Broad money (M3)[1]	**4.2**	**5.2**	**11.1**	**3,552.6**	**353.6**
Of which: foreign currency deposits	13.7	15.4	30.5	575.3	134.5

[1]Since the amount of marketable instruments issued by the MFI sector is negligible, at present M2 is equal to M3.

Source: Central Bank of Malta.

Chart 2.2
DEPOSIT AND LENDING RATES
(percentages per annum, end of month)



Source: Central Bank of Malta.

contributed to more than three-fourths of the rise. Foreign currency denominated deposits, particularly those belonging to private non-financial companies, also expanded significantly. Sustained growth in deposits with an agreed maturity of up to two years reflected higher deposit interest rates and new products offered by banks, which fuelled demand, and, to a lesser degree, funds deposited under the Special Registration Scheme.[3] Confirmation of Malta's eligibility to join the euro area also had a positive impact on deposit growth, as increasing amounts of cash were placed with banks towards the end of the year, possibly to take advantage of the automatic currency conversion on the euro adoption date. Deposits redeemable at up to three months' notice increased moderately in absolute terms.

At the same time, foreign currency denominated deposits in M2 rose by 30.5%, with corporate deposits accounting for most of the increase.

In 2007 banks raised their deposit and lending rates in response to increases in the central intervention rate. Lending rates rose immediately, though not all the rise in official interest rates was transmitted to borrowers. In addition, the late December cut in the central intervention rate did not have an impact on average lending rates by the end of the year. As a result, the average weighted lending rate increased by 40 basis points during the year, ending December at 6.30% (see Chart 2.2). Meanwhile, rates on deposits went up gradually, with higher rates being applied only to new deposits. At the same time, investors showed a clear preference for deposits offering higher interest rates. As a result, the weighted average interest rate on Maltese lira deposits rose from 2.37% at the end of 2006 to 3.00% a year later. Average interest rates on demand, savings and time deposits all increased during the year under review, ending December at 0.78%, 1.73% and 3.95%, respectively.

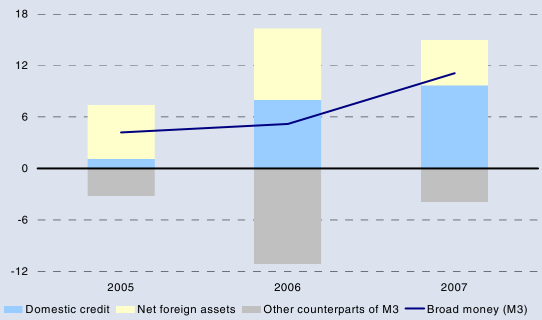
Counterparts of monetary growth

Monetary growth during 2007 was driven by further expansion in domestic credit – particularly to the non-bank private sector – and in the net foreign assets of the banking system (see Chart 2.3). Movements in the other counterparts of M3 mainly reflected inflows of share capital from abroad, which influenced the banking system's net foreign assets but had no impact on monetary aggregates.

Growth in domestic credit gathered pace in 2007, rising to 10.7% from 9.2% in the previous year (see Table 2.3). This was mainly driven by a continued strong increase in claims on other residents, though a recovery in net claims on central government after three years of negative growth also contributed (see Chart 2.4).

Claims on other residents expanded by 9.3%, a less rapid rate than in 2006. Loans, which account for almost all such claims, put on 9.4%, with demand stemming almost entirely from the non-bank private

Chart 2.3
CONTRIBUTIONS TO MONETARY GROWTH
(annual percentage change and percentage point contributions)



Source: Central Bank of Malta.

[3] The Special Registration Scheme was launched on 23 April 2007 to provide individuals residing in Malta with a one-time opportunity to regularise their position in respect of their holdings of eligible assets in those cases where the associated income had not been declared for the purposes of the Income Tax Act. The Scheme closed on 31 August 2007.

Table 2.3
BROAD MONEY AND ITS COUNTERPARTS
Lm millions

	Annual percentage changes			Amount outstanding	Change
	2005	2006	2007	2007	2007
Broad money (M3)	**4.2**	**5.2**	**11.1**	**3,552.6**	**353.6**
Domestic credit	**1.3**	**9.2**	**10.7**	**3,187.3**	**308.5**
Net claims on central government	-18.8	-17.6	20.4	439.5	74.6
Claims on other residents	6.6	14.6	9.3	2,747.8	233.9
Net foreign assets	**11.3**	**14.0**	**8.2**	**2,232.3**	**169.9**
Central Bank of Malta	7.2	2.0	14.4	1,087.4	136.6
Banks	16.1	26.8	3.0	1,144.9	33.4
less:					
Other counterparts of M3[1]	**7.2**	**24.1**	**7.2**	**1,867.1**	**124.8**

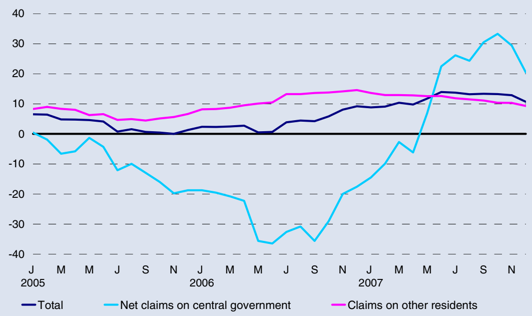
[1] Other counterparts of M3 include the capital base of the MFI sector, longer-term financial liabilities, provisions, interest accrued and unpaid and other liabilities, less fixed and other assets. They are equal to the difference between M3 and the sum of domestic credit and net foreign assets.

Source: Central Bank of Malta.

sector (see Table 2.4). Credit to the latter grew by 10.1%, fuelled mainly by lending to households, mostly for house purchases, and to the real estate, renting & business activities sector. Lending to the construction and manufacturing sectors also rose substantially. Nonetheless, whilst credit to most borrowing categories continued to expand, annual rates of credit growth decelerated across all sectors except manufacturing. This general slowdown may reflect rising borrowing costs and tighter credit supply conditions in certain sectors.

During 2007 net claims on central government expanded by 20.4%, as the banking system subscribed actively to new issues of Treasury bills and Malta

Chart 2.4
DOMESTIC CREDIT
(annual percentage changes)



Source: Central Bank of Malta.

Government Stocks. At the same time, growth was restrained by an overall increase in government deposits with the banking system.

The net foreign assets of the banking system grew at a slower pace during 2007, rising by 8.2% as against 14.0% in 2006 (see Chart 2.5).

The net foreign assets of the Central Bank of Malta accelerated substantially, with their annual growth rate rising from 2.0% at the end of 2006 to 14.4% a year later. The expansion in the Bank's net holdings was mainly attributable to a rise in reserve deposits towards the end of the year as international banking institutions operating in Malta became obliged to hold such deposits with the Bank. These institutions placed significant amounts of reserve deposits in foreign currency. The Bank's foreign assets were also boosted by net receipts from the European Commission, proceeds from the divestment of equity held by a public non-financial corporation in an associated company, receipts from the sale of land and net tax receipts from companies engaged in international business. The increase in the Bank's net foreign assets was partly offset by substantial foreign currency sales to the rest of the

Table 2.4

CLAIMS ON OTHER RESIDENTS[1]

Lm millions

	Annual percentage changes			Amount outstanding	Change
	2005	2006	2007	2007	2007
Claims on the non-bank private sector	9.0	15.3	10.2	2,596.7	240.2
of which loans	10.0	15.2	10.1	2,539.0	232.4
Claims on the non-bank public sector	-17.7	4.7	-4.1	150.3	-6.4
of which loans	-25.1	9.1	-2.6	126.6	-3.4
Claims on other general government[2]	-6.1	15.6	14.4	0.9	0.1
Total claims	**6.6**	**14.6**	**9.3**	**2,747.8**	**233.9**
of which loans					
Electricity, gas & water supply	-35.9	32.7	4.1	84.4	3.3
Transport, storage & communication	-1.8	18.7	-5.4	138.3	-8.0
Agriculture & fishing	-11.7	13.1	-2.6	9.6	-0.3
Manufacturing	-12.5	6.1	13.4	128.3	15.2
Construction	-0.7	16.8	15.3	290.2	38.5
Hotels & restaurants	-0.8	3.8	-3.7	203.7	-7.9
Wholesale & retail trade; repairs	2.2	3.5	2.4	314.4	7.5
Real estate, renting & business activities	52.1	37.3	18.8	311.1	49.3
Households & individuals	16.4	15.5	14.5	1,109.2	140.5
Other[3]	10.9	13.3	-10.4	77.3	-9.0
Total loans	**7.1**	**14.9**	**9.4**	**2,666.5**	**229.1**

[1] Claims on other residents consist mainly of loans and holdings of securities, including equities, issued by the non-bank private sector and public non-financial companies. Interbank claims are excluded.

[2] This refers to the local councils.

[3] Includes mining and quarrying, public administration, education, health and social work, community recreation and personal activities, extra-territorial organisations and bodies and non-bank financial institutions.

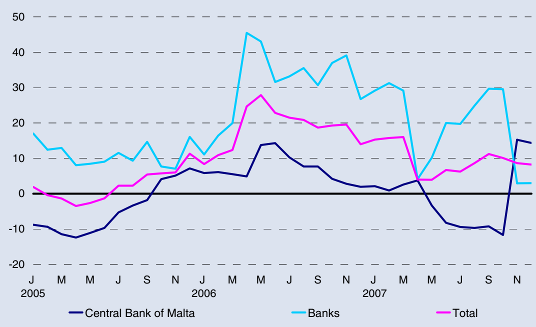
Source: Central Bank of Malta.

banking system as the public's demand for euro currency gained momentum ahead of the euro changeover.

The net foreign holdings of the rest of the banking system also rose, but at a slower pace compared to the previous year. These grew by just 3.0% in 2007, underpinned by foreign currency purchases from the Central Bank of Malta and a sizeable inflow of equity capital into two foreign-owned banks. Other foreign direct investment inflows also contributed to the increase, while the transfer of reserve deposits in foreign currency towards the end of the year and a reduction in unrealised fair value reserves had a dampening effect.

The other counterparts of M3 increased by 7.2% in 2007, mainly on account of the share capital inflow mentioned above, though this was partly offset by the drop in revaluation reserves referred to earlier.

Chart 2.5
NET FOREIGN ASSETS
(annual percentage changes)



Source: Central Bank of Malta.

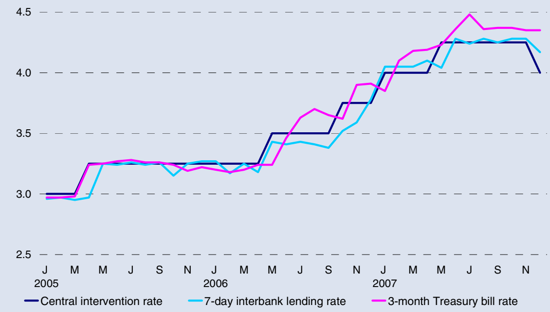
The money market

Activity in the interbank market slowed down during 2007, as rapid deposit growth and the issue of debt securities reduced banks' dependence on such funding. Thus, the value of deals transacted fell to Lm118.8 million (EUR 276.7 million), from Lm240.0 million (EUR 559.0 million) in the previous year. Liquidity within the banking sector was asymmetrically distributed, with two banks accounting for almost 92% of total borrowings. The maturity structure of interbank loans ranged from one day to 94 days, with loans of one week or less being the most common. Changes in the interest rate on 7-day loans broadly reflected movements in the central intervention rate. The former ended the year at 4.17%, 39 basis points above its level at the end of 2006 (see Chart 2.6).[4]

During 2007 the Treasury made more frequent use of short-term debt to finance its operations, issuing Lm476.8 million (EUR 1,110.6 million) worth of Treasury bills, as opposed to Lm396.1 million (EUR 922.7 million) during the previous year. However, at the same time, the amount of maturing bills also increased, to Lm484.9 million (EUR 1,129.5 million). At year-end, the amount of Treasury bills outstanding totalled Lm152.4 million (EUR 355.0 million), down from Lm160.5 million (EUR 373.9 million) in 2006. Three-month bills accounted for more than half of the total issued, with most of the rest having maturities ranging between one month and nine months. As in previous years, banks were the main participants in Treasury bill auctions, subscribing to almost three-fourths of the amount issued, with insurance companies taking up most of the remainder. The yield on the three-month bill rose during the year in response to increases in official interest rates, adding 44 basis points to end the year at 4.35%.[5]

In the secondary market for Treasury bills turnover declined by almost two-fifths compared with the previous year, falling to Lm55.2 million (EUR 128.6 million). Turnover involving the Bank amounted to

Chart 2.6
MONEY MARKET INTEREST RATES
(percentages per annum, end of month)



Source: Central Bank of Malta.

Lm38.2 million (EUR 89.0 million), with purchases accounting for nearly 90% of the Bank's transactions. The remainder represented trade between the banks and other financial institutions. As in the primary market, secondary market Treasury bill yields followed movements in the central intervention rate during 2007, with the yield on the three-month bill ending the year at 4.35%.

The capital market

Net issues of long-term debt securities in the primary market surged to Lm104.4 million (EUR 243.2 million) in 2007, from Lm6.5 million (EUR 15.1 million) in the preceding year (see Table 2.5). On a net basis, government issues rose to Lm54.1 million (EUR 126.0 million), while securities issued by other residents went up to Lm50.3 million (EUR 117.2 million).

The Government turned to the primary capital market in May, June and October, issuing stocks with a combined value of Lm124.1 million (EUR 289.1 million). Terms to maturity ranged from five to fourteen years, whereas coupon rates varied from 5% to 5.9%. Around 70% of the total bonds issued were sold by auction. Of these, three-fourths were taken up by banks, with the rest being mostly acquired by insurance companies. Bonds sold at fixed prices were taken up by retail investors, predominantly households.

At the same time, the value of debt securities issued by banks and non-financial corporations increased.

4 As no interbank deals in this maturity took place in December 2007, the official fixing rate was used instead.
5 Since no primary market transactions took place in December, the end-year yield is that in effect at the end of November.

Table 2.5

ISSUES OF LONG-TERM DEBT SECURITIES[1]

Lm millions

	2005	2006	2007
Government			
Total issues [2]	165.0	44.3	124.1
Redemptions	55.0	44.3	70.0
Net issues	110.0	0.0	54.1
Corporate sector			
Total issues	0.0	17.7	51.4
Redemptions	27.3	11.2	1.1
Net issues	-27.3	6.5	50.3
Total net issues	**82.7**	**6.5**	**104.4**

[1] Includes public issues of debt securities by residents in Maltese liri and foreign currencies, with the spot rate at time of issue used for conversion of foreign currencies to Lm. Banks and public non-financial companies are included with corporate issuers. Long-term securities are those with an original term to maturity exceeding one year, and include preference shares.

[2] Data exclude Malta Government Stocks that were issued directly to the Foundation for Church Schools. These amounted to Lm0.6 million in 2005, Lm1.5 million in 2006 and Lm4.7 million in 2007.

Sources: Central Bank of Malta; The Treasury.

Four bonds were issued during the year, with a combined value of Lm51.4 million (EUR 119.7 million), with one bank accounting for almost half the amount. Terms to maturity ranged between four and ten years and coupon rates varied between 4.6% and 7.5%. Almost one-third of the amount issued was denominated in euro.

Turnover in the secondary market for government bonds more than doubled when compared to the previous year, rising from Lm68.0 million (EUR 158.4 million) in 2006 to Lm140.0 million (EUR 326.1 million) (see Table 2.6). The significant increase in turnover stemmed from a decline in the demand for fixed-interest securities in an environment of rising interest rates, both in the euro area and domestically, with investors probably switching to bank deposits and foreign assets instead. Consequently, the Central Bank of Malta, acting as market-maker, was a net buyer in the market and accounted for more than three-fourths of the value traded. Participants traded mainly in short- and medium-term securities, with bonds having a term to maturity of up to five years accounting for three-fifths of the total turnover. In line with movements in euro area rates, yields on 5-year and 10-year government bonds both rose considerably during the first seven months of the year, before easing gradually. Over the year as a whole

Table 2.6

SECONDARY MARKET TRADING IN GOVERNMENT STOCKS

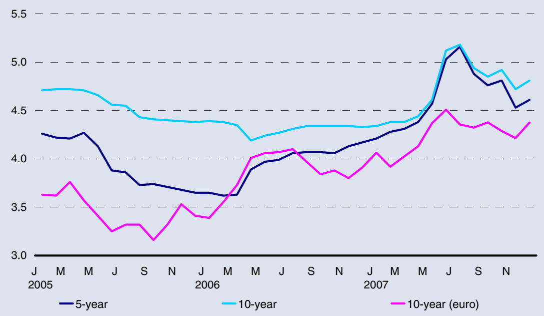
Lm millions

	2005	2006	2007
Central Bank of Malta purchases	3.9	30.1	88.3
Central Bank of Malta sales	8.8	7.6	19.4
Other deals[1]	53.7	30.3	32.2
Total	**66.4**	**68.0**	**140.0**

[1] Including deals effected by the Bank's broker on behalf of Government Sinking Funds, the Maltese Episcopal Conference and the MSE.

Sources: Central Bank of Malta; MSE.

Chart 2.7
GOVERNMENT BOND YIELDS
(percentages per annum, end of month)



Sources: Central Bank of Malta; ECB.

Chart 2.8
MSE SHARE INDEX
(end of month)

Source: MSE.

they increased by 44 and 48 basis points, respectively, ending December at 4.61% and 4.81% (see Chart 2.7).

Activity in the secondary market for corporate bonds also increased during the year, though to a much lesser extent, rising by Lm0.6 million (EUR 1.4 million) to Lm5.3 million (EUR 12.3 million). Trading activity mostly involved eight bonds, with the rest being more or less evenly spread among the remaining listed securities. On average, corporate bond yields moved upwards during the year.

In contrast, trading in the equity market fell sharply, dropping from Lm88.0 million (EUR 205.0 million) in 2006 to Lm27.8 million (EUR 64.8 million). Trading was mostly concentrated on the shares of two major banks. Following a significant drop in the previous year, the MSE share index stabilised, putting on 1.3% during 2007, to end the year at 4,937.75 (see Chart 2.8).

3. Output, Employment and Prices[1]

A pronounced recovery in the tourist industry and further growth in other services sectors boosted the Maltese economy's growth rate in 2007, the fourth consecutive year of sustained economic activity. Within manufacturing industry, the shift continued away from traditional labour-intensive sectors, amidst indications of further diversification within the high-technology sectors. Wage growth across the economy remained moderate, although there were some signs of a tighter labour market. Despite the decline in the rate of inflation for the year as a whole, upward price pressures emerged in the latter part of the year, prompted by external factors that are also influencing inflation rates in other countries.

Gross Domestic Product

Economic activity continued at a brisk pace in 2007, with the growth rate accelerating to 3.8% from 3.4% in 2006. Domestic demand was the main driver of growth, with net exports contributing positively but less markedly (see Table 3.1).

Domestic demand strengthened by 2.8% over the year, underpinned by a significant increase in private consumption. The latter accounted for 1.9 percentage points of real GDP growth, compared with 0.5 points a year earlier. In contrast, government consumption was only marginally higher than a year earlier, reflecting the less expansionary stance of fiscal policy.

Gross fixed capital formation rose marginally, with both the public and the private sectors contributing modestly. In nominal terms, general government capital expenditure picked up, reflecting increased

Table 3.1
GROSS DOMESTIC PRODUCT AT CONSTANT PRICES

	2005	2006	2007
	Annual percentage changes		
Household final consumption expenditure	1.9	0.7	2.8
Government final consumption expenditure	0.2	4.2	0.6
Gross fixed capital formation	5.9	3.0	0.3
Domestic demand	**5.7**	**2.3**	**2.8**
Exports of goods & services	-0.9	10.0	-0.6
Imports of goods & services	1.8	8.3	-1.3
Gross domestic product	**3.4**	**3.4**	**3.8**
GDP deflator	**3.0**	**2.9**	**2.3**
	Percentage point contributions		
Household final consumption expenditure	1.3	0.5	1.9
Government final consumption expenditure	0.0	0.8	0.1
Gross fixed capital formation	1.2	0.6	0.1
Changes in inventories	3.5	0.6	0.9
Domestic demand	**6.0**	**2.5**	**3.0**
Exports of goods & services	-0.8	9.3	-0.6
Imports of goods & services	-1.8	-8.4	1.3
Net exports	**-2.6**	**0.9**	**0.8**
Gross domestic product	**3.4**	**3.4**	**3.8**

Source: NSO.

[1] The cut-off date for statistical information in this Chapter is 10 March 2008.

spending on machinery and equipment that offset a fall in construction outlays in view of the completion of the new state hospital. Private sector investment in machinery and equipment declined, while in residential construction it continued to grow as demand for housing remained relatively robust. General government capital formation showed a nominal increase of 3.5%, while private sector investment rose by 1.2%.

The share of inventory changes, which includes the statistical adjustment, climbed to 2.1% of GDP from 1.3% a year earlier and consequently contributed an additional 0.9 percentage points to growth.

In view of a faster drop in imports than in exports, the contribution of net exports to total growth was slightly positive. Net external demand in fact was the main driver of growth in the first half of the year, but its contribution turned negative in the last two quarters.

The overall GDP price deflator increased by 2.3% in 2007, a moderately slower pace than the 2.9% recorded in the previous year. The export deflator went up by 6.3%, faster than the 4.8% rise in the import deflator, implying a further improvement in the terms of trade.

In nominal terms, gross value added grew by 6.2% in 2007 compared with 5.9% a year before. The main source of this growth was the operating surplus of businesses, which advanced by 11.5%, boosted by double-digit growth in the first and third quarters. In contrast, compensation of employees rose more moderately, by 4.3% compared with 4.5% in 2006 (see Chart 3.1).

A sectoral analysis of gross value added shows that the other community, social & personal service activities sector remained a main contributor to growth. This sector's gross value added rose by around a third and contributed 2.2 percentage points to nominal growth in GDP, mainly on account of an increase in the sector's operating surplus and, to a lesser extent, in its labour income (see Table 3.2). The real estate, renting & business activities sector also reported double-digit growth in its gross value added, contributing 1.5 points to overall growth.

Chart 3.1
GROSS VALUE ADDED, EMPLOYMENT INCOME & OPERATING SURPLUS
(annual percentage changes)

Source: NSO.

The manufacturing sector was the third largest contributor to growth in 2007, even as the sector underwent further restructuring and consolidation. An increase of 4.6% in the sector's gross value added was almost entirely in the form of higher profits and resulted in a larger contribution to overall nominal growth than in 2006.

In contrast to the weak performance of recent years, the hotels & restaurants sector registered a rise in value added, contributing positively to overall growth. Employee compensation accounted for half of the sector's growth in value added, although there was a sharp increase in its operating surplus. Activity in the transport, storage & communication sector also continued to expand, adding 0.5 percentage points to nominal output.

After recording modest growth in 2006, gross value added in public administration and in the education and the health & social work sectors increased substantially. Together these sectors added almost one percentage point to growth, mainly in the form of higher labour income.

The financial intermediation sector registered a sharp decline in its operating surplus because of higher operating expenses incurred by some international banking institutions. This notwithstanding, compensation to employees within the sector continued to increase. But the sector's overall contribution to total value added was a negative 0.6%, compared with a positive 0.4% the year before.

Table 3.2
CONTRIBUTION OF SECTORAL GROSS VALUE ADDED TO NOMINAL GDP GROWTH

Percentage point contributions

	2005	2006	2007
Agriculture, hunting & forestry	0.0	0.0	-0.2
Fishing	0.0	0.2	0.0
Manufacturing	0.8	0.2	0.7
Electricity, gas & water supply	-0.4	0.0	-0.2
Construction	0.1	0.2	0.1
Wholesale & retail trade	0.9	0.1	0.2
Hotels & restaurants	-0.1	-0.2	0.3
Transport, storage & communication	0.4	0.3	0.5
Financial intermediation	1.0	0.4	-0.6
Real estate, renting & business activities	0.8	1.6	1.5
Public administration	0.0	0.1	0.4
Education	0.2	0.1	0.2
Health & social work	0.3	0.3	0.3
Other community, social & personal service activities	1.1	1.9	2.2
Gross value added	**5.0**	**5.0**	**5.3**
Net taxation on production and imports	**1.4**	**1.4**	**0.8**
Annual nominal GDP growth (%)	**6.4**	**6.4**	**6.1**
Annual nominal GNI growth (%)	**2.8**	**6.5**	**8.1**

Source: NSO.

Two other sectors that also contributed negatively to gross value added were the agriculture and the energy-related sectors, the latter mainly on account of rising intermediate consumption as a result of higher oil prices.

Gross national income, defined as the GDP plus net property income from abroad, increased by 8.1% in nominal terms in 2007.

Manufacturing

On the basis of official surveys, turnover in manufacturing during the first nine months of 2007 was marginally higher than in the same period in 2006 (see Table 3.3).[2] Output for export increased by Lm21.8 million (EUR 50.8 million), while that for the domestic market declined by Lm19.8 million (EUR 46.1 million). Pharmaceutical firms, included in the chemicals sub-sector, were important contributors to export growth, reporting an increase in sales of 32.9% over the year. This was partially offset by a decline of 2.7% in exports by the radio, TV & telecommunications sector, which comprises the electronic components industry. Other significant export gains were made by firms in electrical machinery and in printing & publishing, reversing the contraction registered by the same two sub-sectors in 2006. The downward trend in exports of clothing, textiles & leather persisted throughout 2007, though at a slower pace than in the previous year.

The decline in domestic sales during 2007 was almost entirely due to the closure of a firm in the tobacco sector towards the end of 2006. However, a modest contraction in sales of furniture and other non-metallic minerals reversed the gains made by the same sub-

[2] These results are compiled from a quarterly survey of a sample of around 390 manufacturing enterprises conducted by the NSO.

Table 3.3
MANUFACTURING PERFORMANCE - SELECTED INDICATORS[1]
Lm millions

	2005	2006	Jan.-Sep. 2006	Jan.-Sep. 2007
Total turnover	**943.8**	**1043.9**	**767.6**	**769.6**
Change in exports	**-57.9**	**106.8**	**72.4**	**21.8**
Radio, TV & telecommunications	-87.4	110.7	78.2	-9.8
Medical & precision equipment	-5.8	2.1	1.9	-1.6
Printing & publishing	2.6	-1.1	-0.6	5.3
Clothing, textiles & leather	-3.6	-20.8	-14.8	-5.1
Chemicals	18.5	23.8	16.5	15.9
Electrical machinery	13.9	-11.5	-7.8	10.8
Machinery & equipment	1.4	2.4	1.9	0.3
Food, beverages & tobacco	4.5	0.8	-0.4	-1.0
Others	-2.0	0.4	-2.5	7.0
Change in local sales	**2.8**	**-6.6**	**-4.4**	**-19.8**
Food, beverages & tobacco	-8.4	-9.5	-7.7	-19.0
Machinery & equipment	0.7	-2.5	-2.0	0.6
Other non-metallic minerals	5.5	1.0	0.9	-0.7
Printing & publishing	1.5	0.7	0.5	1.5
Fabricated metal products	3.8	1.5	0.9	0.9
Clothing, textiles & leather	-2.6	-1.0	-0.4	-0.1
Furniture	2.9	0.8	0.8	-0.6
Others	-0.6	2.4	2.6	-2.4
Change in investment	**-3.5**	**9.7**	**11.8**	**11.8**
Radio, TV & telecommunications	3.5	10.6	14.9	-14.1
Chemicals	-3.3	1.2	0.8	2.1
Food, beverages & tobacco	0.5	1.0	-0.7	10.2
Printing & publishing	-2.7	-1.1	-1.7	10.2
Others	-1.5	-2.0	-1.5	3.4
Change in employment [1]	-346	-999	-1,099	-253
Change in wages per employee (%)	0.5	6.0	6.4	3.8

[1] Figures represent differences in average employment levels between the respective periods.
Source NSO.

sectors in the previous year. In contrast, there was a rise in the domestic sales of machinery & equipment, which had declined in 2006. Similarly there was an increase in output for the domestic market by firms in the printing & publishing sub-sector in 2007.

During the first three quarters of 2007 investment in manufacturing increased by the same amount as in 2006. Higher capital outlays in the food, beverages & tobacco and the printing & publishing sub-sectors were partly offset by a considerable reduction in investment by the radio, TV & telecommunications sub-sector.

With regard to the average employment level in the whole manufacturing sector during the first three quarters of 2007, this was 253 lower than in the same period of 2006. The decline is attributable mainly to redundancies in the clothing sector during the third quarter. Meanwhile, wages per employee rose by 3.8%, compared with 6.4% in 2006.

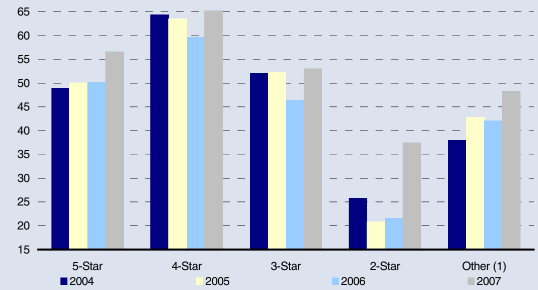
Tourism

A strong recovery in the tourism industry during 2007 reversed the decline observed in the previous two years. The number of tourist departures rose by 10.6%, with a higher influx of tourists from the UK, Ireland and Scandinavia more than compensating for a decline in tourists from Austria, Belgium and the Netherlands. Operations to and from Malta by a major low cost airline from November 2006 had a positive effect as the number of visitors rose in both the peak and the off-peak months.

Expenditure by tourists grew by 6.0% in 2007, as the decline in spending reported in May, November and December was compensated for by sharp increases during the summer period (see Chart 3.2). Non-package travel gained in importance, as the increase in the non-package and 'other' spending elements made up for the decline in expenditure by package holiday tourists.[3]

Although total nights stayed increased by 3.3%, the average length of stay continued to contract, falling to 8.9 nights from 9.5 nights in 2006. This appeared to reflect the successful marketing of weekend breaks by low cost airlines and the changing preferences of travellers.

Chart 3.3
AVERAGE OCCUPANCY RATES
(percent)



(1) Includes guesthouses, hostels & holiday complexes.
Source: NSO.

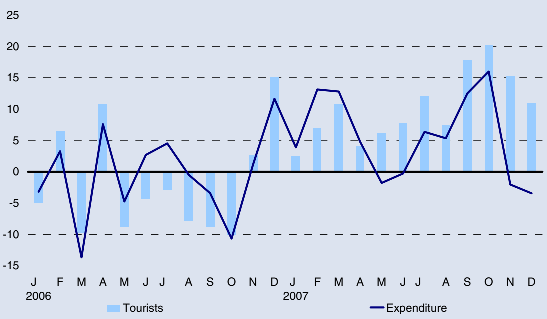
Occupancy rates rose across all accommodation categories, with the sharpest improvement recorded at the lower end of the spectrum, particularly in the two-star hotel category. The performance of the latter was to some extent boosted by the reduction in bed stock that had taken place over the last two years (see Chart 3.3).

Cruise liner visitors increased by 21.4% in 2007, as the number of cruise liners visiting Malta rose significantly and established shipping operators started to include the island in their itineraries.[4] The number of visitors rose sharply in May, June, July and November, with the major source markets continuing to be Spain, Italy and Germany (see Chart 3.4).

Construction

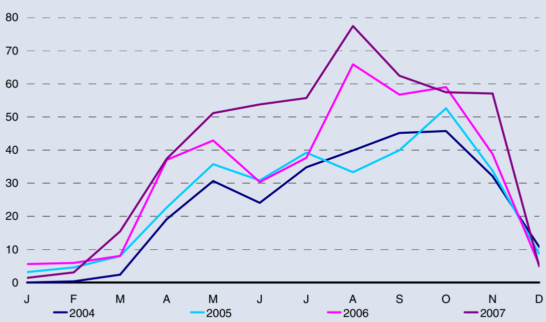
After having increased by 5.9% in 2006, the gross

Chart 3.2
TOURISM INDICATORS
(annual percentage changes)



Source: NSO.

Chart 3.4
CRUISE PASSENGERS
(in thousands)



Source: NSO.

[3] The 'other' category captures all other tourist expenditure except accommodation and airfares.
[4] Cruise passengers are not included in the reported tourist figures.

Table 3.4
CONSTRUCTION ACTIVITY INDICATORS[1]

	2005	2006	2007
Gross value added (Lm millions)	**69.0**	**73.0**	**75.0**
Share of gross value added in GDP (%)	3.4	3.4	3.2
Total employment	**10,565**	**11,212**	**11,444**
Private employment	**7,625**	**8,168**	**8,355**
Share of private sector in total construction employment (%)	72.2	72.9	73.0

[1]Employment data are averages for the first nine months of the year.

Source: NSO.

value added of the construction industry, measured in nominal terms, rose by 2.7% in 2007 (see Table 3.4). According to ETC data, full-time employment in private construction increased by 2.3% during the first nine months of 2007, as against 7.1% in 2006. After having declined in 2006, the industry's average annual gross salary as reported in the LFS rose by 2.3% in the first three quarters of the year, a faster rate than the 1.7% recorded across all other sectors.

At the same time, there was a 9.0% rise in the number of building permits issued during the year. Although still high, the rate of increase was sharply down from the double-digit growth rates of previous years. The preponderance of permits issued in 2007 was for flats, while approvals for other dwelling types declined from the level of the year before (see Table 3.5).

Residential property prices

The rate of increase in residential property prices decelerated further in 2007, to 1.1% (see Chart 3.5), reflecting a slowdown in asked prices for most property types, particularly flats. While prices for finished flats, the predominant category, rose by 1.8%, as against 2.5% a year earlier, those for flats in shell form went up by 1.4%, considerably slower than the 8.5% rise recorded in 2006.

Similarly, growth in asked prices for villas decelerated to 0.9%, from 10.6% in 2006. Prices for maisonettes in finished form and town houses contracted by 4.6% and 7.1%, respectively. On the other hand, prices of terraced houses and houses of character increased by 4.6% and 11.0%, respectively.

The labour market

Labour market conditions tightened in 2007. Statistics for the first three quarters based on the LFS show that the number of persons at work increased by 2.0%, while the labour supply expanded by 1.0%.[5] As a result, the number of unemployed fell by 11.2% (see Table 3.6). In seasonally-adjusted terms, the

Table 3.5
APPROVED DWELLING UNITS BY TYPE

	2003	2004	2005	2006	2007
Flats	4,548	5,265	7,539	8,961	10,252
Maisonettes	1,085	966	1,058	932	696
Terraced houses	414	353	363	375	257
Other	81	123	121	141	138
Total	**6,128**	**6,707**	**9,081**	**10,409**	**11,343**

Source: Malta Environment & Planning Authority.

[5] The LFS is a quarterly survey of the labour market conducted by the NSO using a random sample of 2,500 private households.

unemployment rate dipped to a record low of 5.8% in December, down by 1.1 percentage points on a year earlier (see Chart 3.6).[6]

The survey shows that the activity rate increased by 0.4 percentage points in the first nine months of 2007, to 59.6%, while the employment rate rose by 0.9 points to 55.6%.[7] At the same time, the divergence between private and public sector employment persisted, with employment in the former rising by 4.1%, while that in the latter contracted by 2.7%. The full-time and part-time employment categories each increased by over 1,100 persons.

Labour market statistics for the first nine months of 2007 based on administrative records showed increases of 0.9% in full-time jobs and 0.5% in the labour supply, resulting in a sharp decline in unemployment.[8] In fact the average unemployment rate in 2007, at 4.6%, was almost half a percentage point lower than in the previous year. A further indication of the buoyancy of the labour market was

Table 3.6

LABOUR MARKET INDICATORS BASED ON THE LABOUR FORCE SURVEY[1]

Persons, annual percentage changes

	2006 Jan.-Sep.	2007 Jan.-Sep.	
Labour force	**164,562**	**166,279**	**1.0**
Unemployed	12,251	10,879	-11.2
Employed	152,311	155,400	2.0
By type of employment:			
Full-time	136,962	138,112	0.8
Full-time with reduced hours	1,719	2,487	44.7
Part-time	13,630	14,800	8.6
By ownership:			
Private	104,914	109,261	4.1
Public	47,397	46,139	-2.7

[1] Figures are based on averages for the first three quarters.

Source: NSO.

[6] Eurostat, *Euro Indicators News Release*, 13/2008. Seasonal adjustment corrects the data for seasonal regularities and permits a wider range of inter-period comparisons.

[7] The employment rate and the activity rate represent the number of employed and the labour force, respectively, as a share of the working-age population.

[8] These statistics are compiled from the administrative records of the ETC.

Table 3.7

LABOUR MARKET INDICATORS BASED ON ADMINISTRATIVE RECORDS[1]

Persons, annual percentage changes

	2006 Jan.-Sep.	2007 Jan.-Sep.	
Gainfully occupied	**139,013**	**140,288**	**0.9**
Public sector	**43,806**	**42,470**	**-3.0**
Private sector	**94,666**	**97,367**	**2.9**
Private direct production	**33,048**	**32,912**	**-0.4**
Manufacturing	22,292	21,938	-1.6
Construction	8,168	8,355	2.3
Private market services	**61,618**	**64,455**	**4.6**
Wholesale & retail	21,103	21,184	0.4
Hotels & catering establishments	8,694	8,752	0.7
Transport, storage & communication	7,518	8,038	6.9
Banks & financial institutions	4,669	4,834	3.5
Real estate, renting & business acivities	9,965	11,234	12.7
Other	9,668	10,414	7.7
Temporary employed	**541**	**451**	**-16.6**
Part-time employees	**42,230**	**45,681**	**8.2**
Part-time as a primary job	**23,536**	**25,610**	**8.8**
Part-time holding a full-time job	**18,694**	**20,071**	**7.4**

[1] Figures are based on averages for the first three quarters.

Source: NSO.

the placements-to-vacancies ratio, which dropped to 28.5% from 36.9% in 2006, as a result of a sharp rise in vacancies.

Data on the number of unemployed persons show a declining path almost throughout the year. This was interrupted briefly in August, mainly on account of layoffs in the textiles sub-sector, before it resumed to reach a low of 6,172 unemployed persons in December (see Chart 3.7).

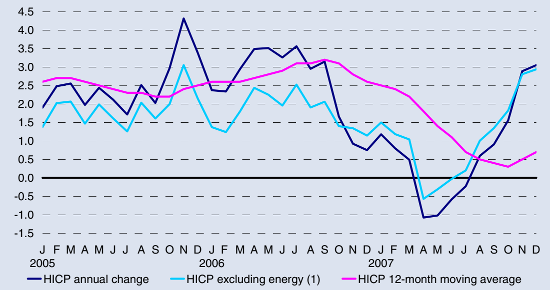
Administrative figures reveal that full-time employment in the private sector expanded by 2.9%, while that in the public sector declined by 3.0%, mainly on account of the privatisation of a telecommunications company in 2006, which led to a re-classification of the company to the private sector. The data also show an increase of 8.2% in part-time employment, as a result of an expansion in both primary and secondary part-time activity.

Within the private sector, employment in manufacturing declined by 1.6%, mostly reflecting the termination of jobs in the wearing apparel sub-sector, where two factories were closed down. In contrast, employment in services firms rose by 4.6%, with the largest gains being registered in the real estate, renting & business activities and the transport, storage & communications sub-sectors (see Table 3.7).

Chart 3.7
REGISTERED UNEMPLOYED
(persons)

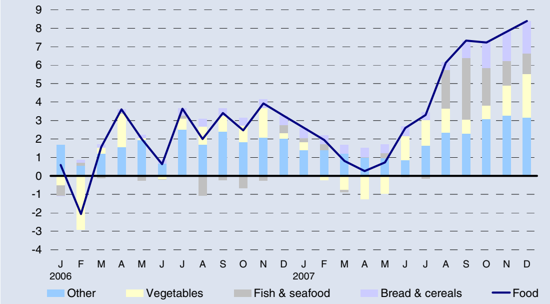
Source: NSO.

Chart 3.8
HICP INFLATION RATES
(annual percentage changes, annual average percentage changes)



(1) Excludes "liquid fuels and lubricants for personal transport equipment" and "electricity, gas and other fuels"
Source: Eurostat.

Chart 3.10
FOOD PRICES
(contribution in percentage points, annual percentage changes)



Source: Eurostat.

Prices and wages

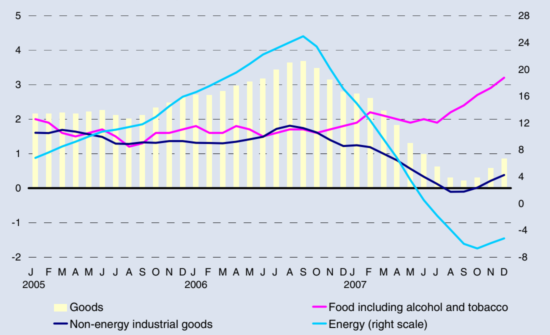
Inflation based on the Harmonised Index of Consumer Prices (HICP)

Inflation in Malta declined substantially during 2007, although in the last quarter price pressures began to emerge. On the basis of the HICP, the average annual inflation rate was 0.7%, 1.9 percentage points lower than in 2006. However, the persistent downward path observed in the year-on-year inflation rate since October 2006 came to an end in April 2007, when it bottomed at -1.1% (see Chart 3.8). This notwithstanding, the year-on-year rate remained negative until July 2007, when it stood at -0.2%. It increased steadily in the subsequent months to end the year at 3.1%. This acceleration was mainly the result of a surge in energy prices to an average year-on-year increase of 4.6% in the last two months of the year, and rising food prices, which led to an average annual increase of 7.7% between September and December.

With regard to the main categories within the HICP basket, the price of goods increased on average by 0.9% during 2007, around two percentage points slower than in the previous year. The average inflation rate in the energy component declined from 17.1% in 2006 to -5.2% in 2007, reflecting stable to lower oil prices during most of the year and a reduction in the utility surcharge from a monthly average of 60.7% in 2006 to 48.6% in 2007 (see Chart 3.9). In contrast, the food index including alcohol and tobacco, which accounts for almost 40% of the goods category, rose by an average of 3.2% during 2007, mainly in response to the persistent rise in prices of imported foodstuffs. In fact, all major food components registered increases, particularly bread & cereals, fish & seafood and vegetables (see Chart 3.10). Meanwhile, clothing and footwear prices increased by 0.4% for the year as a whole, compared with -1.8% in 2006.

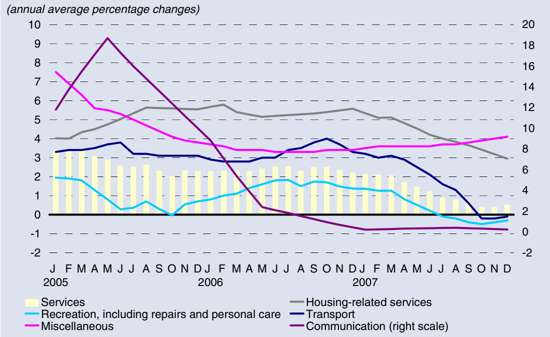
Prices of services moderated as the average increase during the year decelerated to 0.5% from 2.2% in 2006 (see Chart 3.11). This, in part, was attributed to the 0.6% drop in hotel & restaurant prices, compared with

Chart 3.9
INFLATION IN GOODS
(annual average percentage changes)



Source: Eurostat.

Chart 3.11
INFLATION IN SERVICES
(annual average percentage changes)



Source: Eurostat.

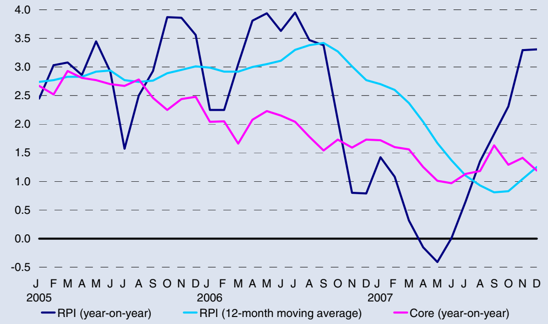
a rise of 1.9% in 2006. Prices of communications services, which had increased at a modest rate during 2006, were virtually unchanged during 2007.

The prices of other types of services advanced at a generally slower pace during 2007. Indeed, inflation in transport and housing-related services fell by 3.4 and 2.7 percentage points, respectively. However, prices of miscellaneous services, such as health and education, rose by an average of 4.1% during the year, 0.7 percentage points higher than the 2006 level.

Inflation based on the Retail Price Index (RPI)

Meanwhile, movements in the RPI to a large extent mirrored developments in the HICP. In annual average terms, growth in the RPI declined from 2.8% in 2006 to 1.3% in 2007. The RPI-based inflation rate was consistently higher than the comparable HICP inflation rate mainly on account of the larger weight assigned to food in the RPI. In fact, during 2007 food items contributed, on average, one percentage point to overall RPI inflation, half a percentage point more than twelve months earlier (see Table 3.8). Furthermore, hotel & restaurant prices, which have a notable impact on the HICP and were trending downward during 2007, are assigned a much smaller weight in the RPI, which consequently did not benefit from the downward movement.

Chart 3.12
RPI AND CORE INFLATION
(annual percentage changes, annual average percentage changes)



Sources: Central Bank of Malta estimates, NSO.

Core inflation index

Core inflation as measured by the Central Bank of Malta stood at 1.2% in 2007, down by 0.5 percentage points from the level recorded in 2006 (see Chart 3.12). The divergence of the core measure from the RPI is mainly due to the exclusion from the former of the fuel-related and food sub-indices.[9]

Wages

Estimates of wage growth based on officially registered collective agreements indicate a moderation to 2.9% in 2007 from 3.5% in the previous year. While collectively negotiated wage growth in the private sector declined from 3.8% in 2006 to 2.6% in 2007, that in the public sector accelerated to 3.5% in 2007, after having slowed down in the previous year. In turn, the

Table 3.8
CONTRIBUTIONS TO RPI INFLATION
Percentage points

	Weights	2005	2006	2007
Food	23.82	0.4	0.5	1.0
Beverages & tobacco	6.11	0.2	0.1	0.1
Clothing & footwear	8.24	0.0	-0.1	0.0
Housing	7.57	0.4	0.4	0.2
Water, electricity, gas & fuels	2.25	0.5	0.7	-0.2
Household equipment & house maintenance costs	7.65	0.2	0.1	0.0
Transport & communications	23.13	0.9	0.8	-0.3
Personal care & health	6.22	0.2	0.2	0.1
Recreation & culture	8.84	0.1	0.0	0.1
Other goods & services	6.17	0.2	0.2	0.0
RPI	**100.00**	**3.0**	**2.8**	**1.3**

Source: NSO.

[9] Core inflation excludes one-off fluctuations and reflects developments only in those sub-indices that show persistent price increases.

Table 3.9
ESTIMATED CHANGE IN NEGOTIATED WAGES
Annual percentage changes

	2005	2006	2007
Private sector	3.8	3.8	2.6
Public sector	2.8	2.4	3.5
Overall	3.5	3.5	2.9

Sources: Central Bank of Malta estimates; Department of Employment & Industrial Relations; Ministry of Finance.

pick-up in public sector wages reflects the back-loaded nature of the six-year collective agreement between the Government and the trade unions covering the civil service over the period from 2005 to 2010 (see Table 3.9).

Broader measures of labour cost developments similarly reflect moderate growth. National Accounts data show that growth in average employment income per employee slowed from 3.3% in 2006 to 1.5% in 2007. To some extent the deceleration in the latter also reflected a downward bias as a result of the lower earning capacity of the part-time category, which had a downward impact on the average income of all employees.

At 1.5%, the increase in nominal compensation per employee exceeded the 1.1% rise in productivity, measured in terms of real GDP per person in employment. As a result, unit labour costs, defined as the wage cost per unit of real output, increased by 0.5% from a year earlier (see Table 3.10). In comparison, unit labour costs in the euro area increased by 1.3%.

Short-term outlook

As in past years, the Bank's forecast for the Maltese economy in 2008 is mainly based on its macroeconomic model. In carrying out this exercise the Bank takes into consideration past relationships between macroeconomic variables for Malta and those of its trading partners, besides using judgemental inputs. Given the small size and high degree of openness of the Maltese economy and its vulnerability to external shocks, the macroeconomic projections remain subject to a higher degree of uncertainty relative to larger and more mature economies.

Assumptions

Before making the forecast a number of assumptions are made. These relate in particular to the expected economic performance of Malta's main trading partners (the euro area countries, the UK and the USA). Another important assumption concerns the domestic fiscal stance during the one-year forecast period.

With regard to the performance of Malta's main trading partners, this is assumed to deteriorate in 2008, with growth rates decelerating in all of these countries. This reflects lower growth in private consumption and investment, as the impact of the turmoil in international financial markets exerts a dampening effect on both these components of aggregate demand. Inflationary pressures in trading partners are also expected to

Table 3.10
EMPLOYEE COMPENSATION, PRODUCTIVITY AND UNIT LABOUR COSTS
Annual percentage changes

	2005	2006	2007
Nominal compensation per employee	2.0	3.3	1.5
Productivity	2.0	2.2	1.1
Unit labour costs	-0.1	1.0	0.5

Source: Central Bank of Malta estimates.

Table 3.11
OUTLOOK FOR SELECTED ECONOMIC INDICATORS
Annual percentage changes

	2006	2007	2008*
GDP growth at constant market prices	3.4	3.8	2.3 - 2.9
Growth in GDP components at constant prices			
Private consumption expenditure	0.7	2.8	1.1 - 1.7
Government consumption expenditure	4.2	0.6	0.9 - 1.6
Gross fixed capital formation	3.0	0.3	2.9 - 3.5
Inventories (as % of GDP)	1.3	2.1	2.1
Exports of goods & services	10.0	-0.6	1.1 - 1.7
Imports of goods & services	8.3	-1.3	0.0 - 0.6
Unemployment rate	7.3	6.3	6.4 - 6.8
HICP inflation rate	2.6	0.7	3.5 - 3.9
Fiscal deficit (as % of GDP)	2.5	1.7	1.4 - 1.8
External goods & services deficit (as % of GDP)	4.0	2.0	2.1 - 2.7

* Central Bank of Malta forecasts.

intensify as the upward trend in oil and food prices persists. An average oil price of USD 91 per barrel is assumed for the year, up by 17% in euro terms from the previous year's level.

As regards the fiscal policy stance in Malta, it is assumed that the deficit will decline to 1.2% of GDP in 2008, as indicated in the *Malta Stability Programme Update 2007-2010*.

A number of assumptions about exchange rates, short-term interest rates and inventory levels in Malta are also made. Thus it is assumed that the average nominal exchange rate of the euro against the US dollar will remain constant at EUR 1=USD 1.46, while Maltese short-term interest rates will remain stable at the levels observed in the first quarter of 2008. As regards inventories, these are assumed to remain unchanged in terms of their share of GDP when compared to the previous year.

The forecast

On the basis of the above assumptions, economic growth in 2008 is projected to slow down to a range of between 2.3% and 2.9%, after having peaked at 3.8% in the previous year, largely under the impact of slower growth in private consumption. In contrast, the contribution of net exports is expected to improve, partly reflecting a positive turnaround in exports. Imports are also expected to expand in real terms, but their growth is likely to be more contained due to the effects of subdued private consumption. At the same time, investment is expected to recover after it had increased only marginally in 2007. Growth in government consumption is also expected to pick up moderately.

The forecast slowdown in private consumption stems primarily from slower growth in real disposable income, as the projected sharp rise in inflation (discussed below) is expected to more than offset the favourable effects of personal income tax relief measures announced in the 2008 Budget. Another factor contributing to the slowdown in private consumption is a projected deceleration in employment growth and a rise in the unemployment rate. Weaker growth in private consumption is also attributable to a base effect resulting from the exceptionally strong growth in 2007, which to a certain extent reflected personal expenditure emanating from hoarded cash balances ahead of the euro changeover.

Stronger growth in government consumption is anticipated as a result of lower growth in sales by government departments and authorities to the public. It is expected that the growth rate will range from 0.9%

to 1.6%, compared to 0.6% in 2007. Meanwhile the government wage bill in real terms is expected to remain stable as public sector employment is projected to be virtually unchanged from the previous year.

Investment is expected to recover in 2008, with the growth rate accelerating to 2.9% - 3.5%, after rising by just 0.3% in 2007. This increase is attributed to private sector sources, as work on the SmartCity project gains momentum and construction activity remains buoyant despite the marked slowdown in house prices. Industrial and commercial investment is also expected to grow further, particularly in the pharmaceuticals sub-sector and in the financial and business services sectors. In contrast, no growth in public sector investment expenditure is expected as higher capital outlays on the infrastructure financed by EU structural funds are expected to be offset by reduced expenditure on the new state hospital following its completion in 2007.

Although external demand is expected to weaken in 2008, export growth is projected to rise within a range of 1.1% - 1.7% compared with a negative growth rate of 0.6% in the previous year. The tourism industry is expected to register further growth as the expansion of flight capacity by low-cost airlines is set to continue. Similarly, the financial services sector, as well as providers of various business services, are expected to continue to record robust growth. In contrast, the manufacturing sector is expected to grow at a slower rate due to increased global competition and the anticipated downturn in economic activity abroad.

The slowdown in private consumption is expected to dampen growth in imports, although the latter are still expected to expand in response to the projected pick-up in exports. Similarly, the recovery in investment should also give rise to higher import leakages, particularly in the form of machinery investment. The net effect of these factors is a projected growth of imports in the range of 0.0% - 0.6%. Meanwhile, export prices should continue to rise, though at pace that is slower than the previous year's and closer to those of Malta's main trading partners.

The forecast developments in exports and imports will be reflected in a widening of the deficit on the goods and services account. This is expected to increase to between 2.1% and 2.7% of GDP, up from 2.0% in 2007. As net export volumes are projected to contribute positively to economic growth, the increase in the deficit is wholly due to the anticipated slower growth in export prices relative to import prices, with the terms of trade expected to remain stable.

Despite the slowdown in Malta's major trading partners, inflation in these countries is forecast to rise, mostly due to persistently high energy and food prices. These developments will have a significant impact on inflation in Malta, where the annual average inflation rate based on the HICP is forecast to rise sharply, to around 3.5% - 3.9%, from 0.7% in 2007. However, the acceleration in HICP inflation is also expected to be underpinned by a rise in hotel accommodation rates. In part, the expected rise in rates is attributable to a continuation of buoyant conditions in the tourism sector during 2008.

Labour market conditions are expected to soften during 2008, reflecting the slowdown in economic growth. While growth in the labour supply is expected to remain relatively stable, employment growth, driven entirely by the private sector, is projected to decelerate to around 1%, down from about 2.7% in the previous year. Thus, the unemployment rate is forecast to rise from 6.3% to a range of 6.4% - 6.8%.

Forecast risk

The projections presented above are dependent to a large extent on the assumptions concerning economic developments in Malta's main trading partners. A sharper than expected slowdown in the major euro area countries, the US and the UK would pose downside risks to Malta's economic growth rate. Such risks could stem from further turmoil in international financial markets, which would give rise to higher interest rate spreads, affecting negatively both consumption and investment abroad. An upsurge in oil and non-energy commodity prices could lead to a further weakening in foreign demand, and hence exacerbate the downside risks to economic growth and upside risks to inflation in Malta.

Offsetting upside risks to economic growth in Malta arise from a continuation of the economic transformation process towards a more services-oriented economy, with particular emphasis on financial and business services, which have been gaining momentum in recent years.

Overall, it appears that the risks to economic growth are somewhat balanced, although there still remains a relatively high degree of uncertainty surrounding the forecasts due to the turmoil in international financial markets and volatility in oil and commodity prices, and their effects on global economic activity.

Box 1: Business and Consumer Confidence

Industrial confidence

Survey results published by the European Commission indicate that the measure of sentiment in the manufacturing sector moved into positive territory during 2007 (see Chart 1). The seasonally-adjusted index added 16 points over the course of the year, mainly reflecting fuller order books. The survey also showed that stocks of finished goods were stable in the first half of the year, declined during the third quarter but then recovered in the last three months of 2007. For the year as a whole, they registered a slight decline. Meanwhile, expectations concerning production levels were optimistic throughout the year.

All major categories of the manufacturing sector reported generally positive sentiment over the year. In the intermediate goods sector the outlook improved significantly, reflecting enhanced current order books. Whereas stocks of finished goods increased in the first half of the year, they had declined somewhat by the fourth quarter so that by the end of the year they were back to the levels recorded at the end of 2006. Expectations about future production orders, whilst remaining positive, declined marginally in December 2007.

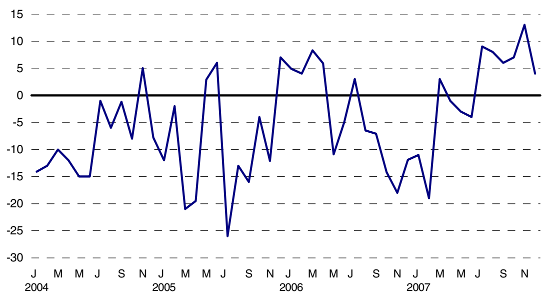
Meanwhile, a high level of confidence was reported by producers of consumer goods, reflecting positive results regarding order books and the utilisation of productive capacity.

In the investment goods sector, producers were initially cautious but their sentiment became more optimistic, reflecting an improved outlook for production, a drawdown of stocks and, to a lesser extent, an expansion in order books.

Consumer confidence

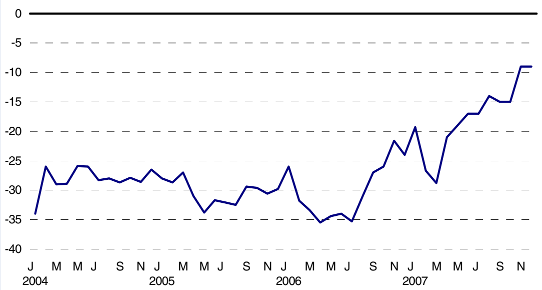
The indicator of consumer confidence, as measured in a survey by the European Commission, improved by 15 points but remained in negative territory (see Chart 2). Respondents are questioned about the general economic situation as well as their personal situation. More positive perceptions were recorded in both areas during 2007, particularly in consumers' outlook on the general economy and on unemployment. A greater degree of optimism was also evident in terms of the financial situation of consumers and their ability to save in the short to medium term.

Chart 1
INDUSTRIAL CONFIDENCE INDICATOR
(seasonally adjusted, percentage points)



Source: European Commission.

Chart 2
CONSUMER CONFIDENCE INDICATOR
(seasonally adjusted, percentage points)



Source: European Commission.

4. The Balance of Payments and the Maltese Lira

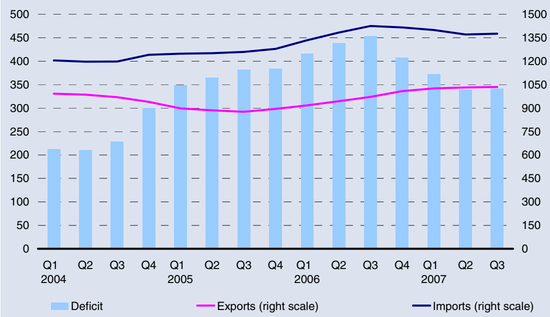
The balance of payments

During the twelve-month period to September 2007 the current account deficit narrowed, falling to 4.3% of GDP from 8.9% a year earlier (see Chart 4.1). Net inflows on the capital and financial account, which were exceptionally high during the previous corresponding period, fell by almost 7 percentage points to 2.1% of GDP.[1] With the current account deficit exceeding the surplus on the capital and financial account, reserve assets declined by Lm82.1 million (EUR 191.2 million) over the period surveyed.

Meanwhile, preliminary information for 2007 as a whole also suggests that the current account deficit narrowed, mainly due to a smaller visible trade gap.[2] This is also supported by a smaller shortfall on net exports of goods and services, as reported in GDP data for the year.

In absolute terms, during the twelve months to September 2007 the current account deficit almost halved on a year earlier, dropping to Lm98.7 million (EUR 229.9 million). This sharp decline was mainly spurred by a smaller goods deficit, which resulted from a decrease in imports and a rise in exports (see Chart 4.2). Meanwhile, net receipts on the services account, which had gathered momentum throughout

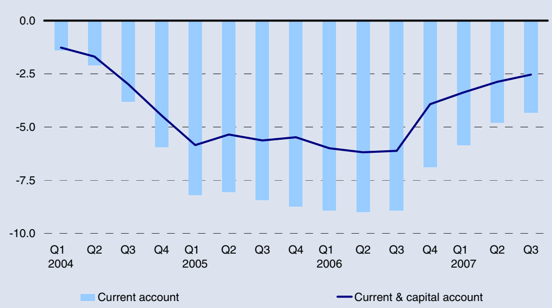
Chart 4.2
GOODS DEFICIT
(four-quarter moving sums; Lm millions)



Source: NSO.

2006, increased slightly over the same period (see Chart 4.3). As the Chart shows, although exports of services extended their upward trend, service payments also rose. Income from transport activities grew, mostly mirroring higher receipts from sea transport services. Net travel receipts also increased, albeit marginally, as higher expenditure by residents travelling abroad almost matched growth in receipts from inbound tourists. On the other hand, net inflows on other services fell as gains from the gaming sector were offset by larger payments effected by banks. Meanwhile, higher net receipts by residents on their foreign investments led to a drop in the negative balance on the income account. However, the transfers account, which is heavily influenced by tax payments effected by companies engaged in international

Chart 4.1
CURRENT & CAPITAL ACCOUNT
(four-quarter moving sums; percentage of GDP)



Source: NSO.

Chart 4.3
SERVICES
(four-quarter moving sums; Lm millions)

Source: NSO.

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[1] In this Chapter flows on the capital and financial account exclude movements in reserve assets.

[2] Data on trade in goods reported in the balance of payments statistics are compiled by adjusting Customs statistics on merchandise trade for coverage, valuation and timing.

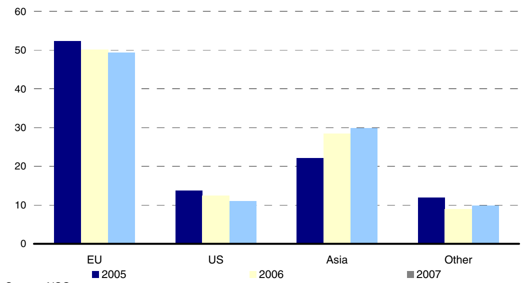
Box 2: Merchandise Trade Developments in 2007

On the basis of Customs data available for the entire year, the merchandise trade gap narrowed by 2.7% in 2007, after having widened by 4.9% in the previous year (see Table 1). While both exports and imports contracted, the latter fell more markedly over the year. This contrasts sharply with the rapid growth in both components recorded in 2006.

Imports were down by 1.4% on the previous year, though this masked significant changes among the various categories. Purchases of capital goods fell substantially, influenced by a base effect, as imports of machinery and seacraft had been exceptionally high during 2006. At the same time, imports of electrical machinery and transport equipment, captured under industrial supplies, decreased, mirroring the decline in foreign sales by the electronics sub-sector. On the other hand, the fuel bill went up by a third, driven by higher import volumes and, to a lesser extent, by rising international oil prices. Imports of food and beverages also rose, influenced by higher global prices for key agricultural commodities, and accounted for most of the increase in foreign purchases of consumer goods.

During 2007 exports contracted by 0.7%. There were significant declines in sales of farmed fish and of electronic machinery & transport equipment.

Chart 1
DIRECTION OF EXPORTS
(percentage share of total)



Source: NSO.

Exports of clothing also fell, with the latter reflecting the continued decline in output by this industry. Conversely, the export performance of the pharmaceuticals industry continued to gather momentum, with exports rising by almost 50%. Foreign sales by firms in the printing sector also grew, while the expansion in the capacity of oil bunkering operations in Malta was reflected in increased exports of mineral fuels.

As regards the direction of trade, the EU remained Malta's largest export market during 2007, accounting for nearly half of total exports, with the euro area alone taking up more than a third. However, exports to the EU and the euro area markets fell, both in absolute terms and as a share of the total. Similarly, exports to the US declined moderately both in absolute terms and as a proportion of the total (see Chart 1). In contrast, the share of foreign sales

Table 1
MERCHANDISE TRADE
based on Customs data, Lm millions

				% change	
	2005	2006	2007[1]	2006	2007
Imports	**1,325.3**	**1,460.0**	**1,440.1**	**10.2**	**-1.4**
Industrial supplies	599.7	713.5	669.4	19.0	-6.2
Capital goods & others	229.0	244.9	210.9	6.9	-13.9
Consumer goods	356.0	370.6	386.5	4.1	4.3
Fuel & lubricants	140.5	130.9	173.4	-6.8	32.5
Exports	**841.0**	**952.3**	**946.0**	**13.2**	**-0.7**
Trade deficit	**484.2**	**507.7**	**494.1**	**4.9**	**-2.7**

[1] Provisional
Source: NSO.

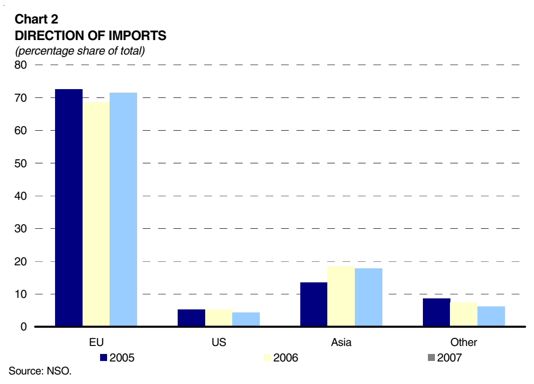


Chart 2
DIRECTION OF IMPORTS
(percentage share of total)
Source: NSO.

to Asia went up by 1.4 percentage points, to 29.8%. Exports to other markets, which are relatively small, accounted for 9.9% of the total, with their share rising by 0.9 percentage points.

On the import side, the EU remained by far the most important source market. After they had declined to 68.7% of the total in 2006, imports from the EU increased to 71.6% in 2007 (see Chart 2). The share of imports from the euro area fell, however, to 54.2%. The proportion of imports sourced from Asia and the US also edged down and accounted for 17.9% and 4.4% of the total, respectively. Imports from other countries fell further.

business activities, posted net outflows, in contrast to net inflows a year earlier.

After having increased substantially during the previous corresponding period, net inflows on the capital and financial account dropped by Lm143.0 million (EUR 333.1 million) to Lm48.4 million (EUR 112.7 million) during the four quarters to September 2007. The decline in capital account inflows was mainly due to the termination of temporary compensating grants associated with EU accession and a fall in grants due under the Italian Financial Protocol. However, as a result of the marked improvement in the current account, the combined current and capital account deficit declined to 2.5% of GDP from 6.2% a year earlier (see Chart 4.1).[3]

Net inflows on the financial account also fell on a year earlier, contracting to Lm7.4 million (EUR 17.2 million) in the twelve months to September 2007. As Chart 4.4 shows, direct investment inflows had risen significantly a year earlier, spurred by privatisation proceeds and capital injections into the banking sector. A part of these inflows were re-invested abroad, leading to concurrent outflows in the combined portfolio and other investment categories. As foreign direct investment inflows declined over the year to September 2007, so did net outflows on the portfolio and other investment accounts. Higher net inflows on the derivatives account also impacted positively on the financial account.

With the current account deficit exceeding the capital and financial account surplus, reserve assets declined by Lm82.1 million (EUR 191.2 million) in the period surveyed as against an increase of Lm90.9 million (EUR 211.7 million) in the comparable period a year earlier. At the same time net errors and omissions turned negative and stood at Lm31.8 million (EUR 74.1 million).[4]

Balance of payments developments during the first

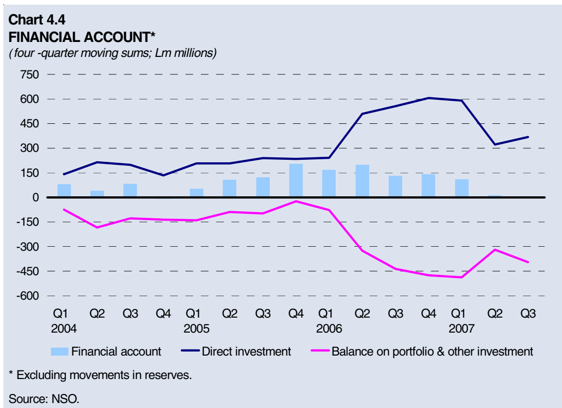


Chart 4.4
FINANCIAL ACCOUNT*
(four -quarter moving sums; Lm millions)
* Excluding movements in reserves.
Source: NSO.

[3] Transfers have a significant impact on both the current and the capital account of the balance of payments. Depending on the use of these transfers, they can be classified either as current account or as capital account items. An analysis of the current and capital accounts combined avoids the difficulties posed by such classification issues.

[4] Negative errors and omissions imply an underestimation of the current account deficit and/or an overestimation of net inflows on the capital and financial account. Conversely, an overestimation of the current account deficit and/or an underestimation of net capital and financial account inflows results in positive errors and omissions.

Table 4.1
BALANCE OF PAYMENTS SUMMARY[1]
Lm millions

	2006 Q1-Q3		2007 Q1-Q3	
	credit	debit	credit	debit
Current account balance		**103.0**		**52.1**
Goods		345.9		279.7
Services	273.1		269.3	
Transport	29.5		35.9	
Travel	137.6		151.2	
Other services	105.9		82.1	
Income		57.1		54.4
Current transfers	27.0		12.6	
Capital and financial account balance[2]	**127.0**			**30.1**
Capital account balance	36.7		13.6	
Financial account balance	90.3			43.7
Direct investment	506.2		268.2	
Portfolio investment		712.3	93.9	
Financial derivatives	9.5		33.2	
Other investment	286.9			439.0
Movements in reserves[3]		**54.6**	**63.2**	
Net errors and omissions	**30.5**		**19.1**	

[1] Provisional.

[2] Excludes movements in official reserves.

[3] Excludes revaluation adjustments.

Source: NSO.

nine months of 2007 followed patterns similar to those outlined for the twelve-month period to September.[5] During this period, the current account deficit contracted markedly on a year earlier, falling to Lm52.1 million (EUR 121.4 million), from Lm103.0 million (EUR 239.9 million) a year earlier (see Table 4.1). A considerable reduction in the visible trade gap reflected a rise in exports and a contraction in imports. To a lesser extent, lower net investment income outflows also impacted favourably on the current account deficit. However, these were dampened by a smaller positive balance on services and a decline in net inflows on the transfers component.

On the capital and financial account, net outflows worth Lm30.1 million (EUR 70.1 million) were posted during the first three quarters of 2007, whereas net inflows of Lm127.0 million (EUR 295.8 million) were registered during the same period of 2006. The swing mainly stemmed from lower net direct investment inflows, which were exceptionally large in 2006. However, the decline was partly outweighed by a drop in net outflows on the combined portfolio and other investment categories. Against this backdrop, reserve assets fell by Lm63.2 million (EUR 147.2 million), while net errors and omissions, though remaining positive, dropped to Lm19.1 million (EUR 44.5 million).

The Maltese lira

Exchange rate developments

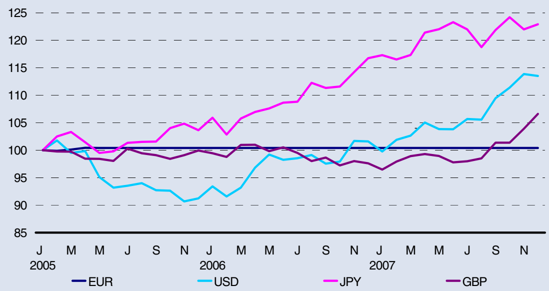
Throughout 2007 the Maltese lira remained unchanged

[5] A fuller analysis of balance of payments developments during the first three quarters of 2007 can be found in the Central Bank of Malta *Quarterly Review* 2007:4.

from its central parity rate in ERM II as the authorities abided by their unilateral commitment to maintain the exchange rate of the Maltese lira at MTL/EUR 0.4293 (see Chart 4.5). On 10 July 2007 in the context of Malta's successful application to join the euro area on 1 January 2008, the ECOFIN Council, in agreement with the Maltese authorities, set the central parity rate as the permanent conversion rate for the lira.[6]

As a consequence of the fixed peg to the euro, the Maltese lira's movements against other major currencies were conditioned by those of the single European currency. Thus, as the euro firmed substantially against the US dollar, the Maltese lira rose sharply, extending the upward trend that was evident since the beginning of 2006. Over the year it gained 11.7%, having reached a high of USD/MTL 3.4632 at the end of November. The euro's rise against the pound sterling was also reflected in the Maltese currency's appreciation against the UK unit: the lira rose by 9.2% after registering strong gains towards the end of the year. In terms of the Japanese yen, the lira ended the year 5.3% higher than its level at the close of 2006 (see Table 4.2).

Chart 4.5
EXCHANGE RATE MOVEMENTS OF THE MALTESE LIRA*
(index of end-of-month rates, January 2005=100)



*A higher index reflects a nominal appreciation of the Maltese lira against the respective currency.
Source: Central Bank of Malta.

Meanwhile, on an average basis, the lira appreciated against the US dollar and the Japanese yen by 9.1% and 10.4%, respectively. Against the pound sterling, it edged up by just 0.4%.

Effective exchange rates

The Nominal Effective Exchange Rate (NEER) of the Maltese lira continued on an upward trend throughout the year. At the end of December it was 2.1% higher than at end-December 2006, driven mainly by strong gains against the US dollar, sterling and

Table 4.2
EXCHANGE RATES OF THE MALTESE LIRA[1]

	EUR	USD	GBP	JPY
Average for 2007	0.4293	3.1920	1.5943	375.5
Average for 2006	0.4293	2.9259	1.5882	340.2
Appreciation(+)/depreciation (-) of the MTL (%)	0.0	9.1	0.4	10.4
Closing rate for 2007	0.4293	3.4291	1.7082	384.2
Closing rate for 2006	0.4293	3.0699	1.5639	364.9
Appreciation(+)/depreciation (-) of the MTL (%)	0.0	11.7	9.2	5.3
High for the MTL during the year	N/A	3.4632 (27 Nov.)	1.7149 (28 Dec.)	392.8 (13 July)
Low for the MTL during the year	N/A	3.0664 (12 Jan.)	1.5256 (22 Jan.)	352.1 (05 Mar.)

[1] The exchange rate of the Maltese lira against the euro is quoted in terms of units of the lira per euro. The other currencies, i.e. the USD, the GBP and the JPY, are quoted per one Maltese lira.

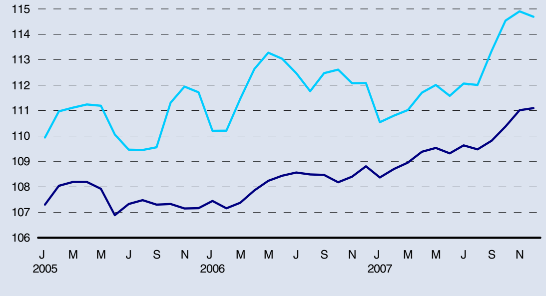
Source: Central Bank of Malta.

[6] The ECOFIN Council refers to the EU Council meeting in the composition of the ministers responsible for economics and finance.

the yen (see Chart 4.6).

The Real Effective Exchange Rate (REER) declined in January, as inflation differentials narrowed, but then increased in response to the nominal appreciation of the domestic currency against major currencies.[7] With consumer price inflation in Malta gaining some momentum toward the end of the year, the upward trend was reinforced. Consequently, over the twelve-month period to December 2007 the lira rose by 2.3% in real effective terms.

Chart 4.6
REAL AND NOMINAL EFFECTIVE EXCHANGE RATES OF THE MALTESE LIRA
(monthly indices, 1995 = 100)



Source: Central Bank of Malta.

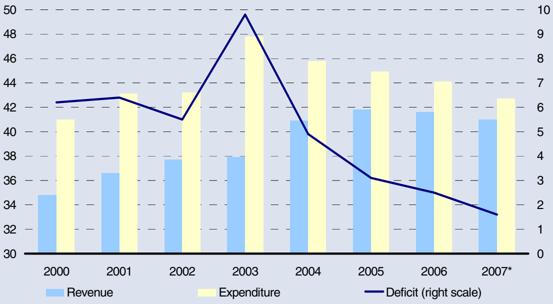
[7] The REER index is compiled by the Central Bank of Malta and is based on movements in exchange rates and consumer prices in 25 countries.

5. Government Finance

The general government deficit fell further in 2007, dropping below 2% of GDP, with revenue increasing more rapidly than expenditure.[1] However, during the first nine months of the year the general government deficit expanded on a year earlier as expenditure grew at a faster pace than revenue, mirroring developments in the Consolidated Fund. The declining trend in the debt-to-GDP ratio was maintained.

In April 2007 the European Commission confirmed that Malta's general government deficit had fallen below the 3% of GDP threshold in 2006 (see Chart 5.1). As a result, on 5 June 2007, the excessive deficit procedure was abrogated, with the ECOFIN Council considering that Malta's deficit had been reduced in a credible and sustainable manner.

Chart 5.1
GENERAL GOVERNMENT REVENUE AND EXPENDITURE
(percentages of GDP)



*Forecast
Sources: Eurostat, Ministry of Finance.

General government deficit and debt

According to Malta's Stability Programme 2007-2010, in 2007 the general government deficit is expected to have contracted to 1.6% of GDP, from 2.5% in 2006 (see Table 5.1).[2] With economic activity picking up, part of the projected improvement in the fiscal position reflects the favourable impact of the business cycle. Nevertheless, the deficit is expected to have narrowed even after taking cyclical factors into account, as shown by the drop in the cyclically-adjusted deficit. This fiscal improvement relied especially on expenditure restraint, in particular moderate growth in compensation of employees. As a proportion of GDP, government expenditure is estimated to have fallen by more than revenue. The ongoing fiscal adjustment is expected to have resulted in a fall of 1.8 percentage points in the ratio of debt to GDP, to 62.9%, mainly on account of a higher primary surplus (see Chart 5.2).[3]

Table 5.1
GENERAL GOVERNMENT INDICATORS
Percentages of GDP

	2006	2007	2008	2009	2010
Revenue	41.6	41.0	40.9	39.9	39.5
Expenditure	44.1	42.7	42.2	40.0	38.5
Interest payments	3.6	3.3	3.2	3.0	2.9
Balance	-2.5	-1.6	-1.2	-0.1	0.9
Primary balance	1.0	1.7	2.0	2.9	3.8
Cyclically adjusted budget balance	-1.7	-1.1	-1.0	-0.4	0.2
Gross debt	64.7	62.9	60.0	57.2	53.3

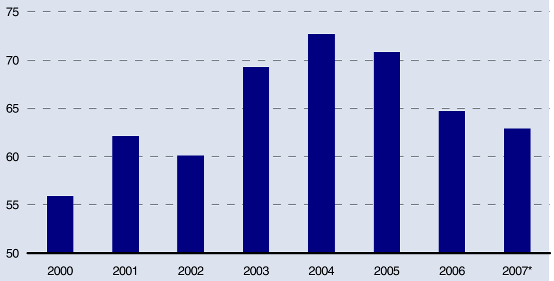
Source: *Stability Programme 2007-2010*, Ministry of Finance.

[1] General government captures all the operations of central government, including extra-budgetary units and local government.

[2] As a new Member State of the euro area, Malta was required to submit a Stability Programme within six months of the Council Decision on its participation in the single currency. The Stability Programme was prepared in accordance with Council Regulation (EC) No 1466/97 as amended by Council Regulation (EC) No 1055/05 and submitted on 30 November 2007.

[3] The primary balance is the difference between revenue and expenditure excluding interest payments.

Chart 5.2
GENERAL GOVERNMENT DEBT
(percentages of GDP)



* Forecast
Sources: Eurostat, Ministry of Finance.

The achievement of the Government's fiscal targets for 2007 hinges on developments in the final quarter of the year. Indeed, data for the first nine months of 2007 indicate that the general government deficit expanded by Lm13.3 million (EUR 31.0 million) on a year earlier, as expenditure grew at a faster pace than revenue. The primary deficit also widened. According to the Government's projections, this should have been reversed in the fourth quarter, largely on the basis of a projected expansion in revenue.

During the first nine months of 2007 general government revenue remained broadly unchanged on a year earlier. Although tax receipts grew strongly, driven particularly by taxes on income and wealth, capital and current transfers fell significantly on account of lower funding received from the EU. The latter reflects a shift in the nature of funding away from automatic budgetary compensation in the years immediately following EU accession towards project-related funding within the financial framework for the period 2007 to 2013.

Expenditure was 2.0% higher than a year earlier, mainly driven by recurrent spending. Almost all major categories of current expenditure increased, with outlays on social benefits and subsidies accounting for a significant proportion of the rise. The former mainly reflected retirement pensions and energy support measures to households, while transfers to public non-financial corporations in the energy sector accounted for the increase in subsidies.[4] In contrast,

Table 5.2
GENERAL GOVERNMENT REVENUE AND EXPENDITURE
Lm millions

	2006	2007 [1]	2006 Q1-Q3	2007 Q1-Q3	Change Amount	Change %
Revenue	**896.4**	**941.1**	**625.2**	**625.5**	**0.3**	**0.0**
Taxes on production and imports	325.3	346.6	238.6	245.0	6.3	2.7
Current taxes on income and wealth	257.4	303.0	163.8	186.0	22.2	13.6
Social contributions	167.6	176.8	117.9	120.2	2.3	2.0
Other	146.1	114.7	104.9	74.3	-30.6	-29.2
Expenditure	**951.1**	**980.2**	**688.1**	**701.7**	**13.6**	**2.0**
Intermediate consumption	122.1	128.5	81.7	84.5	2.8	3.4
Compensation of employees	290.7	296.1	217.8	224.6	6.8	3.1
Subsidies	40.7	48.2	26.5	34.4	7.9	29.8
Interest	76.7	75.8	61.0	56.0	-5.0	-8.2
Social benefits	272.1	282.3	199.8	212.0	12.2	6.1
Gross fixed capital formation	93.7	91.8	58.4	61.1	2.7	4.6
Other	55.1	57.5	42.9	29.1	-13.8	-32.3
Primary balance	**22.0**	**36.7**	**-1.8**	**-20.2**	**-18.3**	**-**
General government balance	**-54.7**	**-39.1**	**-62.9**	**-76.2**	**-13.3**	**-**

[1] Data for 2007 are estimates, as shown in the *Malta: Stability Programme 2007-2010* published in December 2007.

Sources: Ministry of Finance; NSO.

[4] In the 2007 Budget, the Government announced that families eligible for non-contributory benefits would be awarded vouchers redeemable on the payment of utility bills to counter the impact of higher water and electricity charges.

on an accrual basis, interest payments decreased. Moreover, 'other' expenditure fell sharply as a result of the sale of land during the second quarter, which is recorded as negative spending.

Consolidated Fund performance in 2007[5]

With expenditure growing at a slightly faster pace than revenue, the deficit on the Consolidated Fund for the first eleven months of 2007 expanded by 2.5% on a year earlier, to Lm82.0 million (EUR 191.0 million) (see Table 5.3). Similarly, with the absolute rise in expenditure, excluding interest payments, exceeding that in revenue, the primary deficit widened. Therefore, the achievement of the Government's targets laid out in the Financial Estimates for 2008 depends on an acceleration in tax revenues and a pick-up in grants in December.

Revenue

During the first eleven months of 2007 revenue continued to expand, entirely on account of higher tax proceeds, particularly from direct taxes. These offset a drop in non-tax revenue.

Revenue from direct taxes continued to grow rapidly, yielding 7.7% more than in the corresponding period of 2006. Despite the reduction in average effective tax rates as from January 2007, income tax receipts expanded by 11.4% and accounted for more than four-fifths of the increase in direct tax revenue. Higher yields from capital gains tax and from withholding taxes on bank deposits boosted income tax revenues. At the same time, social security contributions added 1.5%, down from 5.7% a year earlier. The entry into force, at the beginning of the year, of lower contribution rates for part-time employees appears to have dampened their rate of growth, despite buoyancy in the labour market. Indirect tax proceeds expanded by 5.5% over a year earlier, partly driven by higher revenues from customs and excise duties. VAT receipts grew less rapidly than in the corresponding period of 2006.

Table 5.3
GOVERNMENT BUDGETARY OPERATIONS
Lm millions

	2006	2007 [1]	Jan-Nov 2006	Jan-Nov 2007	Change Amount	%
Revenue	**877.3**	**905.2**	**734.0**	**747.3**	**13.3**	**1.8**
Direct tax [2]	391.5	431.7	307.9	331.7	23.8	7.7
Indirect tax	338.3	361.8	306.7	323.5	16.8	5.5
Non-tax	147.5	111.8	119.4	92.0	-27.4	-22.9
Grants	59.8	34.5	56.5	21.9	-34.6	-61.2
Expenditure	**935.1**	**954.1**	**813.9**	**829.2**	**15.3**	**1.9**
Recurrent expenditure [2]	798.1	823.3	711.7	740.1	28.4	4.0
Social security benefits	233.5	243.3	213.3	223.8	10.5	4.9
Personal emoluments	203.1	207.1	170.9	174.9	4.0	2.3
Contributions to Government entities	73.7	67.2	67.3	61.1	-6.2	-9.2
Interest payments	77.4	77.1	73.4	73.4	0.0	0.0
Capital expenditure	137.0	130.8	102.2	89.1	-13.1	-12.8
Primary balance [3]	**19.5**	**28.2**	**-6.5**	**-8.5**	**-2.0**	**-30.8**
Balance on Consolidated Fund	**-57.9**	**-48.9**	**-80.0**	**-82.0**	**-2.0**	**-2.5**

[1] Data for 2007 are the revised estimates, as shown in the *Financial Estimates 2008* and the *Budget Speech 2008* published in October 2007

[2] Excluding the state contribution to the social security account

[3] Revenue less expenditure excluding interest payments

Source: Ministry of Finance

[5] The analysis is based on information for the period January to November 2007. The Consolidated Fund captures most of the transactions of central government on a cash basis.

Table 5.4
CHANGES IN GOVERNMENT DEBT
Lm millions

	2006	2006 Jan-Nov	2007 Jan-Nov
Gross government debt[1]	**-39.4**	**-19.5**	**54.8**
Malta Government Stocks	1.3	1.3	58.7
Treasury bills	-29.8	-9.6	-0.7
Local loans	-0.5	-0.5	-0.3
Foreign loans	-10.4	-10.7	-2.8

[1] Excluding government debt held by Sinking Funds.
Source: Central Bank of Malta.

In contrast, non-tax receipts declined by 22.9%, entirely on account of lower grants received from the EU as a result of the shift in the composition of funding referred to earlier. This outweighed an increase in Central Bank of Malta profits transferred to Government and the proceeds received under the Special Registration Scheme.[6]

Expenditure

During the first eleven months of the year expenditure grew by Lm15.3 million (EUR 35.6 million), or 1.9%, over the comparable period of 2006, as further growth in recurrent expenditure was dampened by lower capital outlays. Recurrent expenditure growth, however, accelerated to 4.0% from 3.7% a year earlier. Spending on new measures to offset the impact of increased energy costs accounted for nearly half of the rise. Social security benefits – mainly retirement pensions – also increased significantly. Growth in personal emoluments picked up compared to a year earlier, but remained in line with the salary increases stipulated in the collective agreement covering the Civil Service. In contrast, contributions to government entities declined, largely reflecting a reclassification from this spending category to another.[7]

On the other hand, capital spending continued to fall. After having declined by 6.3% during the first eleven months of 2006, it contracted by a further 12.8% during the period reviewed, mainly reflecting lower outlays on the new state hospital, which was completed and began to operate in 2007.

Gross government debt

The deficit on the Consolidated Fund during the first eleven months of the year was mainly financed by additional long-term borrowing. Consequently, gross government debt increased by Lm54.8 million (EUR 127.6 million) to Lm1,423.2 million (EUR 3,315.2 million).

The composition of the debt also changed (see Table 5.4). Whereas long-term bonds in issue increased by Lm58.7 million (EUR 136.7 million), foreign borrowing declined by Lm2.8 million (EUR 6.5 million) as external debt was repaid. Short-term bills outstanding also contracted marginally, while local loans remained broadly stable. Consequently, Malta Government Stocks (MGS) outstanding at end-November amounted to Lm1,183.4 million (EUR 2,756.6 million), or 83.2% of government debt, while Treasury bills totalled Lm162.7 million (EUR 379.0 million), or 11.4%. Local and foreign loans accounted for 1.7% and 3.7% of the debt, respectively.

[6] The Special Registration Scheme was launched in April 2007 to provide individuals residing in Malta with a one-time opportunity to regularise their position in respect of their holdings of eligible assets in those cases where the associated income had not been declared for the purposes of the Income Tax Act. The Scheme closed on 31 August 2007.

[7] Until 2006 Malta Freeport interest payments were classified under contributions to government entities. In 2007 they were classified under programmes and initiatives.

Medium-term prospects

With regard to medium-term fiscal developments, Malta's Stability Programme shows that the deficit-to-GDP ratio is expected to continue on its downward trajectory over the forecast horizon, turning into a surplus of 0.9% in 2010 (see Table 5.1). This implies that the Government's medium-term objective of a balanced structural budget in 2010 will be attained. The projected reduction in the fiscal imbalance will continue to be mainly based on expenditure restraint, in particular as regards compensation of employees, due to the Government's policy to restrict recruitment in the public sector.

The Stability Programme also projects a gradual decline in the general government debt-to-GDP ratio. Thus, as a result of increasing primary surpluses and GDP growth, the debt ratio should fall to 60% in 2008 and to decrease further to 53.3% by 2010.

6. Financial Stability Analysis

In 2007 favourable domestic economic conditions continued to sustain the financial sector's positive performance. The capital buffer of the banking sector as a whole increased, complemented by an improvement in asset quality, though profits remained at the same level as in the previous year. The same trends were reported by domestic banks, except for a small decline in profits. At the same time, the financial standing of households improved further, reflecting the rise in compensation levels nationally and the fall in the unemployment rate. The corporate sector registered higher gearing and liquidity ratios and stable profitability. These developments also led to an improvement in the quality of bank asset portfolios. Nevertheless, the private sector continued to accumulate debt which, in the case of an economic downturn, could put some strain on repayment capability and, hence, on the banks' profits and capital base. This would be more acute if – given the high concentration of the banks' exposures to real estate – a sharp fall in property prices resulted in a rise in borrowers' default rates.

The deterioration in financial market conditions in 2007 resulted in a weaker economic environment.[1] An extension of this financial turmoil constitutes a downside risk to economic performance. Consequently, the risks to financial stability mentioned above have intensified for the period ahead. Nonetheless, stress-testing of the banks' resilience to extreme but plausible shocks suggests that the major banks would be able to withstand even such strains.[2]

Regulatory and legislative developments

A number of important international initiatives were implemented during the year. The majority of the provisions of Directives 2006/48/EC and 2006/49/EC, implementing Basel II, came into effect on 1 January 2007. The Markets in Financial Instruments Directive (MiFID) 2004/39/EC, which came into force on 1 November 2007, is intended to harmonise the regulatory framework for investment trading while enhancing competition, leading to greater efficiency. Also, in November 2007 the new Payment Services Directive (PSD) 2007/64/EC came in force. This Directive, which has to be implemented by Member States by November 2009, provides the legal foundation for the SEPA and aims to ensure that payments within the EU – in particular credit transfers, direct debits and card payments – become as easy, efficient and secure as domestic payments within a Member State.

Following the Northern Rock debacle, which raised concerns regarding the efficacy of the relevant deposit insurance scheme, the debate on the appropriateness and design of the insurance guarantee schemes adopted by EU Member States intensified. Moreover, partly as a result of the international financial turmoil, the discussions initiated within European and international financial stability fora in 2006 on liquidity risk management took on greater relevance. Meanwhile, in the insurance sector, the third Quantitative Impact Survey (QIS 3) in respect of Solvency II was completed. Solvency II, which establishes a new capital framework for the insurance sector, and which is expected to enhance the protection of policyholders, deepen the integration of the EU insurance market and improve the competitiveness of European insurers, is to be implemented by 2010. In December 2007, the ECOFIN Council agreed to a number of refinements in the so-called Lamfalussy process. These included, among other things, provisions to improve and hasten financial market legislation as well as to strengthen co-operation among cross-border supervisory entities. For the latter to be achieved, the ECOFIN

[1] A sharp increase in home foreclosures in the United States during 2006 was followed by a sharp downward correction in house prices and a subsequent increase in defaults by sub-prime mortgage borrowers. This was the source of the global financial turmoil and the catalyst for the ensuing liquidity crunch, which was still unfolding towards the end of 2007.

[2] The stress tests carried out by the Bank do not take into account feedback and second-round effects and any additional capital requirement for other risks.

Council recommended that mandates of national supervisors should include a provision to co-operate within the EU and to work towards European supervisory convergence, taking into account the financial stability concerns in all Member States. It also invited the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR) to strengthen their internal working procedures.

Domestically, the main legislative developments consisted of amendments to the Investment Services Act and the Financial Markets Act, transposing the provisions of the MiFID to domestic legislation and amendments to the Banking Act transposing EU Directives 2006/48/EC and 2006/49/EC on the new capital requirements framework for banks. Additionally, various insurance rules and legal notices were implemented to transpose the EU Reinsurance Directive (2005/96/EC) and the Directive on Supplementary Supervision of Insurance and Reinsurance Undertakings (1998/78/EC). In late 2007 the Financial Intelligence Analysis Unit published a consultative document on the implementation of Directive 2005/60/EC – the third EU anti-money laundering Directive.

The financial sector

Structural developments

The financial system in Malta remained dominated by banks, which accounted for 72.8% of total assets at the end of 2007. Banks whose business is more internationally-oriented grew faster than domestic banks. Consequently, the share of the latter in total banking assets dropped from 45.6% in 2006 to 37.6%. During 2007 two new credit institutions were licensed, bringing their number to 22, with domestically-controlled banks now accounting for 19.7% of banking assets.[3] The banking sector as a whole remained moderately concentrated, with a Herfindahl-Hirschman Index (HHI) of 1,174 as at end-2007, whereas that of domestic banks was high, at 2,886.[4]

Despite the rapid growth of the insurance sector, its importance within the financial system decreased slightly during 2007. At the end of the year it accounted for 2.8% of total financial sector assets, down from 3.7% as at end-2006.[5] The sector is dominated by a few large principals, as indicated by an HHI of 3,606. During 2007 the number of Collective Investment Schemes (CISs) reached 15, up from 14 as at end-2006, whereas the numer of Professional Investor Funds (PIFs) rose by 14 to 43. One domestic CIS changed its licence and began operating as a domestic PIF.

Product innovation continued to serve as an important competitive tool, particularly within the banking sector. A number of banks launched diverse products during 2007, such as buy-to-let mortgages, free access electronic banking and e-commerce services targeted at businesses. The growing importance of electronic channels has some financial stability implications, as it can alter the risk profile of credit institutions. At the same time, internet banking allows banks to reduce transaction costs and improve their market profile, as well as to reach a broader spectrum of customers.

The banking sector

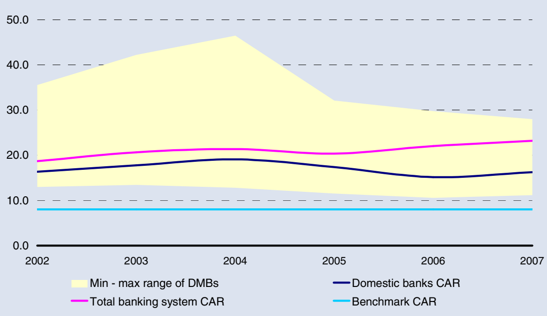
In 2007 the capital adequacy ratio (CAR) of the banking sector as a whole, as well as that of the domestic banks sector, improved by over one percentage point to 23.2% and 16.3%, respectively (see Chart 6.1). An increase in capital, which was partly driven by the introduction of fresh equity, outweighed the expansion in risk-weighted assets (RWA) resulting from strong lending growth. Banks remained adequately covered for credit risk while having an additional buffer for other types of risk. Furthermore, scenario stress testing indicates that capital buffers would remain satisfactory even in extreme tail events related to credit and market shocks.

3 Domestically-controlled banks are those which, on a group consolidated basis, are ultimately regulated by the MFSA.

4 The HHI is a commonly accepted measure of market concentration. A market with an HHI of less than 1,000 is considered to be competitive; a result between 1,000 and 1,800 reflects a moderately concentrated marketplace; whereas a result of 1,800 or over reflects a highly concentrated marketplace.

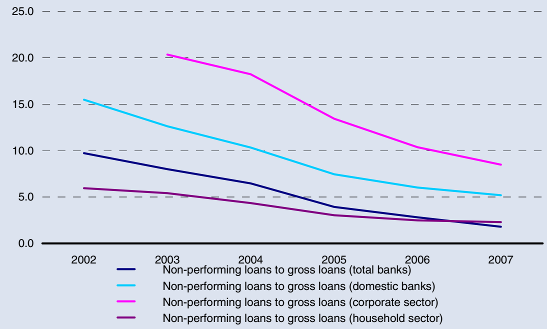
5 The latest data available for the insurance sector relate to September 2007.

Chart 6.1
CAPITAL ADEQUACY RATIOS
(percentages)



Source: Central Bank of Malta.

Chart 6.2
NON-PERFORMING LOANS
(percentages)



Source: Central Bank of Malta.

The total assets of the banking sector grew by 26.0%, double the rate registered a year earlier, reaching Lm16 billion (EUR 37 billion) by the end of 2007. This largely stemmed from growth by internationally-oriented banks, with domestic banks' assets registering a moderate 4.1% increase, a deceleration of 4.5 percentage points from 2006. In both cases, an expansion in lending was the main driver behind this growth, with the share of the loan portfolio in total assets gaining ground at the expense of the securities portfolio. The contraction in the latter was triggered by a fall in the value of securities, as well as by a reallocation of assets following the international financial turmoil. The structure of the liabilities side of the total banking sector remained broadly stable during 2007, despite the considerable changes reported by the domestic banks. Indeed, the latter registered a significant expansion in deposits – partly triggered by the de-hoarding effect related to the euro changeover – while wholesale funding contracted on account of the higher funding costs during the liquidity crunch in the international markets.

The quality of assets continued to improve, with the ratio of non-performing loans (NPLs) to total loans dropping from 2.8% in 2006 to 1.8% by end-2007 (see Table 6.1 and Chart 6.2). This improvement was due both to a contraction in the level of problematic loans and to the statistical effect of a larger loan portfolio (mainly driven by lending to non-residents). Banks continued to reduce their Loan Loss Provisions (LLPs) as the benign economic conditions resulted in lower

Table 6.1

FINANCIAL SOUNDNESS INDICATORS - TOTAL BANKS

(percentages)

	2002	2003	2004	2005	2006	2007
Regulatory capital to risk-weighted assets (CAR)	18.7	20.6	21.3	20.4	22.0	23.2
Regulatory Tier 1 capital to risk-weighted assets (CCAR)	16.1	18.6	18.2	19.0	20.8	21.7
Non-performing loans net of provisions to capital	53.9	38.1	30.0	20.1	12.5	10.3
Non-performing loans to total gross loans	9.7	8.0	6.5	3.9	2.8	1.8
Return on assets (ROA)	0.8	1.0	1.4	1.4	1.3	1.0
Return on equity (ROE)	9.0	9.0	13.2	14.3	11.7	10.7
Interest margin to gross income	71.9	70.9	45.3	48.6	56.3	58.5
Non-interest expenses to gross income	70.5	58.1	47.8	41.3	44.4	51.9
Liquid assets to total assets	24.5	24.4	24.3	21.7	19.5	21.8
Liquid assets to short-term liabilities	54.7	50.0	49.9	55.7	52.2	52.5

Source: Central Bank of Malta.

credit risk, while the coverage ratio dropped by 2.5 percentage points to 29.4% by end-2007.[6] The high concentration in the domestic banks' lending portfolio persisted, with real estate-related loans absorbing 57.0% of total resident loans. This constitutes one of the main sources of risk.

The total banking sector registered stable pre-tax profits. These were translated into a lower return on equity (ROE) and return on assets (ROA), which stood at 10.7% and 1.0%, respectively, as illustrated in Table 6.1. Domestic banks reported a marginal contraction in their pre-tax profits, with a lower operating efficiency affecting both the ROE and the ROA. These fell to 14.6% and 1.6%, respectively, from 15.3% and 1.8% in 2006. During the year, the banks' reliance on interest earning operations increased, as indicated by the rise in the proportion of the net margin to gross income (see Table 6.1). This increase was due both to the steady expansion in the lending portfolio as well as to the upward trend in lending rates. On the other hand, the banks' non-interest income decreased during the year, affected by the turbulence in financial markets which resulted in some banks reporting trading losses.

Market risk remains minimal and adequately hedged. The Bank's stress testing results also confirm the limited risks assumed by the domestic banks. The banks' sensitivity to interest rate changes decreased further, as indicated by duration analysis and by a narrower repricing gap. Foreign exchange risk remained subdued, with banks carrying an overall net long position (excluding euro-denominated positions) of 9.7% of total own funds.

The liquidity position of the banking sector was broadly unaffected by the recent financial turmoil, given the low reliance of banks on interbank funding and their high dependence on retail deposits. Although, as a result of the extreme shortage in wholesale funds, a few domestic banks encountered some difficulties in accessing funds from international institutions, the expansion in retail deposits more than made up for this deficiency. Furthermore, as indicated in Table 6.1, other measures show satisfactory liquidity positions for the banking sector as a whole, as well as for the domestic banks.

The non-bank financial sector[7]

The non-bank financial sector continued to expand during 2007, ending the year with Lm6 billion (EUR 14 billion) in total assets, accounting for around 27.2% of total financial sector assets.

The 19.4% expansion reported by the insurance sector was largely driven by the life business, resulting in further growth in gross premia.[8] Nonetheless, favourable underwriting business was not translated into higher profits for the industry, with both life and non-life insurance registering a lower ROE and ROA. The drop in profits stemmed from weak investment income, possibly as a result of a shift into safer assets. However, despite this reduction in profitability, the risk perception of insurers remained stable, as indicated by steady solvency and risk retention ratios.

The total assets of the investment funds sector (excluding PIFs) surged to Lm1.2 billion (EUR 2.8 billion) in 2007, an increase of 60.6%, mainly attributable to increased business by CISs that transact with non-residents. In contrast, the total assets of domestic CISs – which transact predominantly with residents – contracted by 26.0%. Structural changes, a rising interest rate scenario and, to a lesser extent, the uncertainty instilled by the international financial turmoil have negatively affected the level of investment by residents – predominantly households – in CISs. As a result, the proportion of resident shareholding in the aggregated CIS balance sheet declined considerably, from 76.8% to 32.9%, during the year. The PIF sector continued to expand, with assets rising to over Lm2.2 billion (EUR 5.1 billion). The total assets of those PIFs

[6] The coverage ratio refers only to the amount of provisions set aside by credit institutions against problematic loans and does not take into account collateral held by the banks against such facilities.

[7] Analysis based on annualised September 2007 data.

[8] Based on Central Bank of Malta estimates, gross premia increased by 36% and 5.5% for life and non-life insurance, respectively.

transacting with residents accounted for only Lm59 million (EUR 137 million).

Despite the important intermediary role of the non-bank financial sector, its relatively small size, as well as its limited links with the banking sector and the domestic market, continues to limit the associated risks that might threaten the soundness of the financial system.

The capital market

The Malta Stock Exchange Index increased marginally during the year, closing at 4,938. This rise was largely driven by higher bank equity prices. After a number of years without new issues being placed on the market, three new share issues, in the information technology and transport & shipping industries, were launched during 2007. However, trading activity remained low, as reflected by the volatility, liquidity and turnover ratios.

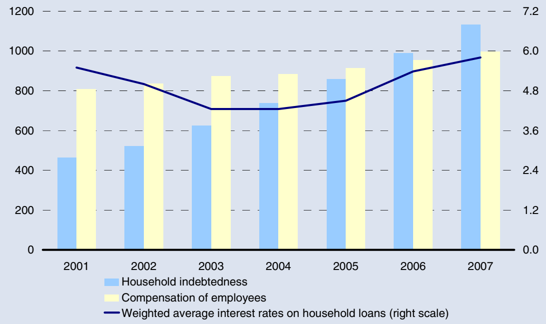
The domestic capital market was virtually insulated from the international financial turmoil. However, it still suffers from structural problems – such as lack of depth – possibly accentuating risks in the event of a domestic shock.

The non-financial sector

The household sector

Household credit demand continued to be a major stimulus for the growth in the banks' lending portfolio, although banks reported a slowdown in demand towards the end of 2007, as indicated by the responses to the Bank Lending Survey (BLS).[9] The expansion in credit demand was also reflected in household indebtedness to banks, which continued to increase throughout the year, reaching 58% of GDP, almost in line with the euro area average. Although the resilience of households to macroeconomic shocks improved, helped by the further accumulation of wealth, the increase in the debt-servicing ratio could result in more debt-repayment problems in the future. The proportion of household NPLs to total household loans remained stable at 2.3%. However, the continued

Chart 6.3
HOUSEHOLD INDEBTEDNESS
(Lm millions, percentages per annum)



Sources: Central Bank of Malta; NSO.

strong growth in household debt during recent years implies a build-up of risks. In fact, shocks to disposable income and wealth remain the major source of vulnerability for households. As indicated in Chart 6.3, household indebtedness continued to increase, while compensation to employees increased at a slower rate during 2007.

The corporate sector

A larger proportion of corporate financing needs was met through the capital market during the year. Nonetheless, borrowing from banks – which remained the main source of external funding for firms – continued to grow during the year, driven primarily by real estate related loans. Risks associated with such lending have grown as a result of cyclical and structural factors. These include both an increase in the mismatch between the supply and the demand for property, and the high concentration of bank exposures to this sector. Indeed, given that corporate bond issuance during the year was related largely to the construction industry, this disintermediation may have partly resulted from tighter standards adopted by credit institutions.

The overall quality of claims on the corporate sector on the banks' books improved further during 2007, in line with the positive developments in various industries, such as tourism. Banks registered a drop in the NPL ratios of all economic sectors – save for the construction industry – with an overall corporate NPL ratio of 8.5%. This, however, is still high by international standards. The improvement was the

[9] The Bank Lending Survey is a questionnaire conducted amongst the major domestic banks on a quarterly basis. As from December 2007, it is being carried out within the ambit of similar regular exercises conducted by the Eurosystem.

result of the benign economic conditions supported by the increased financial strength of the corporate sector, which registered an improvement in its gearing and liquidity positions while recording broadly unchanged profitability compared with 2006.[10]

Risk outlook

The risk outlook for the domestic financial sector deteriorated slightly during 2007 and consequently became more uncertain.

The favourable domestic macroeconomic conditions continued to be reflected in an overall improvement in the financial position of the non-financial sector. As a result, the asset quality of the banks' lending portfolio improved, with liquidity and market risks remaining negligible. However, as a consequence of the global economic slowdown, which is likely to result in a deceleration of the domestic economy, cyclical weaknesses in the financial sector could render some of its current structural weaknesses more acute. This would make the sector more vulnerable to an aggravation of risks. Although the financial condition of the household sector in general remains strong, the build-up of debt continued while debt-servicing capability appears to have deteriorated during the year. As for the financial position of the corporate sector, although this appears to have strengthened, there are indications of strain within the property and construction sectors. Thus, any deterioration in macroeconomic conditions could result in a reversal of the current improving trend in asset quality. This makes the domestic financial stability outlook more uncertain.

[10] The liquidity, gearing and profitability of the corporate sector are based on 2007 interim results of listed companies.

Part II

BANK POLICIES,

OPERATIONS AND ACTIVITIES

1. The Conduct of Monetary Policy

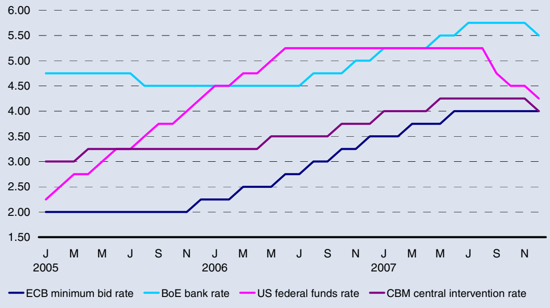
The past year was the last during which the Central Bank of Malta was responsible for the formulation and implementation of monetary policy in Malta, with its main objective being that of maintaining price stability. The Bank pursued this goal through the maintenance of a fixed exchange rate for the Maltese lira in ERM II. In line with this strategy, the Bank continued to orient its monetary policy stance to support the exchange rate peg. The latter remained unchanged at the central parity rate of MTL/EUR 0.4293 in line with the commitment made by the Maltese authorities upon entry into ERM II in May 2005 to eschew the use of the fluctuation bands permitted by the mechanism.

After Malta achieved all the Maastricht convergence criteria in April, the ECOFIN Council approved Malta's entry into the euro area in July. Consequently, on 1 January 2008, Malta adopted the euro as its national currency and the Central Bank of Malta ceased to be directly responsible for monetary policy. The Bank, however, contributes to the formulation of monetary policy for the euro area as a whole through the Governor's participation in the Governing Council of the ECB. The Bank has the task of implementing in Malta the ECB's monetary policy, whose primary objective is the achievement of price stability.

During 2007 monetary policy decisions were taken by the Governor following meetings of the Bank's Monetary Policy Advisory Council (MPAC). The MPAC also included the Deputy Governor, the three non-executive members of the Board and the Directors of the Bank's Economics & External Relations, Financial Markets and Financial Stability Divisions. The MPAC was dissolved on 31 December 2007.

The Bank tightened its monetary policy stance twice during 2007. In response to a decline in the Bank's external reserves and a marked narrowing of interest rate differentials in favour of the Maltese lira, the Bank increased the central intervention rate by 25 basis points to 4.00% on 25 January, and by an additional quarter of a percentage point to 4.25% on 29 May (see Chart 1.1). Official interest rates then remained unchanged until 28 December, when the Bank lowered its central intervention rate to 4.00% to bring it in line with the minimum bid rate on the main refinancing operations set by the ECB ahead of its entry into the Eurosystem at the beginning of 2008.

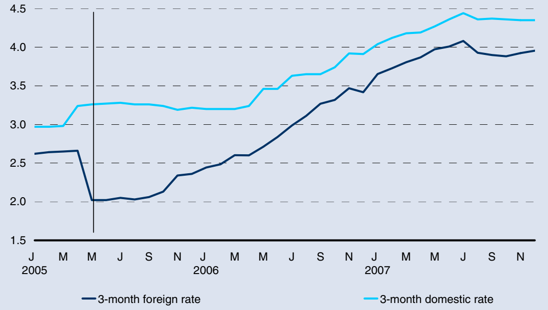
Chart 1.1
OFFICIAL INTEREST RATES IN MALTA AND ABROAD
(percentages per annum, end of month)



Sources: Central Bank of Malta; Reuters.

The increases in the central intervention rate in January and May resulted in corresponding rises in domestic money market rates (see Chart 1.2).[1] However, the increase in the three-month Treasury

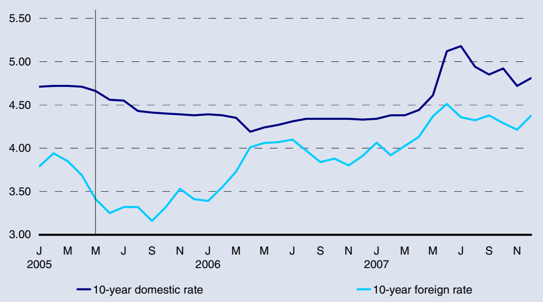
Chart 1.2
DOMESTIC AND FOREIGN SHORT-TERM MARKET INTEREST RATES
(percentages per annum, end of month)



Sources: Central Bank of Malta; Reuters.

[1] The foreign interest rates shown in Charts 1.2 and 1.3 are computed as basket-weighted averages of the relevant interest rates on the euro, the pound sterling and the US dollar until April 2005. Euro interest rates are shown thereafter. Short-term rates refer to yields on three-month government securities, while ten-year rates are government bond yields.

Chart 1.3
DOMESTIC AND FOREIGN LONG-TERM INTEREST RATES
(percentages per annum, end of month)



Sources: Central Bank of Malta; ECB.

bill rate was outpaced by a simultaneous rise in euro interest rates on similar instruments. As a result, the three-month premium on the Maltese lira contracted in the first half of the year, falling from almost 50 basis points in December 2006 to a low of 30 basis points in May. The premium recovered in the second half of the year as the ongoing turmoil in international financial markets caused yields on three-month government securities in the euro area to decline persistently, so that at the end of December the premium on the lira had widened to 40 basis points.

Similarly, the ten-year premium on the Maltese lira generally declined during the first five months of 2007, falling by 18 basis points from its end-2006 level to 24 basis points in May (see Chart 1.3).[2] The premium widened thereafter, as a drop in the demand for domestic fixed-interest securities in an environment of rising interest rates both in Malta and overseas led to a significant rise in yields on long-term government bonds. As a result, the premium ended the year at 43 basis points.

External reserves management

Throughout 2007 the Central Bank of Malta continued to maintain an adequate level of external reserves to safeguard the external value of the Maltese lira. According to the Central Bank of Malta Act, the Bank was obliged to hold external reserves equivalent to not less than 60% of its currency and deposit liabilities. In managing its reserves, the Bank sought to diversify its portfolio to maintain its value and maximise its return within the established risk parameters. At the same time, it ensured that conditions in the local foreign exchange market remain stable.

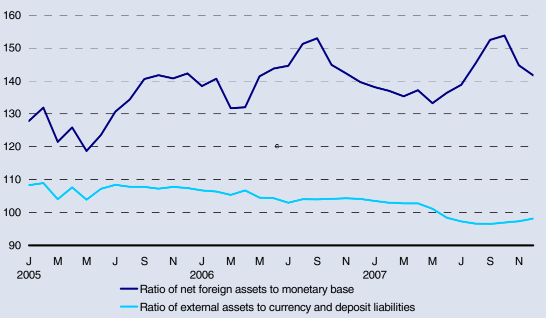
The Investment Policy Committee (IPC) continued to formulate the Bank's investment policy, monitor the performance of the external reserves, evaluate the implementation of investment strategies and review the operational and risk framework underpinning reserve management practices. The IPC is chaired by the Governor and includes senior officials of the Bank. During 2007, the IPC met on a monthly basis.

In the light of the above reserve management objectives, the Bank uses extensive quantitative and qualitative techniques to ensure that any possible losses arising from market and credit risk exposures are kept within the levels prescribed by the IPC and the Board of Directors, respectively. To align its risk management practices more closely with those of the ECB, during 2007 the Bank introduced a more prudent risk management concept, known as the 'second best rating' to bond holdings, in cases where the latter are rated by several agencies.

In fulfilling its obligation to support the exchange rate peg, throughout 2007 the Bank also acted as market-maker in the foreign exchange market, issuing daily spot and indicative forward exchange rates for the Maltese lira against major currencies. Since joining ERM II, all spot transactions effected by the Bank with credit institutions were denominated in euro. In 2007, the Bank continued to be a net seller of foreign currency to credit institutions in the spot market, in part reflecting the extraordinary demand for foreign exchange ahead of the euro changeover. Foreign currency sales totalled Lm141.8 million (EUR 330.3 million), while purchases amounted to Lm1.1 million (EUR 2.6 million). No swap transactions took place during the year. The Bank ceased acting as market-maker in the domestic foreign exchange market on 31 December 2007.

[2] Until November 2006 ECB data on euro area bond yields were compiled on the basis of national government bond yields weighted by the nominal outstanding amounts. From December 2006 onwards euro area yields are computed on the basis of AAA-rated euro area central government bonds.

Chart 1.4
CENTRAL BANK OF MALTA NET FOREIGN ASSETS
(percentages)



Source: Central Bank of Malta.

The ratio between the Bank's external reserves and its currency and deposit liabilities remained considerably higher than the statutory minimum limit. However, it declined through most of 2007, reaching its lowest point in September at 96.5% (see Chart 1.4). The ratio recovered slightly during the last quarter of the year, ending the year at 98.2%.

During the first half of 2007 there was a consistent decline in both the net foreign assets of the Bank and the monetary base. Going into the second half of the year, the net foreign assets reversed their downward trend but the decline in the demand for domestic currency persisted in anticipation of the euro changeover. As a result, the Bank's net foreign assets expressed as a proportion of the monetary base contracted between January and May before recovering during the following five months, peaking in October at 153.8% (see Chart 1.4). The ratio of net foreign assets to the monetary base dipped during the last two months of the year, ending December at 141.7%.

Transactions in the foreign exchange market, excluding deals between the Bank and the rest of the banking system, amounted to Lm3.4 billion (EUR 7.9 billion) as opposed to Lm3.0 billion (EUR 7.0 billion) in 2006. Meanwhile, activity in the interbank foreign exchange market increased slightly in 2007, rising to Lm57.6 million (EUR 134.2 million) from Lm54.3 million (EUR 126.5 million) in the previous year. The value of foreign exchange transactions between credit and financial institutions and their customers amounted to Lm2.8 billion (EUR 6.5 billion), up from Lm2.6 billion (EUR 6.1 billion) in 2006.

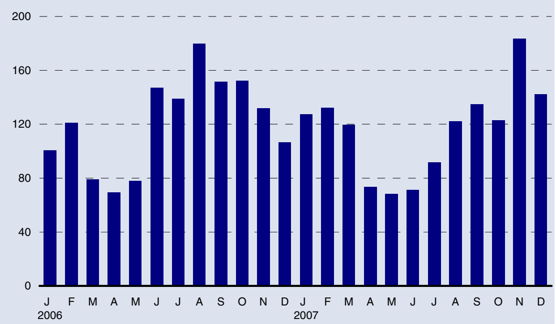
During 2007 the Bank continued to collect daily statistics related to foreign exchange transactions against the Maltese lira. These were transmitted to the ECB as part of the daily exchange of information between the ECB and NCBs regarding developments in foreign exchange markets in ERM II member countries. During the year, the Bank also participated in a number of ERM II intervention simulation exercises conducted with the ECB and selected NCBs. The Bank also continued to provide advice to the Government and public sector organisations on external financing.

Open market operations

Throughout the year the Bank engaged in open market operations to ensure that the level of liquidity in the banking system and, hence, short-term interest rates, remained compatible with its monetary policy stance. Interventions in the money market were typically conducted by means of weekly auctions of term deposits. Reflecting an overall excess of liquidity, the Bank absorbed a total of Lm6.2 billion (EUR 14.4 billion) through term deposit auctions, a comparable amount to that absorbed in the previous year. At the end of 2007, outstanding term deposits stood at Lm142.3 million (EUR 331.5 million) (see Chart 1.5). Reverse repos were not utilised during the year. [3]

In line with movements in the central intervention rate,

Chart 1.5
OUTSTANDING TERM DEPOSITS
(Lm millions)



Source: Central Bank of Malta.

3 In a reverse repo, the Bank injects liquidity into the banking system by agreeing to buy eligible securities from a bank and to sell back that collateral at an agreed price when the contract expires.

the weighted average rate of interest paid on term deposits rose from 3.70% at end-December 2006 to 3.95% in January. The rate increased by an additional quarter of a percentage point in May, reaching 4.20%, before falling back to 3.95% in December following the alignment of the central intervention rate with the minimum bid rate of the ECB.

Standing facilities

Throughout 2007 the Central Bank of Malta also offered overnight deposit and lending facilities to absorb or inject liquidity at the request of eligible credit institutions. The marginal lending facility consists of an overnight loan facility secured by a pledge of collateral. This facility was only used twice by credit institutions during the year and the amount borrowed amounted to Lm0.8 million (EUR 1.9 million) as opposed to Lm3.6 million (EUR 8.3 million) in 2006. Meanwhile, the overnight deposit facility was utilised more frequently, with the volume of transactions amounting to Lm237.8 million (EUR 553.9 million), an increase of Lm82.9 million (EUR 193.1 million) over the previous year.

The interest rates on the two facilities set a lower and an upper bound for overnight interbank interest rates. While the interest rate on the overnight deposit facility was set at 100 basis points below the Bank's central intervention rate, the interest rate charged on the marginal lending facility was 100 basis points above the central intervention rate. Both rates moved in tandem with the central intervention rate, ending the year at 3.00% and 5.00%, respectively.

To ensure an efficient implementation of the Eurosystem monetary policy operational framework as from 1 January 2008, extensive testing on the conduct of Eurosystem open market operations, liquidity forecasting and collateral management was carried out throughout 2007.

Reserve requirements

In terms of the Central Bank of Malta Act, the Bank obliged credit institutions to maintain a certain minimum amount of reserve deposits with it. This provided the Bank with an additional monetary policy tool for controlling money and credit growth and for maintaining stable money market interest rates.

Throughout 2007 the reserve requirement ratio was left unchanged at 4% of the credit institutions' specified liabilities. However, credit institutions were allowed a certain degree of flexibility in managing their liquidity, as balances in these accounts could vary as long as the requirement was met on average during the maintenance period.

For most of the year, the remuneration rate paid on reserve requirements held in Maltese lira was linked to the Bank's central intervention rate, less a margin. Therefore, in line with the rise in the central intervention rate, the Bank increased the remuneration rate applied to reserve requirements from 3.50% in December 2006 to 3.75% and 4.00% in January and May, respectively. From 15 November 2007, however, the remuneration rate was linked directly to the central intervention rate and was raised to 4.25%. Following the alignment of the central intervention rate with the ECB's minimum bid rate in December, the remuneration rate was lowered to 4.00%.

In November, in preparation for the adoption of the euro, the Bank amended Central Bank of Malta Directive No 1, which deals with minimum reserve requirements. The amendments catered for the introduction of an exceptional maintenance period running from 15 November to 31 December 2007. The Bank also changed the method used in the computation of minimum reserve requirements, redefined the reserve base to align it with that used in the euro area and linked the remuneration of reserve deposits directly to the central intervention rate or the ECB's minimum bid rate, depending on the currency in which they were held. In addition, all exemptions previously granted in terms of the Directive expired. As a result, as from 15 November 2007, all credit institutions established in Malta became obliged to maintain reserve deposits with the Bank.

As from 1 January 2008, the ECB's regulations on minimum reserve requirements entered into force. In particular, this entailed the lowering of the reserve requirement ratio from 4% of the reserve base to 2%.

Market making operations

During 2007 the Bank continued to act as market-maker in the secondary market for Malta Government Stocks (MGS) and Treasury bills. In so doing, the Bank ensured adequate secondary market liquidity and enhanced investor confidence in the market. Nonetheless, in line with the Central Bank of Malta Act, the Bank did not participate in the primary market for government securities and did not provide any other form of financing to the Government.

The Bank continued to publish daily opening indicative bid prices and yields for all listed MGS as well as daily buying and selling rates for Treasury bills. In addition, the Bank also quoted International Securities Market Association (ISMA) redemption yields for MGS on a daily basis.[4] A major development during 2007 was the dematerialisation of Treasury bills in April. These were then listed on the MSE. Thereafter, all outstanding Treasury bill certificates ceased to be negotiable in the secondary market and only bills registered in electronic form in the Central Securities Depository of the MSE were eligible for secondary market trading.

The Bank also continued to collect and analyse data on government debt so as to be able to fulfil its role as advisor to the Maltese Government on debt management matters. In addition, during the final quarter of the year, a working group made up of representatives from the Treasury, the Economic Policy Division, the MSE and the Central Bank of Malta was set up. The objective of this group is to discuss proposals to ensure a smooth and effective integration of the domestic government securities market into the international euro bond market, and to formulate a debt restructuring programme aimed at making Maltese Government debt more marketable in a competitive European market.

The Financial Markets Committee (FMC), which provides a forum for the regular exchange of views and information between the Bank and credit institutions on market-related issues, met eight times during 2007. It discussed developments in the primary and secondary markets for Malta Government securities as well as issues related to the foreign exchange markets. Other major topics discussed were mostly related to the euro changeover process and the Eurosystem monetary policy and collateral management frameworks, interest rate conventions, the dematerialisation of Treasury bills and TARGET2 operating time.

[4] ISMA yields represent an annualisation of the yields-to-maturity, hence making yields on MGSs, which pay interest on a semi-annual basis, comparable to those on bonds that pay interest annually.

Box 3: Preparations for Euro Adoption

Preparations for the adoption of the euro were the highlight of the Bank's activities during 2007 and were spread across the entire spectrum of the Bank's operations.

Participation in institutional structures

At the institutional level, the Governor was a member of the Steering Committee for Euro Adoption, chaired by the Parliamentary Secretary in the Ministry of Finance. The Deputy Governor was the Deputy Chairman of the NECC. He also chaired the Financial Services Sectoral Committee of the NECC, which played a key role in implementing those aspects of the changeover related to finance and banking and was responsible for updating major sections of the National Euro Changeover Plan.

The Bank was also a participant in the MBA Euro Adoption Sub-committee, which discussed various issues related to banking and finance, including anti-money laundering procedures during the changeover and the interest rate convention on euro adoption. The sub-committee also examined advertising material issued by the Association and discussed logistics with regard to ATMs and EPOS machines.

Key events involving the Bank

Key events forming part of the preparations are highlighted below. They are described in greater detail elsewhere in this Report.

In January the Bank entered into an agreement with the Monnaie de Paris for the minting of euro coins with the Maltese national side. Concurrently, a Memorandum of Understanding was signed between the President of the Eurogroup, the EU Commissioner for Economic and Monetary Affairs and the Governor on the start of euro coin production and related preparatory tasks.

In February the House of Representatives amended the Central Bank of Malta Act (Cap 204) to cater for the Bank's membership of the Eurosystem, bringing the Act in line with the relevant provisions of the EC Treaty and the Statute of the ESCB and the ECB. The Act was amended again in March to fully reflect the ECB's powers in its fields of competence. The amending legislation was published on 2 March 2007 and 16 March 2007, respectively, and came into force on 1 January 2008.

At the end of February the Governor and the Prime Minister formally requested the ECB and the European Commission for a Convergence Report under Article 122 of the Treaty. Both Convergence Reports were published in May and were discussed by the Economic and Financial Committee and the ECOFIN Council. In June, the ECOFIN Council and the Heads of State and Government agreed with the assessment of the European Commission and the ECB that Malta had achieved a high degree of sustainable convergence and fulfilled the necessary conditions for euro adoption. Therefore, on 10 July, the ECOFIN Council confirmed Malta's entry into the euro area and fixed the irrevocable conversion rate for the Maltese lira at MTL/EUR 0.429300.

Soon after the confirmation of the euro adoption date, the minting of the Maltese euro coins commenced, with the first deliveries reaching Malta in September. At the end of the month, the ECB and the Central Bank of Malta launched their joint communications campaign for the euro changeover. Indeed, a substantial part of the Bank's communications strategy during 2007 was related to the euro, particularly the appearance of the notes and coins and their security features.

In November the Bank revised the framework governing minimum reserve requirements to align it more closely with that used by the Eurosystem. Later that month, Malta joined TARGET2 as part of the first wave of countries to use this new payment system. In December, starter kits made up of Maltese euro coins began to be distributed to retailers and the general public.

On 28 December the Bank aligned its official interest rates with those of the ECB and the Bank's Monetary Policy Advisory Council was formally dissolved at the end of the year.

Throughout the year, preparations for euro adoption entailed substantial work on the Bank's IT infrastructure. Moreover, work was carried out to ensure that accounting systems, statistics and payment and settlement systems were smoothly integrated into those of the ECB. In addition, extensive security arrangements were put in place. Where relevant, the Bank also introduced the dual display of prices as required by law.

2. Financial Stability

One of the statutory tasks of the Central Bank of Malta is to ensure the stability of the financial system. The Bank carries out this task through regular monitoring, including of the domestic payment and securities settlement systems. This enables the early detection of emerging trends that may threaten the stability of the system. The Bank's assessment is shared and discussed with other relevant authorities, which are jointly responsible for the introduction of preventive corrective measures as deemed necessary. In carrying out this function, the Bank continues to contribute to the work of the Banking Supervision Committee (BSC) of the ESCB. The latter provides a forum for co-operation among the EU national central banks, the ECB and the relevant supervisory authorities.

The Bank assesses the soundness of the financial system through research and analysis of financial data, the interpretation of financial soundness indicators and the identification of risk exposures that could lead to vulnerabilities. The overall assessment of systemic risks and vulnerabilities apparent in the balance sheet and profitability of the financial system is supplemented by market intelligence. This is further complemented by an assessment of developments in the corporate and household sectors and their implications for the stability of the financial sector as a whole. Moreover, to ascertain the robustness of the capital base of credit institutions in the event of exceptional but plausible adverse events, a number of stress tests are carried out. Against this background, the Bank continued to enhance its early warning system and to develop a macro stress-testing model. The latter will help the authorities to assess the possible impact of macroeconomic events on the financial system.

The Bank shares its findings with the Ministry of Finance and the MFSA and publishes a summary of its analysis on financial stability in its *Quarterly Review* and *Annual Report*.

The Standing Committee established through a memorandum of understanding (MOU) between the Bank and the MFSA continued to meet periodically during the year to discuss matters of mutual interest relating to the financial system and to exchange relevant information.

Meanwhile, in June, a Working Group for Co-operation in the Management of Financial Crises consisting of senior representatives of the Bank, the Ministry of Finance and the MFSA, completed its work and presented its proposals on the setting up of a domestic framework to deal with financial crises. These proposals were accepted in principle by the respective authorities, with a High Level Executive Committee being set up to co-ordinate the resolution of any eventual financial crisis. In addition, a Domestic Standing Group, chaired by the Deputy Governor of the Bank and comprising senior representatives from the Bank, the MFSA and the Ministry of Finance was established. This is a permanent body that meets regularly to assess financial stability risks and vulnerabilities that may lead to a crisis. It met twice during 2007. In September a financial crisis simulation exercise was undertaken with the participation of the members of the High Level Executive Committee and the Domestic Standing Group. The objectives of the exercise were to test communications and information sharing between the relevant authorities, the co-ordination of decision making during a crisis and the management of potential conflicts of interest. These objectives were achieved, though a number of weaknesses were identified.

Meanwhile, the Bank continued to participate actively in the BSC of the ESCB and in its associated working groups. In view of its responsibilities regarding the management of financial crisis situations, the Bank also took part in the BSC Task Force on Crisis Management. Other *ad hoc* task forces under the BSC structure, in which the Bank was represented, addressed topics particularly relevant to the monitoring of financial stability at both the national and the EU level. Finally, the Bank, jointly with the MFSA, continued to attend meetings of the EU Committee of European Banking Supervisors.

The Bank, along with another sixty-one countries, continued to participate in the long-term IMF initiative relating to the compilation of financial soundness indicators. This forms an important part of the Fund's Financial Sector Assessment Programme. During 2007 the first phase of the project was finalised, with the first set of data and metadata being published by the IMF in January 2007.

3. Currency, Payment Systems and Banking Services

The Central Bank of Malta played a central role in 2007 as regards the changeover of the domestic currency to the euro. In particular, it was responsible for the procurement of euro coins and notes and co-ordinating their distribution to the banks. In addition, as sole issuer of the domestic currency, the Bank continued to ensure that the supply of notes and coins was at all times sufficient to meet the needs of the public, that the currency in circulation was fit for use and that any counterfeits were quickly detected.

The Bank also continued to develop the payment and securities settlement infrastructure to enhance its efficiency and thus ensure a smooth transition to the adoption of the single currency. As banker to the Government and to the rest of the domestic banking system, the Bank continued to provide banking services to the public sector and to credit and financial institutions in Malta.

Figure 1: THE NATIONAL SIDES OF THE MALTESE EURO COINS

Currency operations

During 2007 the Bank was directly involved in the acquisition of euro banknotes and coins as well as their frontloading, or advance delivery, to the banks. Additionally, it continued to meet the Maltese currency requirements of the banking sector. It took in currency notes and coins surplus to requirements and issued them in line with the demand of the banking system. It also examined notes and coins regularly to ensure a high quality standard was maintained. Notes and coins that were deemed unfit for circulation were destroyed.

Minting of euro coins

In January 2007, following an international call for tenders issued in 2006, the Bank signed a contract for the minting of the Maltese euro coins with the Monnaie de Paris, the French state mint . The Maltese variants of the euro coins, depicting a neolithic altar, the emblem of Malta and the eight-pointed Maltese cross, which can be seen in Figure 3.1, were designed by the Maltese artist Noel Galea Bason. The minting of 200 million euro coins started in mid-July 2007, with the first consignment arriving in September. Coin deliveries were spread over a period of seven weeks, lasting to mid-October. The coins were delivered directly to the main commercial banks as well as to the Bank's coin depot in Luqa. The Monnaie de Paris was also entrusted with the packaging of the introductory euro coin kits for use by retailers and the public. These contained coins to the value of Lm56.24 (EUR 131.00) and Lm5.00 (EUR 11.65), respectively. The retailer kits began to be distributed from 1 December, while the mini-kits were made available to the general public from 10 December.

Supply of euro currency notes

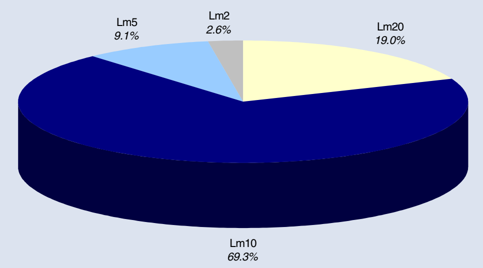
In preparing for the provision of euro currency notes to the banking system from January 2008, the Bank entered into an agreement with the Italian central bank, the Banca d'Italia, to borrow a total quantity of 72 million euro notes for a value of EUR 1,566 million. The notes were delivered in October and frontloading was carried out directly to the major banks. From 2009 the Central Bank of Malta is obliged to procure its own stock of euro currency notes. Consequently, during the year it initiated discussions with other euro area central banks on the procedures to be followed in this regard.

Circulation of banknotes and coins

The stock of currency notes and coins issued and outstanding at the end of 2007 stood at Lm291.0 million (EUR 677.8 million), a fall of 42.3% since the end of 2006 (see Table 3.1). The declining trend in the amount of currency in issue that was discerned in the second half of 2006 continued throughout 2007 and gathered momentum during the final quarter of the year. This mainly reflected the switching of Maltese lira currency holdings into euro by the public prior to the introduction of the euro on 1 January 2008. As a result, the share of notes and coins in broad money fell to 8.2% by December from 15.8% a year earlier.

At the end of 2007 the value of notes in issue totalled Lm272.3 million (EUR 634.3 million), a fall of 43.6%, from the previous year's level. Their composition remained broadly unchanged, with the Lm10 note accounting for 69.3% of the total (Chart 3.1). The Lm20 note remained the second most popular banknote, although the amount in circulation and its share in the total both fell. The volume of notes processed by the Bank during the year increased by 57.2%, with around one-third of the notes examined being destroyed.

Chart 3.1
COMPOSITION OF CURRENCY NOTES ISSUED AND OUTSTANDING AS AT END-2007



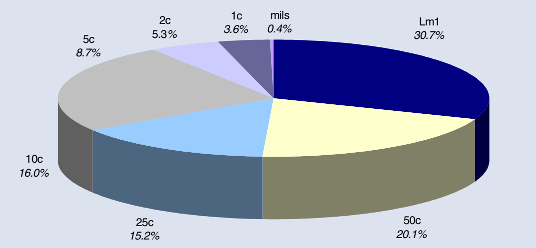
Similarly, albeit to a lesser degree, the value of the outstanding stock of coins fell to Lm18.7 million (EUR 43.6 million) from Lm20.9 million (EUR 48.7 million) the previous year. The shares of the various denominations in the total remained broadly

Table 3.1
CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE BANK IN 2007
Lm thousands

	Notes and coins			
	Issued	Paid in	Net issue	Issued and outstanding[1]
January	22,967	41,438	-18,471	485,505
February	25,501	33,445	-7,944	477,561
March	32,406	35,025	-2,619	474,942
April	31,775	40,546	-8,771	466,171
May	33,927	47,508	-13,581	452,590
June	31,076	40,276	-9,200	443,390
July	35,474	53,756	-18,282	425,108
August	31,326	49,171	-17,845	407,263
September	32,817	42,709	-9,892	397,371
October	34,852	56,247	-21,395	375,976
November	32,311	57,035	-24,724	351,252
December	28,725	89,000	-60,275	290,977
2007	**373,157**	**586,156**	**-212,999**	**290,977**
2006	357,035	373,103	-16,068	503,976

[1] Includes currency in circulation and currency held by the banking system.

Chart 3.2
COMPOSITION OF COINS ISSUED AND OUTSTANDING AS AT END-2007



unchanged, with the Lm1 coin still recording the highest share by value, followed by the 50c coin (see Chart 3.2). In anticipation of the euro changeover, the volume of coins examined by the Bank was exceptionally high.

Commemorative coins

On 12 February the Bank issued a new decimal set dated 2007. The set consists of the seven Maltese coins of the Second Series together with a five mils coin of the First Series. The coins were struck at the Royal Mint in the UK. The designs on the obverse and reverse sides of the coins remained unchanged.

On 1 December the Bank issued the first official Maltese euro set dated 2008. This set consisted of the eight Maltese euro coins in bright uncirculated finish, together with a commemorative ingot.

On 17 December the Bank, as part of the Europa Programme 2007 with the theme 'European Realisation', issued the last commemorative coin denominated in Maltese lira. This featured Jean de la Valette, the Grandmaster of the Sovereign Military Order of St John of Jerusalem of Rhodes and of Malta, who led the Knights in the Great Siege of 1565 and after whom the city Valletta is named. The emblem of Malta and the year of issue appear on the obverse of the coin, while the reverse depicts a likeness of Grandmaster la Valette and the Europa Star, which is the official logo of the Programme. The coin was designed by the Maltese artist Noel Galea Bason. The gold and silver proof coins, which are legal tender in Malta for the value of Lm25 and Lm5 respectively, were struck at the Royal Dutch Mint, with a minting limit of 2,000 and 15,000 coins, respectively.

Anti-counterfeit measures

During 2007 the Bank continued to examine local and foreign banknotes suspected of being counterfeits. With regard to euro notes, the Bank continued to work closely with the ECB. Staff members also participated in a number of working groups organised by the ECB and the EU Commission specialising in the material examination of euro banknotes. Meanwhile, the Bank's Currency Surveillance Unit continued to act as the National Counterfeit Centre, the National Analysis Centre and the Coin National Analysis Centre in accordance with ECB and European Commission requirements.

Payment and securities settlement systems

In terms of the Central Bank of Malta Act, the Bank is responsible for the regulation and oversight of the payment and securities settlement systems in Malta. During the year, it intensified its preparations to ensure that, after euro adoption, payments are effected smoothly between Malta and the other euro area Member States. This included the upgrading of the domestic payment infrastructure to enable it to handle new forms of collateral used by the Eurosystem in the implementation of monetary policy.

On 17 November 2007 Malta formed part of the first group of countries that joined TARGET2, the new payment system used by the Eurosystem for the settlement of central bank operations, large-value euro interbank transfers and other euro payments. This system replaced the domestic MaRIS system, which ceased to operate on 1 January 2008.

During 2007, 54,554 payments were processed by MaRIS for a total value of Lm21.1 billion (EUR 49.1 billion). Compared with 2006, the volume and value of payments processed by MaRIS rose by 9.5% and 5.5%, respectively, mainly reflecting payments related to the euro changeover and an increased volume of deposit transactions related to minimum reserve requirements.[1]

[1] As explained in more detail elsewhere in this Report, from 15 November 2007 all credit institutions established in Malta became obliged to maintain reserve deposits with the Bank.

The Bank also continued to manage the Malta Clearing House, through which most cheques issued in Malta are settled. While the amount of cheques cleared fell by nearly 2% to 6.0 million during the year, their value increased by around 3% to Lm3.1 billion (EUR 7.2 billion). The daily average number and value of cheques processed in 2007 amounted to 24,039 and Lm12.5 million (EUR 29.1 million), respectively. During the year, the Bank made changes to the working procedures of the Clearing House to ensure its smooth operation after the currency changeover.

The Bank continued its preparations for the implementation of the Single European Payments Area (SEPA) in 2008. This is expected to increase the efficiency of payments in the euro area through the adoption of a single standard for credit transfers, direct debits and payment cards.

Banker to the public sector

As banker to the Government, the Bank continued to maintain accounts for the Treasury, other Government departments and a number of public corporations. It also offered various foreign exchange services to public sector entities and Government departments.

During 2007 the number of government cheques drawn on the Bank and presented for settlement by the rest of the banking system continued to decrease, falling by 1.9% over 2006. However, their value rose by 13.1% to Lm452.4 million (EUR 1,053.8 million). The primary factor behind the reduced volume remains the growing use of the direct credit system. In fact, the number of payments made by direct credit increased from 1.6 million in 2006 to 1.7 million in 2007, while their value rose by 6.9% to Lm376.9 million (EUR 877.9 million). The use of the direct credit system specifically to pay Government salaries increased further and the latter continued to account for most of the value of such payments. However, payments of social security benefits and of dividends on Malta Government Stocks also rose.

The foreign exchange services provided by the Bank include the use of documentary letters of credit, inward and outward bills for collection, transfers, guarantees, and the sale and purchase of foreign exchange and travellers' cheques. The majority of cross-border foreign exchange transactions continued to be carried out through SWIFT transfers, the standardised service for transferring payments between banks and other financial institutions overseas. In 2007 the value of foreign exchange receipts processed by the Bank on behalf of the Government and public corporations declined to Lm282.2 million (EUR 657.4 million), from Lm293.5 million (EUR 683.7 million) in 2006. This mainly reflected the non-recurrence of a large transaction relating to the Government's privatisation programme in 2006 and a lower take-up of EU funds. Foreign exchange payments increased to Lm261.6 million (EUR 609.3 million), driven by tax refunds paid to companies engaged in international business.

The Bank continued to effect payments in connection with the servicing of the Government's external debt. In 2007 repayments of capital totalled Lm2.5 million (EUR 5.8 million), down sharply from Lm9.9 million (EUR 23.1 million) a year earlier. Meanwhile, interest payments declined marginally to Lm2.4 million (EUR 5.6 million) from Lm2.8 million (EUR 6.5 million) in 2006. The Government also set aside Lm26.3 million (EUR 61.3 million) by way of transfers to sinking funds earmarked for foreign debt servicing.

Banker to the banking system

As banker to the rest of the banking system the Bank continued to provide credit institutions with deposit facilities. These institutions maintain balances with the Bank to comply with statutory reserve requirements, to settle interbank transactions and to finance their daily operations in the domestic financial markets. The Bank also kept settlement accounts for the MSE, enabling brokers to settle trades in listed securities, and provided deposit facilities to some financial institutions, including foreign exchange bureaux.

The Bank continued to act as investment manager for the Depositor Compensation Scheme and the Investor Compensation Scheme, providing financial, accounting and other related services.[2] As the designated custodian of assets under the Insurance Business Act of 1998, the Bank also kept in its name, on behalf of insurance companies, certain specified assets backing funds guaranteed by them.

[2] The Investor Compensation Scheme protects clients of licensed investment services providers that are unable to satisfy their obligations towards investors. The Depositor Compensation Scheme was set up to compensate depositors in the event of a bank failure.

4. Internal Management

Administration

Board of Directors

The Board of Directors is responsible for the policy and general administration of the Bank, except for decisions related to monetary policy, which in 2007 continued to be the responsibility of the Governor.

During 2007 the Board was composed of Michael C Bonello, Governor and Chairman, David A Pullicino, Deputy Governor and Joseph V Gatt, Philomena Meli and Charles J Falzon as non-executive directors. Mr Gatt's term expired on 31 December 2007. Stephanie Sciberras served as Secretary to the Board. The Board met thirteen times during the year.

Audit Committee

The Audit Committee, which is established in terms of the Central Bank of Malta Act, consists of three Board members. During 2007 it was composed of Joseph V Gatt as Chairman, Charles J Falzon and David A Pullicino. The Committee reports and makes recommendations to the Board regarding financial reporting, internal audit and control, external audit and risk management. It also played an active role in monitoring the implementation of the recommendations made either by the internal auditors in their audit reports or by the external auditors in their Management Letter to the Bank.

The Committee is required to meet and report to the Board at least four times a year. It also holds meetings with the external auditors of the Bank to discuss issues regarding the annual statutory audit. During 2007 the Committee held ten meetings in which it discussed various topics, including the quarterly reports drawn up by the Divisional Director responsible for Internal Audit as required under the Internal Audit Charter, the appointment of the external auditors, the statutory audit of the Bank's financial statements, the annual internal audit plan, as well as internal control and risk management issues. During the year, the Audit Committee was instrumental in the introduction of a new Management Control Policy for the Bank.

Management

The Executive Management Committee (EMC) is responsible for advising the Governor and Deputy Governor on administrative matters. The EMC includes the Governor as Chairman, the Deputy Governor and the five Directors responsible for the divisions of the Bank. During 2007 the Committee held 48 meetings.

As part of the continuing restructuring process within the Bank, the External Transactions Data Office was dismantled and its statistical tasks were taken over by the Balance of Payments Section of the Statistics Office.

Furthermore, in preparation for the Bank's new role within the Eurosystem as from January 2008, a Governors' Secretariat was established to assist the Governor and Deputy Governor in tasks related to the Bank's international commitments, particularly those related to the ECB's Governing Council meetings, and to provide legal services. The new office was formed by merging the international section of the Bank's External Relations Office with the Legal Office.

In October the Bank organised a Strategic Planning Seminar for its employees. The seminar aimed to provide an overview of the changes that were being undertaken by the Bank in preparation for membership of the Eurosystem and to establish the strategic objectives for 2008 and beyond.

In December the Board of Directors approved changes to the Bank's Mission Statement after a working group set up for that purpose proposed several amendments. The salient changes reflect the

Eurosystem Mission Statement and the primacy accorded to price stability, the Bank's independence and the resultant obligations of transparency and public accountability.

Governor's official activities in Malta

In May the Governor appeared before the Public Accounts Committee of the House of Representatives to testify on the conduct of the Bank's monetary policy. The Governor also continued to sit on the Board of Governors of the MFSA and to participate in the Steering Committee for Euro Adoption.

In the course of the year, the Governor addressed various conferences and seminars organised by constituted bodies and other organisations, including the Strickland Foundation and the Institute of Financial Services. The speeches and presentations mainly focused on the challenges facing the Maltese economy and its convergence with the euro area. In June the Governor addressed two conferences held in Malta by the European Association for Banking and Financial History (EABH) and the European Government Business Relations Council. In October the Governor addressed the national conference marking Malta's adoption of the euro with a speech entitled 'The Euro and Beyond'.

The Governor also gave a number of interviews to the local and foreign media.

Governor's official activities overseas

During 2007 the Governor continued to attend the quarterly meetings of the General Council of the ECB and from July the Governing Council meetings as an observer. He also accompanied the Prime Minister to the ECOFIN Council meetings and the Parliamentary Secretary at the Ministry of Finance to the Monnaie de Paris, the mint entrusted to produce the Maltese euro coins. Mr Bonello also attended the Annual General Meeting of the BIS in Basel as an observer and the Annual Meeting of the IMF in Washington DC.

In January the Governor attended the conference and State celebrations held in Slovenia to mark the country's adoption of the euro. In March he participated in the Euro-Mediterranean Seminar organised jointly by the ECB and the Banco de España in Valencia. In June the Governor travelled to Brussels to deliver a speech entitled 'Malta's Economy on the Path to the Euro' to the Third Brussels Economic Round Table. Similar presentations were also given to the senior management of the National Bank of Belgium in July and to the Czech National Bank in September. In the latter month he also made a presentation on banking and financial services in Malta during a seminar organised by the MFSA in Prague. In November the Governor spoke about the economic challenges facing Malta on the verge of euro adoption during a seminar in Vienna organised by the Oesterreichische Nationalbank.

Legal issues

In the earlier part of the year, the Bank continued to advise the Attorney General's Office on proposed amendments to the Central Bank of Malta Act in the context of the legal convergence process associated with the adoption of the euro.

The Bank also amended the Central Bank of Malta Directive No 1 to align its minimum reserve requirements framework with that of the Eurosystem. By virtue of Article 105(4) of the EC Treaty, which requires national authorities to consult the ECB on draft legislative provisions falling within the ECB's fields of competence, ECB Opinions CON/2007/16 and CON/2006/58 were issued.

With the assistance of experts from the ECB, the Bank drafted the harmonised conditions for participation in TARGET2-Malta, which provide the terms applicable to counterparties participating in the TARGET2-Malta component system of TARGET2, the new payment system of Eurosystem central banks for large value and urgent payments. In this regard, Central Bank of Malta Directive No 6: Harmonised Conditions for Participation in TARGET2-Malta was issued on 19 November 2007, the date TARGET2 was launched by the Eurosystem.

In the course of 2007 and in January 2008, the Governor signed sixteen agreements and memoranda of understanding with the ECB and the European Commission associated with Malta's entry into the euro area. These covered a range of areas including the use of collateral, euro banknote production, TARGET2, SWIFT, communication activities and a code of conduct for members of the Governing Council.

The Bank was actively involved in the drawing up of regulations establishing a new Government-sponsored Special Registration Scheme. The Scheme gave an opportunity to residents to regularise their position with regard to holdings of eligible assets, including cash, in cases where the associated income had not been declared for the purposes of the Income Tax Act. To this effect, Legal Notices 112 and 126 were issued in April 2007.

Data protection

The Bank worked closely with the Data Protection Commissioner in order to keep Bank clients using SWIFT services adequately informed that personal data could be transferred to the United States and could be used by the US authorities for the prevention of crime. The Bank, through its Data Protection Officer, also conducted an exercise to update its inventory of all personal data used within the Bank and kept its staff updated on matters relating to data protection.

Economic analysis and research

Bank staff continued to analyse economic and financial developments in Malta and abroad, providing key inputs into the monetary policy process through the preparation of regular reports for the Monetary Policy Advisory Council. A wide range of data relating to the Maltese economy was analysed. During the year, the Bank revised its Business Perceptions Survey, shifting the emphasis onto the services sector, where information is relatively limited. The first results on the basis of the revised survey were analysed during the year. The Bank continued to publish an analysis of economic and financial developments in Malta and abroad in its *Quarterly Review* and the *Annual Report*. An article on the reformed Stability and Growth Pact was also published in the *Review*.

In the early part of 2007 the Bank was actively involved in discussions related to the preparation of the Convergence Report issued by the ECB in May and monitored the convergence process regularly. Following the decision taken by the ECOFIN Council to allow Malta to adopt the euro on 1 January 2008, briefing reports on economic and financial developments in the euro area were prepared for the Governor ahead of meetings of the ECB's Governing Council, which the Governor attended as an observer from July until the end of the year. The Bank continued to contribute to the ECB's Bi-Annual Monetary Policy Co-ordination Exercise with analyses and projections relating to the Maltese economy.

During 2007 the Bank's forecasts began to be subjected to peer review within the Eurosystem as part of the preparations for the integration of Maltese data into the latter's regular euro area forecasts. From August onwards, the Bank was also invited to participate in ECB macroeconomic exercises that were focused solely on the euro area. The Bank thus provided macroeconomic and inflation forecasts for Malta as part of its contribution to the Broad Macro-economic Projection Exercise and the Narrow Inflation Projection Exercise. In this regard, the Bank developed a new model for the purpose of producing inflation forecasts on a monthly frequency and at a more disaggregated level. The Bank also continued to prepare fiscal forecasts for the General Council using an upgraded framework. Furthermore, it undertook other research tasks, particularly on projections for negotiated wages as part of an ECB exercise.

Statistics

The Bank continued to compile, disseminate and publish a wide variety of monetary, financial and other economic statistics to support the Bank's monetary policy process, and to fulfil its statistical obligations in a national and international context. As the Bank did not apply for any derogations from the relevant ECB statistical regulations and guidelines, a key focus of its statistical work during 2007 was to strengthen preparedness for transmitting data to the ECB by the established deadlines. Key conceptual issues related to monetary and balance of payments data were addressed with technical assistance from a foreign consultant.

During 2007 a major task was the conversion of all databases from Maltese lira into euro as well as the preparation of amendments to statistical directives and reporting schedules to cater for the currency conversion and the classification of data as a result of the enlargement of the euro area. Towards the end of the year the Bank started to transmit monthly and quarterly back-data to the ECB both in euro and in Maltese lira.

The presentation of statistics in the Bank's *Quarterly Review* was substantially improved during the year, with the addition of new data and the revision of existing data to ensure that these were aligned with the statistical concepts employed by the ECB. The statistics section on the Bank's website was also revamped to provide more data for external users and the new version was launched on 2 January 2008.

The Bank co-operates closely with other agencies involved in the collection of statistics, particularly the NSO and the MFSA. The co-operation agreement between the Bank and the NSO was updated in August 2007, mainly to reflect the new tasks and responsibilities of the two institutions in the area of financial accounts statistics. The Technical Committee on Financial Statistics continued to meet regularly during the year to co-ordinate the smooth transition to new reporting systems and to enhance existing ones. The Committee, which is under the chairmanship of the Bank, included representatives from the credit and financial institutions, the MFSA, the NSO, the MBA and the MSE.

Apart from its obligations to provide statistical data to the ECB, the Bank also continued to provide data to the IMF in line with the standards set by the Fund's General Data Dissemination System (GDDS) and the Data Quality Assessment Framework (DQAF). In this regard, the Bank released, for the first time, the full international reserves and foreign currency liquidity template for Malta and transmitted it both to the IMF and the ECB.

In the area of monetary and financial statistics, Banking Regulation No 6 was updated during 2007, in conjunction with the MFSA, to enable the Bank to fulfil all the relevant ECB requirements. In particular, new schedules on interest rates applied by MFIs on deposits and loans were included in the updated Regulation. Furthermore, in line with ECB guidelines, statistics on issues of securities were compiled, while new reporting requirements to be imposed on resident investment funds by the end of 2008 were drafted.

Together with the NSO and the Ministry of Finance, the Bank continued to participate actively in the Government Finance Statistics Committee, which was set up to improve standards in the compilation of government finance statistics and to calculate government deficit and debt levels under the Excessive Deficit Procedure notification that is submitted to Eurostat biannually.

In the area of balance of payments (BOP) and international investment position (IIP) statistics, the Bank, in conjunction with the NSO, started compiling a new monthly accruals-based BOP statement and quarterly IIP using the direct reporting system.[1] It also collected portfolio investment data on a security-by-security basis for BOP purposes under the guidance of an expert from De Nederlandsche Bank.

Throughout the year, Bank officials regularly participated in ESCB committees and working groups and in the work of the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB).

Preparation of financial statements

During 2007 work was completed on the creation of a new chart of accounts designed to bring the Bank's accounting framework in line with the ECB's reporting guidelines. Thus, as from 1 January 2008 the Bank

[1] The type of data collection system used to compile BOP/IIP statistics is a direct reporting system supplemented by other data sources. An important element of the direct reporting system is the monthly survey sent to reporting agents in the non-financial and financial sectors.

was able to transmit its balance sheet to the ECB on a daily basis.

Internal audit

During the year the Bank's internal auditors continued to provide an independent assurance and consultancy function to senior management, the Audit Committee and the Board of Directors. Separate assurances were also provided to the ESCB, through work undertaken on behalf of the Internal Auditors Committee (IAC).

Given the importance of the Bank's operations related to the euro changeover, the audit objects in the 2007 Internal Audit Plan mainly focused on areas heavily related to changeover activities. Towards the end of the year, the Bank's internal auditors also carried out a series of on-site bank inspections to establish whether the custody of frontloaded and sub-frontloaded euro currency balances adhered with the provisions of the relevant ECB guideline.

The Bank's internal auditors concluded 17 risk-based audit engagements during the year with the objective of examining, evaluating and reporting on the adequacy of systems of internal control, risk management and governance processes. Two of these audits were conducted on behalf of the ESCB. The coverage included audits on information systems, finance, payment systems, currency issues, market operations, banking operations and statistics. Several procedural audits were also undertaken, together with a number of follow-up audits to ensure the implementation of recommendations made both at a local and at ESCB level.

Internal Audit Office continued to report to the Audit Committee on the Bank's operations and related policy matters on a quarterly basis. It also made recommendations to the Board on its findings through the Audit Committee.

Risk assessment

In preparation for the euro changeover, the Bank undertook various new risk assessments during 2007. This also involved additional work on business continuity planning and an emphasis on project management, as well as the establishment of new policies and procedures to cover the business processes resulting from the changeover. Moreover, the Bank updated its policies and procedures to make them euro compliant.

The Bank participated in four meetings of the Forum on Pandemic Preparedness in the Financial Services Sector, which was set up jointly with the MFSA to exchange information and to collaborate with financial institutions. During these meetings the Bank's Pandemic Contingency Plan was presented to the Forum members.

As part of its collaboration with other central banks, the Bank began participating in the meetings of the International Operational Risk Working Group, which acts as a centre of competence on operational risk management for central banks world-wide. At the ESCB level, the Bank joined the newly-established Task Force on Operational Risk and Business Continuity Management with the objective of formulating key policies in these areas.

Human resources

The Bank's total workforce as at the end of December 2007 was 314 full timers and 16 part timers, compared with 310 and 16, respectively, at the end of 2006. Taking into consideration absences, resignations and recruitment exercises during 2007, the staff complement on a full-time equivalent basis was 303, up from 299 in 2006.[2]

Over the year the Bank recruited one legal officer/analyst, three auditors, nine economic officers, two IT technicians and nine clerks. Four currency handlers were engaged for a specific period. At the same time, one employee retired on medical grounds, five opted for voluntary severance and a further 13 resigned. One employee was seconded to the Ministry of

[2] Absences cover family-friendly measures, unpaid leave and attachments with other institutions.

Finance, while another took up a temporary position with the ECB. A third employee continued to fulfil his assignment as a euro analyst with the NECC.

The Bank, once again, offered temporary employment during the summer months to five University students. In 2007 the Bank also participated in a scheme administered by the Malta College of Arts Science and Technology (MCAST) and offered unpaid work placements to two students from the Institute of Information and Communications Technology and three students from the Institute of Business and Commerce. Meanwhile, the sponsorship of an IT Trainee under the Traineeship Scheme, a programme administered by the Bank together with STC Training, expired in March.

Training and development

The Bank continued to provide training opportunities for its employees both through in-house programmes and through external courses organised by local and foreign institutions.

As highlighted in Table 4.1, a large number of employees participated in external courses on a wide range of topics of interest to the Bank. Meanwhile, 28 different courses were delivered in-house, in the areas of statistics, econometrics, financial stability, IT, counterfeit notes detection, foreign languages and health & safety. Furthermore, lunchtime presentations were also delivered by various staff members involved in projects related to the euro changeover process and the Bank's participation in the Eurosystem.

In 2007 the Bank continued to offer bursaries to external applicants with an academic background. One bursary, for a twelve-week period, was awarded. The beneficiary prepared a report on the implementation of the EU's Payment Services Directive in Malta.

Table 4.1
STAFF TRAINING DURING 2007

Type of training	Number of courses/seminars	Number of participants
In-house	28	609
External	126	265
Local	82	221
Overseas	44	44

The Bank also invited University students reading Economics, Banking & Finance, and Maths & Statistics & Operations Research Honours degree courses to two talks on the Bank and the career opportunities that it offered to graduates in those fields.

Academic and professional courses

During 2007, an economist was offered a one-year scholarship under the Bank's Development Scheme to read for a Masters in Economics at the University of Warwick.

Increasing numbers of employees benefited from the Bank's other study scheme (see Table 4.2). Over the course of the year, 21 staff members successfully completed their course of studies, while a further 29 embarked on approved courses on a part-time basis. Another two employees were on unpaid leave to follow doctoral studies abroad.

Table 4.2
ACADEMIC AND PROFESSIONAL COURSES DURING 2007

	Number of employees	
Type of programme	Programmes completed	Programmes being pursued
Postgraduate courses	10	16
Honours first degree courses	7	9
Diploma courses	4	6

Gender equality and discrimination

During the year representatives of the Bank's Working Group on the Promotion of Equality continued to attend meetings organised by the National Commission for the Promotion of Equality (NCPE).

Health and safety

In terms of the Occupational Health and Safety Authority Act (Cap 424), a new workers' Health and Safety Representative was nominated. Furthermore, the Bank provided a number of health services to its employees.

Premises

In 2007 renovation works on the Polverista, a listed building adjacent to the Bank's premises on St James' Counterguard, were finalised. This building will be used to host conferences, meetings and training activities. Restoration works were also carried out on the historical arch that forms part of the access passage to St James' Counterguard.

In the course of the year, work on the coin depot situated at the Armed Forces of Malta Headquarters in Luqa was finalised and a heavy duty coin examination machine was installed. This building has been used throughout the euro changeover process. Meanwhile, substantial maintenance and construction works were carried out on the Bank's currency examination room to cater for the additional processing of both euro and Maltese lira banknotes. A CCTV monitoring system was also installed. In addition, the main vaults were refurbished to increase storage space for both euro and Maltese lira banknotes.

Towards the latter part of the year, extensive refurbishment works were also carried out on the main premises ahead of the visit of the ECB President, Mr Jean-Claude Trichet, in September.

Information technology

The major project in 2007 was the euro conversion of the Bank's core systems, as well as systems and applications developed in-house. These were also reviewed and adjusted to comply with ESCB reporting requirements. Another project was the transition from the domestic real-time gross settlement system for the Maltese lira (MaRIS) to TARGET2. Furthermore, in view of the Bank's new role within the Eurosystem, new applications relating to collateral management, financial accounting, internal audit and external transactions were developed. At the same time, additional investment in software and hardware was also necessary.

The Bank participated in the rollout of EXDI, a common services platform for the ESCB systems. This project, driven by the ECB, required NCBs to implement various applications and interfaces and to carry out the related testing. Furthermore, apart from participating in various ESCB committees and working groups, officials from the Bank were asked to contribute to expert groups on vulnerability and patch management, malicious and mobile code and networks.

Information and public relations

Throughout the year the Bank continued to keep the public informed on various issues relating to its functions and operations through press releases, its regular publications and its website. The latter was revamped in the later part of the year to reflect the Bank's membership of the Eurosystem. The Bank continued to issue a *Quarterly Review,* an *Annual Report*, a weekly money market report and a monthly release of monetary statistics. The Bank was also responsible for the translation into Maltese of documents and press releases. These included, in co-operation with the ECB, the Convergence Report on Cyprus and Malta.

A substantial part of the Bank's communications strategy during 2007 was related to the dissemination of information on the euro, in particular the appearance of the notes and coins and their security features. This undertaking was supported by the ECB after the two institutions concluded a Memorandum of Understanding to embark jointly on an extensive publicity campaign. As stated elsewhere in this Report, the ECB and the Central Bank of Malta formally launched this campaign on 30 September 2007, when the ECB President visited Malta and also presented the 14th Euro Star to the Governor. Apart from a large number of TV adverts and newspaper articles, the campaign involved the issue of other material such as leaflets, conversion cards, training booklets, posters and sound cards for the visually impaired.

This communications campaign was complemented by a series of articles in the press on new functions the Bank would assume on entering the euro area as well as press and TV advertisements to encourage the de-hoarding of Maltese currency notes. Surveys were conducted by the Bank before and after the communications campaign to ensure that the latter was effective. Through its participation in a joint committee with the NECC, the Bank also ensured that its campaign was consistent with the Master Plan for the Euro Changeover in Malta. In November the Bank presented to the press its new logo to reflect its entry into the Eurosystem.

Library

The Central Bank of Malta Library continued to enhance its collection, in print and electronic format, in specialised areas such as banking, finance, and economics. In line with its development policy, the Library acquired new books, periodicals and specialised publications related to central banking. The Library also continued to maintain its collection of local newspaper clippings files.

Library facilities were provided primarily to the Bank's staff, though selected services were also made available to the public and private sector. In particular, students involved in research activities on economic and financial matters made frequent use of such services.

The Bank's Library also continued to serve as a depository for publications issued by international organisations, such as the IMF, the World Bank Group and the EBRD.

Cultural and educational activities

During the year the Bank sponsored a number of philanthropic and cultural activities. It organised educational visits for schoolchildren, who were briefed on the Bank's functions, euro currency notes and coins, the ECB and the Eurosystem. A number of stands demonstrating the history and development of the euro were set up in the Bank's foyer, while part of the Bank's coin collection was exhibited in Brussels to mark the adoption of the euro.

In June, the Bank, in conjunction with the Bank of Valletta, a credit institution, hosted a seminar organised by the EABH.

During the year, research work in preparation for a commemorative booklet on the history of the Bank's premises was finalised. This booklet will be published in early 2008.

5. International Relations

During 2007 the Central Bank of Malta intensified its relationship with the ECB ahead of the adoption of the euro and the Bank's consequent membership of the Eurosystem as from 1 January 2008. The Bank also strengthened its ties with other EU institutions, particularly the European Commission, while building upon existing relations with international financial institutions such as the IMF, the World Bank Group and the EBRD.

A major development in Malta's relationship with the EU was the positive outcome of its request to participate fully in EMU. This process commenced in February, when the Prime Minister and the Governor applied to the European Commission and the ECB for an assessment of Malta's fulfilment of the economic and legal criteria for euro adoption. Subsequently, the European Commission and the ECB each prepared a Convergence Report. In this regard, experts from these two institutions visited Malta for discussions with Central Bank of Malta and Ministry of Finance officials on the state of the economy. The Bank was given the opportunity to comment on the ECB's Convergence Report, along with the other NCBs, at the level of the General Council of the ECB, prior to its publication. The two Convergence Reports were published in May and were later discussed by the Economic and Financial Committee (EFC) and the ECOFIN Council. In June, the ECOFIN Council and the Heads of State and Government agreed with the assessment of the European Commission and the ECB that Malta had achieved a high degree of sustainable convergence and therefore fulfilled the necessary conditions for euro adoption. On 10 July, the ECOFIN Council decided to allow Malta to adopt the euro as from 1 January 2008. At the same time, it determined the irrevocable conversion rate between the Maltese lira and the euro in agreement with the Maltese authorities. The rate was the central parity rate of the lira in ERM II.

European System of Central Banks

During 2007 the Governor participated in the quarterly meetings of the ECB's General Council, while experts from different areas of the Bank took part in meetings of ESCB committees and working groups. The Bank also hosted one ESCB meeting in Malta, that of the Internal Audit Committee.

Following the decision of the ECOFIN Council allowing Malta to adopt the euro, the Governor started to attend meetings of the Governing Council of the ECB as an observer. The Bank was also accorded observer status on all Eurosystem committees and working groups.

As in previous years, Bank officials continued to attend seminars and conferences organised by the ESCB and to benefit from the advice of experts from individual NCBs on various issues related to the adoption of the euro and the tasks of the Eurosystem, drawing particularly on the experience of the central bank of Slovenia regarding the changeover to the euro in that country. In this regard, the Bank benefited from expert advice on the workings of payment systems, reserves management and the security features of euro banknotes. Bank staff also went on short-term attachments with Eurosystem NCBs. These were related to financial stability, monetary operations, collateral management, reserves management and IT. In August a delegation from the National Bank of Slovakia visited the Bank to share its experience regarding euro changeover preparations.

Bank experts participated in ECB meetings that were convened specifically for the central banks of Malta and Cyprus in view of their expected membership of the Eurosystem. These focused on the processing of euro banknotes, IT applications used to execute Eurosystem tasks and ECB statistical databases.

In anticipation of the Governor's full participation in Governing Council meetings, a delegation from the

ECB visited the Bank to explain the relevant procedures and the resources required to manage official documentation at NCB level. This was followed by a visit by Bank officials to the ECB on related practical issues.

The Bank entered into a number of agreements covering various aspects of its relationship with the ECB as a member of the Eurosystem. To ensure a smooth transition to this new status, the Bank carried out comprehensive tests of its infrastructure, databases, reporting systems and means of communication that were expected to be activated on entry into the euro area.

The Bank also held discussions with an ECB delegation on the visual material to be used for the euro information campaign. On 30 September the President of the ECB, Mr Jean-Claude Trichet, visited the Bank and launched the communication campaign, which was undertaken jointly by the Bank and the ECB. The launch was followed a day later by a conference organized by the Bank and the National Euro Changeover Committee, with the co-operation of the European Commission and the ECB. The conference, *EMU Governance and Euro Changeover: Malta on the Path to the Euro,* was addressed by the Prime Minister, the President of the ECB, the European Commissioner for Economic and Monetary Affairs, the Governor of the Central Bank of Malta and a number of experts on central banking issues. In October, the Bank, the MBA and the Malta Chamber of Commerce and Enterprise organised a national conference to launch the Single Euro Payments Area in Malta. This involved the participation of senior officials of the Commission, the ECB and other central banks. It was also attended by the business and financial community.

EU institutions

During the year, the Governor attended two informal meetings of the ECOFIN Council. As in previous years, the Deputy Governor and other senior officials of the Bank took part in meetings of the EFC and its sub-committees when issues relevant to central banks were discussed.

The Bank participated in EFC discussions on the update of the Convergence Programme for Malta for the period from 2006 to 2009, which was prepared by the Ministry of Finance. It also co-operated with the Ministry and the NSO in the preparation of reports on the EU's Excessive Deficit Procedure and projections on the Maltese economy for the European Commission's spring and autumn economic forecasts.

Senior Bank officials continued to attend meetings of the European Anti-Fraud Office of the European Commission (OLAF) and also participated in discussions on financial stability and EU financial regulation and supervision at the level of the Committee of European Banking Supervisors. During the year, the Bank participated in two meetings of the Public Administration Network Committee II (PAN II), which aims to assist governments and central banks in their preparations for euro adoption. Discussions centred on the drafting of guidelines for future euro adoptions, taking on board the lessons learnt from the Slovenian changeover and the experiences of Cyprus and Malta.

The Bank also co-operated with the MFSA, the Ministry of Finance and the Ministry of Foreign Affairs to ensure the timely transposition into Maltese law of EU financial sector legislation and the notification of the corresponding national implementing provisions to the ECB and the European Commission.

International Monetary Fund

As the institution representing Malta at the IMF, the Bank, in consultation with the Ministry of Finance, voted on resolutions proposed by the Fund's Executive Board in the course of the year and monitored ongoing discussions on the reform of the IMF, particularly in relation to its governance, finances and surveillance role. The Governor also continued to fulfil his role as Governor for Malta at this institution, while the Deputy Governor acted as the Alternate Governor.

The Fund's holdings of Maltese currency and Malta's reserve position in the Fund remained unchanged from the levels reported at the end of 2006, at SDR 61.7 million (around EUR 66.3 million) and SDR 40.3 million (around EUR 43.3 million), respectively. Malta's SDR holdings, however, increased by SDR 3.8 million to SDR 37.8 million in 2007, mainly reflecting interest earned on them. During the year, the Bank also pledged Malta's share in the contributions held in an IMF account earmarked to protect the Fund's income against losses arising from members' overdue obligations to another account that was created to help secure a financing package for debt relief to Liberia and thus improve the sustainability of the external debt position of that country.

During May an Article IV Consultation Mission visited Malta to assess the economic situation. During the visit discussions were held with the Parliamentary Secretary in the Ministry of Finance and with the Governor of the Central Bank of Malta. The Mission also met representatives of the public sector, financial institutions and the social partners. The 2007 Article IV Staff Report for Malta, and a Public Information Notice summarising the views of the Executive Board, were published on 7 September.

As in previous years, and as discussed elsewhere in this Report, the Bank also cooperated with the IMF on statistical issues, including the compilation of financial soundness indicators.

World Bank Group

The Bank continued to monitor relevant developments in the World Bank Group.[1] As in past years, it continued to co-operate with the Ministry of Finance on issues affecting Malta and on a number of resolutions proposed by the Executive Board of the World Bank.

Further to the decision adopted at the 2006 World Bank Small States Forum to launch a Small States Network for Economic Development and to locate its Secretariat in Malta, the Bank monitored the process leading to the endorsement of the statute by its founding members, including Malta, and activation of the Network by its Board of Trustees in October. The Bank also held discussions with the World Bank, the Ministry of Finance and the Islands and Small States Institute on the physical and financial arrangements necessary to allow the Network to start operating, including the setting up of the Secretariat.

European Bank for Reconstruction and Development

The Bank continued to monitor relevant developments in the EBRD and collaborated with the Ministry of Finance on issues related to Malta's membership of this institution. Together with the Ministry, the Bank also examined a number of project proposals and resolutions that were presented during the year. In addition, the Governor continued to fulfil his role as Alternate Governor for Malta at the EBRD.

In January the Deputy Governor, acting on behalf of the Governor, and a senior official from the Ministry of Finance, participated in an EBRD constituency meeting in Cyprus. The meeting was organised by the Austrian EBRD Director for the members of the constituency led by Austria, which also includes Bosnia & Herzegovina, Cyprus, Israel, Kazakhstan and Malta. In May, the Deputy Governor attended the EBRD's sixteenth annual meeting.

Bank for International Settlements

The Bank continued to monitor developments related to initiatives endorsed by the BIS in the field of financial stability. Although not a member of the BIS, during 2007 the Bank also took part in seminars organized by the Committee on the Global Financial System and the Financial Stability Institute, which is a joint institution of the BIS and the Basel Committee on Banking Supervision.

Other

During the year, a senior Bank official continued to form part of the Maltese delegation to the Council of

[1] The World Bank Group is made up of the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), the Multilateral Investment Guarantee Agency (MIGA), the International Finance Corporation (IFC) and the International Centre for Settlement of Investment Disputes (ICSID).

Europe Select Committee of Experts on the evaluation of Anti-Money Laundering Measures (MONEYVAL). He also participated in the meetings of the Bureau of the Committee and in the training sessions for evaluators as a Committee representative at the European conference of the Association of Certified Anti-Money Laundering Specialists (ACAMS), which was held in Amsterdam in November. At its 24th Plenary held in Strasbourg in September, the MONEYVAL Committee approved and adopted the Third Round Mutual Evaluation Report on the anti-money laundering and financing of terrorism measures in effect in Malta. The report was published on the Council of Europe website.

ECONOMIC & FINANCIAL POLICY CALENDAR 2007

This calendar lists relevant policy measures in the monetary, fiscal and exchange rate fields that came into effect during the year

9 January: Regulations on dual display and euro pricing published through Legal Notice 4

The objective of these regulations is to regulate the dual display of prices, values and monetary amounts of goods and services offered to consumers and to ensure fair practices in euro pricing.

31 January: Twinning agreement with Austria announced

The NECC announces that it has finalised a twinning agreement with the Austrian Federal Ministry for Economic Affairs and Labour with the aim of building price awareness and consumer confidence in Malta during the euro changeover period. The project is to be funded by the EU Directorate General for Economic and Financial Affairs of the European Commission.

25 January: Central Bank of Malta raises interest rates

The Central Bank of Malta raises its central intervention rate by 25 basis points to 4.00%. The decision is taken against a background of a further decline in the Bank's external reserves and a marked narrowing of interest rate differentials in favour of the Maltese lira as a result of rising euro area rates.

1 February: NECC updates master plan for euro changeover

The NECC releases the third update of its master plan for the euro changeover in Malta. The update outlines the key milestones reached so far and the procedures and tasks that still need to be implemented in preparation for the changeover.

27 February: Malta requests Convergence Report

Malta submits a request for a country examination on the state of its economic convergence for euro adoption purposes to the EU Commissioner for Economic and Monetary Affairs and the President of the ECB. The request is submitted by the Prime Minister and Minister of Finance and the Governor of the Central Bank of Malta.

2 – 16 March: Central Bank of Malta Act amended

Parliament amends the Central Bank of Malta Act so as to ensure that central bank independence is provided for in total conformity with the requirements of the EU Treaty and the ESCB Statute. The amendments also provide for the full integration of the Central Bank of Malta into the Eurosystem once the euro is adopted as the currency of Malta. They are expected to come into force by virtue of a future commencement notice.

2 March: External Transactions Act amended

The External Transactions Act is amended so as to base the residence criterion, for the purposes of statistical compilation, on the transactor's centre of economic interest in conformity with the *IMF's Balance of Payments Manual Guidelines (Fifth Edition)*. This amendment is to come into force by virtue of a future commencement notice.

29 March: Guidelines for rounding and smoothing for the public sector published

The NECC publishes guidelines on the undertaking of specific amendments to specific pieces of legislation and on the process of rounding and smoothing applicable to the public sector in view of the adoption of the euro.

27 February - 16 March: Legislation related to banking and finance

27 February: Rules governing reporting of capital gains by companies amended through Legal Notice 37 issued under the Income Tax Act

This amendment provides for the inclusion of an auditor's signed report as a necessary document when a company reports capital gains for tax purposes.

8 March: Regulations governing insurance business amended through Legal Notice 41 issued under the Insurance Business Act

These amendments are intended to ensure that an applicant for a licence to conduct insurance business fulfils the criteria of sound and prudent management.

8 March: General Financial Regulations amended through Legal Notice 43 issued under the Financial Administration and Audit Act

This amendment to the General Financial Regulations deletes Regulation 74 concerning payment as arrear charges.

20 March: Regulations under European Union Directives concerning income tax amended through Legal Notice 60 issued under the Income Tax Act

The amended regulations, which came into force on 1 January 2007, take into account the fact that Bulgaria and Romania had become Member States of the EU as from that date.

16 March: Dematerialisation of Treasury bills

The dematerialisation date for Treasury bills is set for Monday 2 April 2007. The overall implication is that Treasury bills are no longer to be issued in paper form. To bring this change into force two legal notices are issued under the Malta Treasury Bills Act. The first of these, Legal Notice 58, entitled Directive on the Electronic Central Depository for Malta Treasury Bills, 2007, lists instructions and procedures regarding the return of physical certificates of outstanding Treasury bills in the period following the announcement of, and before the appointed date for, the dematerialisation of Treasury bills. The second, Legal Notice 59, entitled Malta Treasury Bills (Dematerialisation) Regulations, 2007 lists the regulations and describes how the market for Treasury bills is henceforth to be conducted and administered.

20 April: Special Registration Scheme launched

The Government launches a Currency and Bank Deposits Registration Scheme, providing individuals residing in Malta with a one-time opportunity to regularise their position in respect of holdings of eligible assets held locally where the associated income had not been declared for the purposes of the Income Tax Act. The Scheme is also designed to encourage a gradual and orderly surrender of hoarded cash ahead of the euro changeover and to facilitate its integration into the formal economy through the financial system. In connection with this scheme a number of legal notices are issued. These are:

- ***20 April: Regulations establishing and governing Special Registration Scheme published through Legal Notice 112***

  These regulations, issued under the External Transactions Act, provide for the establishment of a registration scheme, to be known as the Currency and Bank Deposits Registration Scheme, whereby individuals residing in Malta who hold eligible assets without declaring the relevant income (including capital gains) for the purposes of the Income Tax Act and other relevant laws, may regularise their position.

- ***20 April: Eligible assets as specified in the External Transactions Act defined in Legal Notice 111***

  Legal Notice 111 defines "eligible assets" as specified in the External Transactions Act to include deposits and currency notes denominated in both Maltese lira and euro.

- ***30 April: Eligible assets as specified under the External Transactions Act further defined through Legal Notice 125***

  This legal notice further defines "eligible assets" as specified in the External Transactions Act to include securities denominated in Maltese lira and euro with a primary listing on the Malta Stock Exchange.

- ***30 April: Regulations governing Special Registration Scheme renamed and eligible assets redefined through Legal Notice 126***

  The purpose of Legal Notice 126, entitled the Currency and Bank Deposits Registration Scheme (Amendment) Regulations 2007, is to rename the regulations as "Special Registration Scheme Regulations, 2007" and to redefine "eligible assets" as currency notes denominated in Maltese lira and euro, deposits denominated in Maltese lira and euro held with credit institutions licensed under the Banking Act, and securities denominated in Maltese lira and euro with a primary listing on the Malta Stock Exchange.

- ***31 July: Legal Notice 206 extends closing date of Special Registration Scheme***

  This legal notice extends the closing date of the Special Registration Scheme from 31 July 2007 to 31 August 2007 and appoints the Central Bank of Malta as one of the agents authorized to register eligible assets.

5 April – 5 June: Legislation related to banking and finance

5 April: Rules governing deductions under the Income Tax Act in respect of euro-related expenditure published through Legal Notice 93

This legal notice lists the Deductions (Euro Related Expenditure) Rules, 2007, which are to be applied under the Income Tax Act in respect of expenditure incurred to enable the proper discharge of business in euro currency as from the date when the euro becomes legal tender in Malta.

29 May: Regulations governing insurance business amended through Legal Notices 142 and 143

Legal Notice 142 publishes the Insurance Business (Penalties for Offences and Infringements) (Amendments) Regulations, 2007 which came into force on 1 June 2007, listing the administrative penalties which may be imposed by the MFSA without recourse to a court hearing.

Legal Notice 143 publishes the Insurance Intermediaries (Penalties for Offences and Infringements) Regulations, 2007 which came into force on 1 June 2007, listing the penalties that are enforceable by prosecution in the courts of Malta as well as the administrative penalties that may be imposed by the MFSA without recourse to a court hearing.

5 June: Cash control regulations published through Legal Notice 149

These regulations, issued under the External Transactions Act, establish the sum equivalent to, or in excess of, Lm4,293 (EUR 10,000) in cash as the sum which any person entering or leaving Malta, or transiting through Malta, is obliged to declare to the Comptroller of Customs.

29 May: Central Bank of Malta raises interest rates

The Central Bank of Malta raises its central intervention rate by 25 basis points to 4.25%. The decision is taken against a background of narrowing interest rate differentials in favour of Maltese lira-denominated financial assets and a further reduction in the Bank's external reserves.

10 July: Adoption of the euro by Malta approved

The ECOFIN Council of Ministers accepts the recommendations of the EU Commission and the ECB to admit Malta, along with Cyprus, to membership of EMU. The Council also releases Malta from the "excessive deficit procedure" since its fiscal deficit had fallen below 3% of GDP in 2006. Malta will thus adopt the euro on 1 January 2008. The Council, in agreement with the Commission, the ECB and the Maltese Authorities also sets the permanent conversion rate of the Maltese lira at 0.4293 lira to the euro, which corresponds to the current central rate of the Maltese lira within the EU's ERM II exchange rate mechanism.

11 July: NECC publishes final update of master plan for euro changeover in Malta

The NECC publishes its final update of the master plan for the euro changeover in Malta. The plan is a consolidation of the key tasks and procedures that have to be implemented in the remaining months ahead of the changeover on 1 January 2008.

16 July: EU report on practical preparations for the adoption of the euro adopted

The European Commission adopts the fifth report on the practical preparations for the adoption of the euro. The report focuses on recent developments in Cyprus and Malta following the Council's decisions that the two countries fulfilled the necessary conditions to adopt the euro in January 2008. In a specific reference to Malta's Final Master Plan, the report remarks that this had further refined what was already a very detailed and comprehensive changeover plan. It also comments that Malta's communication activities on the euro were exceptionally comprehensive and of a very high quality.

5 September: Guidance notes for accountants published

The Malta Institute of Accountants, in conjunction with the NECC, issues guidance notes for accountants to assist its members with the euro changeover. The purpose of these notes is to identify the main considerations that are relevant to accountants in planning and carrying out procedures relative to the euro changeover and to set out the pertinent best practice recommendations.

18 July: Privatisation of Tug Malta

The Government sells its 73.72% share in Tug Malta Ltd to Rimorchiatori Riuniti S.P.A. for the price of Lm10,600,000 (EUR 24,691,358). The new owner will be using Malta's port facilities as a base for its operations in the Mediterranean region.

20 July – 7 August: Legislation related to banking and finance

20 July: Legal Notice 189 brings into force double taxation agreement with Morocco

This legal notice brings into force the Convention regarding the Double Taxation Relief (Taxes on Income) arrangements with the Kingdom of Morocco.

3 August: Act XX, amending various financial services laws, enacted

This Act amends a number of laws governing the financial services industry. These include the MFSA Act, the Financial Markets Act, the Investment Services Act, the Banking Act, the Insurance Business Act, and the Insurance Intermediaries Act. The Act also includes miscellaneous provisions covering the MSE.

7 August: Regulations governing advertising activity under Companies Act amended through Legal Notice 212

This legal notice amends the principal regulations of the Companies Act, enabling the Registrar of Companies, in cases where Malta is the home Member State, to ensure compliance with the requirements of the regulation relating to advertising activity involving an offer of securities to the public.

6 September: Government sells shares in Maltapost to Lombard Bank subsidiary

The Government transfers 25% of its shares in Maltapost to Redbox Ltd, a subsidiary of Lombard Bank p.l.c. As a result, Lombard Bank now owns 60% of the shares in the company. The remaining 40% that are still held by the Government are expected to be listed on the MSE.

30 September: Euro communications campaign launched

The Central Bank of Malta and the ECB officially launch their joint communications campaign for the euro changeover in Malta. To mark this event, Mr Michael C. Bonello, the Governor of the Central Bank of Malta, and Mr Jean-Claude Trichet, the President of the ECB unveil euro banners on the façade of the Bank's main premises in Valletta. The President of the ECB presents the fourteenth "Euro Star" to the Central Bank of Malta, a memento that is offered to each new member of the Eurosystem

15 October: Measures introduced in the Budget for 2008

The Prime Minister and Minister of Finance presents the Budget for 2008 to Parliament.

The main fiscal measures include:

Wage increase

- A cost of living increase of Lm1.50 (EUR 3.49) a week, of which Lm1.00 (EUR 2.33) is intended to make up for the higher cost of food while Lm0.50 (EUR 1.16) is granted under the established mechanism reflecting the behaviour of the RPI.

Tax relief

- A revision of the income brackets for the different income tax rates.
- Tax exemptions for cultural activities, including sports for children. Public sector employees are to be granted unpaid leave for certain arts projects.

Social benefits

- The children's allowance is to be extended to all children, while the children's allowance for second and subsequent children is to be doubled so as to be equal to that for the first child.
- Increases in allowances for fostering and for orphans.

Subsidies

- Students studying for their first degree abroad are to be assisted financially.
- Subsidies, refunds and other incentives are to be given to encourage the use of alternative energy resources.
- Financial incentives to be given the housing sector to enable more people to become owners of their own home.

30 October: Date bringing into force Part 1 of the Central Bank of Malta (Amendment) Act 2007 established

Legal Notice 339 of 2007 establishes 1 January 2008 as the date when Part I of the Central Bank of Malta (Amendment) Act, 2007 (Act No. I of 2007) is to come into force.

15 November: Central Bank of Malta amends Directive No. 1 concerning reserve requirements

On 15 November, in preparation for the adoption of the euro, the Central Bank of Malta amends Directive No. 1, which deals with minimum reserve requirements. The amendments cater for the introduction of an exceptional maintenance period running from 15 November to 31 December 2007. The Bank also changes the method used in the computation of minimum reserve requirements, redefines the reserve base to align it with that used in the euro area and links the remuneration paid on reserve deposits directly to the central intervention rate or the ECB's minimum bid rate, depending on the currency in which they are held. In addition, all exemptions previously granted in terms of the Directive expire. As a result, all credit institutions established in Malta are henceforth required to maintain reserve deposits with the Bank.

19 November: TARGET2 is launched

The Central Bank of Malta starts operating through TARGET2, a new payment system for large value interbank payments operating in central bank money. The launching is the culmination of a major project successfully implemented by euro area central banks that had collaborated on the design of the system. TARGET2 is expected to serve as a development model for other systems currently being devised by the Eurosystem to strengthen and consolidate the smooth functioning of the single European market.

27 November: European Commission adopts sixth report on practical preparations for the euro

The European Commission adopts the sixth report on the practical preparations for the enlargement of the euro area. The report focuses on Cyprus and Malta, which are to adopt the euro in January 2008. With reference to Malta the report says that the country had further refined and completed its practical preparations.

30 November: Ministry of Finance publishes Malta's Stability Programme 2007-2010

The Ministry of Finance publishes Malta's Stability Programme for 2007-2010 and submits it to the European Commission. The report foresees real GDP growth within a range of 3.1%-3.4%. The main macroeconomic policy objectives underlying the programme are the achievement of sustainable economic growth and real convergence with EU average levels, the generation of a high level of employment, the strengthening of public finances, and a low and stable level of inflation. On the fiscal front the Government aims at achieving its medium term objectives of a balanced sustainable budget by 2010.

28 December: Central Bank of Malta lowers central intervention rate

The Central Bank of Malta lowers the central intervention rate by 25 basis points to 4.00%. This brings the rate down to the same level as the minimum bid rate on the main refinancing operations set by the ECB, completing the process of convergence of official interest rates in Malta with those of the euro area.

31 December: Banks established in Malta to comply with minimum reserve requirements set by ECB as from 1 January 2008

The Central Bank of Malta announces that, with the adoption of the euro and the transfer of responsibility for monetary policy to the ECB as from 1 January 2008, banks established in Malta are to comply with the minimum reserve requirements set by the Governing Council of the ECB. The entry into force of the ECB regulations on minimum reserve requirements from 1 January 2008 implies a lowering of the current reserve requirement rates from 4% of the reserve base to 2%. Moreover, banks established in Malta will, from that date, be allowed to deduct liabilities due to other banks established in the euro area from their respective reserve base.

12 October – 28 December: Legislation related to banking and finance

12 October: Legal Notices 286-290 of 2007 issued under the Insurance Business Act

These legal notices publish several regulations and amendments to existing regulations governing the business of insurance in Malta so as to bring the local legislation in line with the relevant EU directives.

30 October: Legal Notices 325-329 of 2007 issued under the Investment Services Act

These legal notices publish various regulations governing the provision of investment services so as to bring the relevant local legislation in line with Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments.

30 October: Legal Notices 330-336 of 2007 issued under the Financial Markets Act

These legal notices publish various regulations and amendments to existing regulations governing financial markets, mainly so as to bring the local legislation in line with Directive 2004/38/EC of the European Parliament and of the Council on markets in financial instruments.

13 November: Legal Notice 369 of 2007 issued under the Euro Adoption Act

This legal notice publishes the Smoothing of Monetary Amounts Regulations, 2007, the objective of which is to regulate the conversion of values and monetary amounts of goods and services offered to consumers to ensure fair practices in euro pricing.

14 December: Legal Notices 407-411 of 2007 issued under the Euro Adoption Act

These legal notices are orders to adapt the laws in Chapters 1 to 250 of the Laws of Malta to the adoption of the euro by changing any monetary amounts expressed in Maltese liri into euro.

14 December: Legal Notice 413 of 2007 issued under the Banking Act

This legal notice repeals the Interest Rates on Loans and Advances Order, 1993 (Legal Notice 188 of 1993), which regulated bank interest rates in Malta. The repeal of this Order is part of a wider process aimed at clarifying the legal framework governing interest rates in Malta.

18 December: Legal Notice 420 of 2007 issued under the Insurance Intermediaries Act

This legal notice repeals the Insurance Intermediaries (Transitional Provisions) Regulations, 2006 governing the provision of services in relation to linked long-term contracts of insurance as well as communications by the competent authority (Legal Notice 319 of 2006).

18 December: Legal Notice 421 of 2007 issued under the Insurance Business Act

This legal notice amends certain regulations governing the European Passport Rights for Insurance and Reinsurance Undertakings Regulations, 2004 (Legal Notice 89 of 2004).

21 December: Legal Notices 423-427 of 2007 issued under the Euro Adoption Act

These legal notices are orders to adapt Chapters 251 to 492 of the Laws of Malta to the adoption of the euro as the national currency by changing any monetary amounts expressed in Maltese liri into euro.

28 December: Legal Notice 441 of 2007 issued under the Euro Adoption Act

This legal notice publishes the Cash Changeover Regulations, 2007, the objective of which is to ensure the smooth changeover of the currency unit from the Maltese lira to the euro and to regulate the services of credit institutions during the changeover period.

Part III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2007

Directors' report

The Directors present their report and the audited financial statements of the Central Bank of Malta for the year ended 31 December 2007.

Principal activities and review of operations

The Bank's Mission and Objectives are set out on pages 4 to 5 of the Annual Report. The Governor's Statement and the Bank's Policies, Operations and Activities, included in the Annual Report on pages 13 to 16 and pages 63 to 89 respectively, give a detailed account of the Bank's activities and operations during 2007.

Presentation of the financial statements

These financial statements have been prepared so as to give a true and fair view of the state of affairs of the Bank as at 31 December 2007, and of its profit and its cash flows for the year then ended. The financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards issued by the International Accounting Standards Board and in accordance with the requirements of the Central Bank of Malta Act (Cap. 204) applicable for the financial period under review.

Financial results

The Bank's financial statements for the year ended 31 December 2007 are set out on pages A-7 to A-53 and disclose an operating profit of Lm12.3 million (2006: Lm11.2 million). The amount payable to Government is Lm14.2 million (2006: Lm10.9 million).

Directors' report - continued

Board of Directors

The members of the Board of Directors during the year ended 31 December 2007 and up to the date of authorisation for issue of the financial statements were:

Mr Michael C. Bonello - Governor
Mr David A. Pullicino - Deputy Governor
Mr Joseph V. Gatt (whose term of office expired on 31 December 2007)
Ms Philomena Meli (whose term of office expired on 21 January 2008)
Mr Charles J. Falzon
Mr Victor Busuttil (appointed on 1 January 2008)

During the financial year under review, Dr Stephanie Sciberras was the Secretary to the Board.

Auditors

Ernst & Young and PricewaterhouseCoopers have signified their willingness to continue in office.

By order of the Board

M. C. Bonello
Governor

D. A. Pullicino
Deputy Governor

Pjazza Kastilja
Valletta
Malta

7 March 2008

Statement of Directors' responsibilities in respect of the financial statements

The Central Bank of Malta is governed by the provisions of the Central Bank of Malta Act (Cap. 204). The Bank has also chosen to prepare financial statements in accordance with the requirements of International Financial Reporting Standards. The Board of Directors is responsible for ensuring that these financial statements give a true and fair view of the state of affairs of the Bank as at 31 December 2007 and of the profit and cash flows for the year then ended. The Board of Directors is also responsible for ensuring that the financial statements are drawn up in accordance with the requirements of the Central Bank of Malta Act (Cap. 204) applicable for the financial period under review.

In preparing the financial statements, the Directors are responsible for selecting and applying appropriate accounting policies and making accounting estimates that are reasonable in the circumstances.

The Directors are also responsible for designing, implementing and maintaining internal control relevant to the preparation and the fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error, and that comply with the requirements set out above. They are also responsible for safeguarding the assets of the Bank and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Independent auditors' report

To the Board of Directors of the Central Bank of Malta

We have audited the financial statements of Central Bank of Malta on pages A-7 to A-53 which comprise the balance sheet as at 31 December 2007 and the profit and loss account, statement of changes in equity and cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory notes.

Directors' Responsibility for the Financial Statements

The Directors are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and the requirements of the Central Bank of Malta Act (Cap. 204). As described in the statement of Directors' responsibilities on page A-4, this responsibility includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Independent auditors' report - continued

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of the Bank as at 31 December 2007, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards and have been properly prepared in accordance with the requirements of the Central Bank of Malta Act (Cap. 204).

Anthony P. Doublet (Partner) for and on behalf of

ERNST & YOUNG

Malta

7 March 2008

Fabio Axisa (Partner) for and on behalf of

PRICEWATERHOUSECOOPERS

Malta

7 March 2008

Profit and loss account

	Notes	**2007**	2006
		Year ended 31 December	
		Lm'000	Lm'000
Interest and similar income	3	**38,907**	31,208
Interest expense and similar charges	4	**(17,531)**	(11,350)
Net interest income		**21,376**	19,858
Net fee and commission expense		**(213)**	(230)
Net losses from foreign exchange activities	5	**(2,891)**	(3,507)
Other net trading (losses)/gains	6	**(10)**	7
Gains less losses on disposal of available-for-sale financial assets	7	**(119)**	109
Other operating income		**87**	107
Administrative expenses	8	**(5,314)**	(4,836)
Depreciation on property, plant and equipment	20	**(508)**	(255)
Currency issue expenses	9	**(91)**	(101)
Profit for the financial year		**12,317**	11,152
Transfer from/(to) reserves for risks and contingencies	29	**1,900**	(250)
Payable to the Government of Malta in terms of article 24(4) of the Central Bank of Malta Act (Cap. 204)		**14,217**	10,902

Balance sheet

	Notes	**2007**	2006
		As at 31 December	
		Lm'000	Lm'000
Assets			
Cash and balances with banks	10	**55,926**	11,038
Gold balances		**3,795**	1,150
Placements with banks	11	**581,597**	341,984
Investment securities:			
Available-for-sale	12	**302,527**	527,175
Held-to-maturity	12	**104,627**	30,491
Claims on the International Monetary Fund	13	**36,011**	36,409
Participating interest in the European Central Bank	14	**108**	107
Other foreign currency assets		**319**	854
Total external assets		**1,084,910**	949,208
Available-for-sale local assets:			
Treasury bills	16	**906**	3,345
Domestic debt securities	17	**86,505**	26,924
Derivative financial instruments	18	**5,082**	1,118
Other assets	19	**32,692**	34,611
Property, plant and equipment	20	**9,878**	8,806
Prepayments and accrued income		**12,748**	12,968
Total assets		**1,232,721**	1,036,980

Balance sheet - continued

	Notes	**2007**	2006
		As at 31 December	
		Lm'000	Lm'000
Liabilities and equity			
Liabilities			
Notes and coins in circulation	21	**290,977**	503,976
Deposits by:			
Central banks	22	**16**	15
Banks	23	**614,951**	283,649
Government	24	**166,243**	106,569
Others	25	**32,487**	17,594
Profits payable to Government		**12,317**	10,902
Derivative financial instruments	18	**345**	926
Other liabilities	26	**31,663**	33,212
Accruals and deferred income		**2,180**	2,174
		1,151,179	959,017
Capital and reserves			
Capital	27	**5,000**	5,000
General reserve fund	28	**23,000**	23,000
Special reserve fund	28	**13,000**	13,000
Reserves for risks and contingencies	29	**43,095**	44,995
Fair value reserve	30	**(6,124)**	(8,032)
Capital contribution	31	**3,571**	-
		81,542	77,963
Total liabilities and equity		**1,232,721**	1,036,980

The financial statements on pages A-7 to A-53 were approved for issue by the Board of Directors on 7 March 2008 and were signed on its behalf by:

M. C. Bonello Governor	D. A. Pullicino Deputy Governor	G. Huber Director Finance and Banking	R. Filletti Financial Controller

Statement of changes in equity

	Capital Lm'000	General reserve fund Lm'000	Special reserve fund Lm'000	Reserves for risks and contingencies Lm'000	Fair value reserve Lm'000	Retained earnings Lm'000	Total Lm'000
Balance at 1 January 2006	5,000	23,000	13,000	44,745	(1,455)	-	84,290
Arising in the financial period:							
- net losses from changes in fair value of available-for-sale assets	-	-	-	-	(6,468)	-	(6,468)
Transfers:							
- net gains transferred to profit for the year on disposal of available-for-sale assets	-	-	-	-	(109)	-	(109)
Net expense recognised directly in equity	-	-	-	-	(6,577)	-	(6,577)
Profit for the financial year	-	-	-	-	-	11,152	11,152
Total recognised (expense)/income for 2006	-	-	-	-	(6,577)	11,152	4,575
Transfer to reserves for risks and contingencies	-	-	-	250	-	(250)	-
Transfer to profits payable to Government	-	-	-	-	-	(10,902)	(10,902)
Balance at 31 December 2006	5,000	23,000	13,000	44,995	(8,032)	-	77,963

Statement of changes in equity - continued

	Capital Lm'000	General reserve fund Lm'000	Special reserve fund Lm'000	Reserves for risks and contingencies Lm'000	Fair value reserve Lm'000	Capital contribution Lm'000	Retained earnings Lm'000	Total Lm'000
Balance at 1 January 2007	5,000	23,000	13,000	44,995	(8,032)	-	-	77,963
Arising in the financial period:								
- net gains from changes in fair value of available-for-sale assets	-	-	-	-	1,789	-	-	1,789
Transfers:								
- net losses transferred to profit for the year on disposal of available-for-sale assets	-	-	-	-	119	-	-	119
Net income recognised directly in equity	-	-	-	-	1,908	-	-	1,908
Profit for the financial year	-	-	-	-	-	-	12,317	12,317
Total recognised income for 2007	-	-	-	-	1,908	-	12,317	14,225
Capital contribution from Government (Note 31)	-	-	-	-	-	3,571	-	3,571
Transfer from reserves for risks and contingencies	-	-	-	(1,900)	-	-	1,900	-
Transfer to profits payable to Government	-	-	-	-	-	-	(14,217)	(14,217)
Balance at 31 December 2007	**5,000**	**23,000**	**13,000**	**43,095**	**(6,124)**	**3,571**	**-**	**81,542**

Cash flow statement

	Notes	**2007**	2006
		Year ended 31 December	
		Lm'000	Lm'000
Cash flows from operating activities			
Interest and similar income received		**42,284**	36,212
Interest and similar charges paid		**(17,531)**	(11,242)
Net fee and commission paid		**(213)**	(230)
Net trading and other expense		**(7,306)**	(2,217)
Cash payments mainly to employees and suppliers		**(5,389)**	(5,437)
Cash flows from operating profits before changes in operating assets and liabilities		**11,845**	17,086
Net changes in operating assets and liabilities:			
Placements with banks		**11,539**	8,818
Other foreign exchange assets		**(1,713)**	630
Treasury bills		**(769)**	1,597
Malta Government securities		**(60,323)**	(20,372)
Other assets		**1,919**	1,160
Currency in issue		**(212,999)**	(16,068)
Deposits		**260,273**	41,155
Other liabilities		**(1,979)**	(986)
Net cash from operating activities		**7,793**	33,020
Cash flows from investing activities			
Purchase of securities		**(139,190)**	(256,894)
Proceeds from sale and maturity of securities		**288,923**	286,119
Purchase of property, plant and equipment	20	**(1,580)**	(307)
Net cash from investing activities		**148,153**	28,918
Cash flows from financing activities			
Capital contribution from the Government of Malta		**3,571**	-
Payment to the Government under article 24(4) of the Central Bank of Malta Act (Cap. 204)		**(12,802)**	(10,001)
Net cash used in financing activities		**(9,231)**	(10,001)
Movement in cash and cash equivalents		**146,715**	51,937
Cash and cash equivalents at 1 January		**66,601**	14,664
Cash and cash equivalents at 31 December	32	**213,316**	66,601

Notes to the financial statements

1. Accounting policies

The principal accounting policies adopted in the preparation of these financial statements are set out below.

(a) Basis of preparation of financial statements

These financial statements have been drawn up so as to give a true and fair view of the state of affairs of the Bank, and of its profit and its cash flows. They have been prepared under the historical cost convention as modified by the fair valuation of available-for-sale investments, all derivative contracts and certain other instruments as outlined in the accounting policies below. The financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards (IFRSs) and with the requirements of the Central Bank of Malta Act (Cap. 204) applicable for the financial periods presented. References in these financial statements to specific articles of the Act refer to legal requirements that were effective up to 31 December 2007.

As a result of Malta's adoption of the euro on 1 January 2008 (refer to Note 36 to the financial statements), on the same date the Bank adopted the Guideline of the European Central Bank of 10 November 2006 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2006/16).

The preparation of financial statements in conformity with IFRSs requires the use of certain accounting estimates. It also requires management to exercise its judgment in the process of applying the Bank's accounting policies (see Note 2 – Critical accounting estimates, and judgments in applying accounting policies).

Standards, interpretations and amendments to published standards effective in 2007

In 2007, the Bank adopted new standards, amendments and interpretations to existing standards that are mandatory for the Bank's accounting period beginning on 1 January 2007. The adoption of these revisions to the requirements of IFRSs did not result in substantial changes to the Bank's accounting policies. IFRS 7, Financial Instruments: Disclosures, and the complementary Amendment to IAS 1, Presentation of Financial Statements – Capital Disclosures, introduce new disclosures relating to financial instruments and capital, but do not have any impact on the classification and measurement of the Bank's financial instruments and capital.

1. Accounting policies - continued

(a) Basis of preparation of financial statements - continued

Standards, interpretations and amendments to published standards that are not yet effective

Certain new standards, amendments and interpretations to existing standards have been published by the date of authorisation for issue of these financial statements but are mandatory for accounting periods beginning after 1 January 2007. The Bank has not early adopted these revisions to the requirements of IFRSs and the Bank's directors are of the opinion that there are no requirements that would have a possible significant impact on the Bank's financial statements.

(b) Interest income and expense

Interest income and expense are recognised in the profit and loss account for all interest-bearing financial instruments and for other instruments measured at amortised cost using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates cash flows considering all contractual terms of the financial instrument but does not consider future credit losses. The calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts. Accordingly, interest income includes coupons earned on fixed income securities and amortised premiums or discounts on Treasury bills and other instruments.

(c) Fee and commission income and expense

Fees and commissions are generally recognised on an accrual basis when the service has been provided.

(d) Foreign currency transactions and balances

Foreign currency transactions are accounted for at the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the profit and loss account.

1. Accounting policies - continued

(e) Demonetised currency notes and coins

(i) Demonetised currency notes

In accordance with article 42 of the Central Bank of Malta Act (Cap. 204), after the expiration of one year following the end of the period established in the notice of demonetisation, any unpresented demonetised notes cease to be included in the Bank's currency liabilities. The value of such notes, after deducting therefrom the value of any notes which are subsequently redeemed, are recognised in the profit and loss account of the Bank until the expiration of ten years from the end of the period above mentioned. After the expiry of ten years from the notice of demonetisation, demonetised currency notes not yet presented are not redeemed by the Bank.

(ii) Demonetised coins

In accordance with article 43 of the Central Bank of Malta Act (Cap. 204), after the expiration of six months following the end of the period established in the notice of demonetisation, any unpresented demonetised coins cease to be included in the Bank's currency liabilities. The value of such coins, after deducting therefrom the value of any coins which are subsequently redeemed, are recognised in the profit and loss account of the Bank until the expiration of two years from the end of the period above mentioned. After the expiry of two years from the notice of demonetisation, demonetised coins not yet presented are not redeemed by the Bank.

(f) Investment securities, Malta Government securities and Treasury bills

In accordance with the requirements of IAS 39, the Bank classifies its foreign currency investment securities, Malta Government securities and Treasury bills in the following categories: financial assets at fair value through profit or loss; loans and receivables; held-to-maturity investments; and available-for-sale financial assets. The classification depends on the purpose for which the financial assets were acquired. Management determines the classification of its financial assets at initial recognition, and re-evaluates this designation at every reporting date in those circumstances where the Bank is permitted to reclassify under the requirements of IAS 39.

1. Accounting policies - continued

(f) Investment securities, Malta Government securities and Treasury bills - continued

(i) Financial assets at fair value through profit or loss

This category has two sub-categories: 'financial assets held for trading', and those designated at fair value through profit or loss at inception. A financial asset is classified in this category if acquired principally for the purpose of selling in the short-term or if so designated by management upon initial recognition. Securities which are either acquired for generating a profit from short-term fluctuations in price, or are included in a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking, are classified as instruments held for trading. Derivatives are also categorised as 'held for trading' unless they are designated as hedging instruments. During the current and preceding financial years, the Bank's management has not designated any financial assets at fair value through profit or loss at inception.

(ii) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Bank provides money directly to an issuer or borrower with no intention of trading the asset. Loans and receivables do not include those instruments for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration.

(iii) Held-to-maturity

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Bank's management has the positive intention and ability to hold to maturity. If the Bank sells other than an insignificant amount of held-to-maturity assets, the entire category would be tainted and reclassified as available-for-sale.

(iv) Available-for-sale

Available-for-sale financial assets are non-derivatives that are either designated in this category upon initial recognition or not classified in any of the other categories. Available-for-sale investments are those intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates or exchange rates.

The Bank recognises a financial asset on its balance sheet when it becomes a party to the contractual provisions of the instrument. All regular way purchases and sales of all foreign currency investment securities, Government securities and Treasury bills (transactions that require delivery within the time frame established by regulation or market convention) are recognised at settlement date which is the date on which an asset is delivered to or by the Bank. Any change in fair value for the asset to be received is recognised between the trade date and settlement date in respect of assets which are carried at fair value in accordance with the measurement rules applicable to the respective financial asset.

1. Accounting policies - continued

(f) Investment securities, Malta Government securities and Treasury bills - continued

Financial assets not carried at fair value through profit or loss are initially recognised at fair value plus transaction costs. Transaction costs consist of the incremental costs that are directly attributable to the acquisition of the investment. Financial assets carried at fair value through profit or loss are initially recognised at fair value and transaction costs are expensed in the profit and loss account. Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or have been transferred and the Bank has transferred substantially all risks and rewards of ownership or has not retained control of the financial asset.

Available-for-sale financial assets and financial assets at fair value through profit or loss are subsequently carried at fair value. Loans and receivables and held-to-maturity investments are carried at amortised cost using the effective interest method. Amortised cost is the initial measurement amount adjusted for the amortisation of any difference between the initial and maturity amounts using the effective interest method.

Gains and losses arising from changes in the fair value of the 'financial assets at fair value through profit or loss' category are included in the profit and loss account in the period in which they arise. Gains and losses arising from changes in the fair value of available-for-sale financial assets are recognised directly in equity, until the financial asset is derecognised or impaired at which time the cumulative gain or loss previously recognised in equity should be recognised in profit or loss. When securities classified as available-for-sale are sold or impaired, the accumulated fair value adjustments recognised in equity are included in the profit and loss account as 'gains less losses on disposal of available-for-sale investments'.

Interest earned whilst holding investments is reported as interest income. Interest on available-for-sale securities calculated using the effective interest method is recognised in the profit and loss account. In respect of available-for-sale investments, any difference between the initial measurement amount and the maturity amount (premium or discount) arising on financial assets that have a fixed maturity is amortised to the profit and loss account using the effective interest rate method over the period to maturity. Fair value changes are computed as the differences between fair value and amortised cost of such instruments.

Changes in the fair value of monetary securities denominated in a foreign currency and classified as available-for-sale are analysed between translation differences resulting from changes in amortised cost of the security and other changes in the carrying amount of the security. The translation differences are recognised in profit or loss, and other changes in carrying amount are recognised in equity.

The fair values of quoted investments in active markets are based on current bid prices. If the market for a financial asset is not active, the Bank establishes fair value by using valuation techniques.

1. Accounting policies - continued

(f) Investment securities, Malta Government securities and Treasury bills - continued

The Bank assesses at each balance sheet date whether there is objective evidence that a financial asset is impaired. A financial asset is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable. The amount of the loss is recognised in the profit and loss account. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed and the amount of the reversal is recognised in the profit and loss account.

If objective evidence of impairment exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss – is removed from equity and recognised in the profit and loss account. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through the profit and loss account.

1. Accounting policies - continued

(g) Derivative financial instruments

Derivative financial instruments, including forward foreign exchange contracts, currency swaps and cross-currency interest rate swaps, are initially recognised at fair value on the date on which a derivative contract is entered into, and are subsequently remeasured at their fair value. Fair values for derivative contracts are determined using forward exchange market rates at the balance sheet date and are obtained from valuation techniques, including discounted cash flow models, as appropriate. Discounting techniques, reflecting the fact that the respective exchange or settlement will not occur until a future date, are used when the time value of money has a significant effect on the fair valuation of these instruments. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative. The Bank uses derivatives principally for macro-hedging purposes so as to hedge foreign exchange risk on its net balance sheet exposure. Accordingly, these derivative transactions, while providing effective economic hedges under the Bank's risk management policies, do not qualify for hedge accounting under the specific rules in IAS 39 and are classified as instruments held for trading, together with other derivative instruments entered into for trading purposes. Changes in the fair value of all derivative instruments that do not qualify for hedge accounting under IAS 39 are recognised immediately in the profit and loss account.

(h) Gold balances

Gold balances are measured at the current market value which in the opinion of the Directors is fairly represented by the Maltese lira equivalent of the London fixings as at the balance sheet date.

(i) Claims on the International Monetary Fund

The International Monetary Fund Reserve Tranche Position and Special Drawing Rights are translated at the prevailing representative rate for the Maltese lira of SDR2.16888 to Lm1 as quoted by the Fund at the close of business on 31 December 2007. The International Monetary Fund Maltese lira holdings are revalued against the SDR at the representative rate for the Maltese lira quoted by the Fund at 31 December 2007. Adjustments on revaluation of the International Monetary Fund holdings are reflected in the corresponding asset - Currency Subscription.

1. Accounting policies - continued

(j) Participating interest in the European Central Bank

Considering the nature of the instrument, the substance of the arrangement in place and the reliability with which its fair value can be measured, the Bank's participating interest in the European Central Bank is carried in the Bank's balance sheet at its original amount in foreign currency, translated at the exchange rate ruling at the date of acquisition.

(k) Sale and repurchase agreements and lending of securities

Securities sold subject to repurchase agreements ('repos') are retained in the financial statements in the appropriate classification but are reclassified as pledged assets when the transferee has the right by contract or custom to sell or repledge the collateral; the counterparty liability is included in amounts due to banks or other customers, as appropriate. Securities purchased under agreements to resell ('reverse repos') are recorded as loans and advances to banks or other customers, as appropriate. The difference between the sale and repurchase price is treated as interest and is accrued in the profit and loss account over the life of the agreements using the effective interest method. Securities lent to counterparties are also retained in the financial statements.

(l) Financial guarantee contracts

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument.

Financial guarantees are initially recognised in the financial statements at fair value on the date the guarantee was given. Subsequent to initial recognition, the Bank's liabilities under such guarantees are measured at the higher of the initial measurement, less amortisation calculated to recognise in the profit and loss account the fee income earned on a straight-line basis over the life of the guarantee, and the best estimate of the expenditure required to settle any financial obligation arising at the balance sheet date. These estimates are determined based on experience of similar transactions and history of past losses, supplemented by the judgment of management.

1. Accounting policies - continued

(m) Other financial instruments

The Bank's other financial assets which have not been referred to in the accounting policies disclosed above, comprising principally placements with banks and other similar assets, are classified as loans and receivables in accordance with the requirements of IAS 39. The recognition and measurement rules applicable to loans and receivables are outlined in Note 1(f) to the financial statements. These financial assets are measured at their face or nominal values. All regular way transactions in assets classified in this category are accounted for using settlement date accounting.

The Bank's financial liabilities other than those referred to in the accounting policies above, including currency in circulation, deposits and other similar liabilities, are classified as financial liabilities which are not at fair value through profit or loss (classified as 'other liabilities') under IAS 39. The Bank recognises a financial liability on its balance sheet when it becomes a party to the contractual provisions of the instrument. Financial liabilities not at fair value through profit or loss are recognised initially at fair value, being the fair value of consideration received, net of transaction costs that are directly attributable to the acquisition or issue of the financial liability. These liabilities are subsequently measured at amortised cost; any difference between the initial carrying amount and the maturity value is recognised in the profit and loss account over the term of the liability using the effective interest method. These financial instruments are carried at their face or nominal values. The Bank derecognises a financial liability from its balance sheet when the obligation specified in the contract or arrangement is discharged, is cancelled or expires.

(n) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(o) Property, plant and equipment

All property, plant and equipment is stated at historical cost less depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items. Subsequent costs are included in the asset's carrying amount or are recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Bank and the cost of the item can be measured reliably. All repairs and maintenance are charged to the profit and loss account during the financial period in which they are incurred.

1. Accounting policies - continued

(o) Property, plant and equipment - continued

Depreciation is calculated using the straight-line method to allocate the cost of the assets to their residual values over their estimated useful lives as follows:

Freehold buildings	2%
Leasehold property	Over the remaining term of the lease
Computer equipment and other fixed assets	10 - 25%

Assets in the course of construction are not depreciated.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Property, plant and equipment is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. The recoverable amount is the higher of the asset's fair value less costs to sell and value in use.

An item of property, plant and equipment is derecognised upon disposal or when no future economic benefits are expected from its use or disposal. Gains and losses arising on derecognition are determined by comparing proceeds with carrying amount. These are included in the profit and loss account in the year the asset is derecognised.

(p) Leases

Leases entered into by the Bank as lessee where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. The total payments made under operating leases are charged to the profit and loss account on a straight-line basis over the period of the lease.

(q) Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with maturity of three months or less from the date of acquisition including: cash and balances with banks, Treasury bills, placements with banks and deposits.

2. Critical accounting estimates, and judgments in applying accounting policies

Estimates and judgments are based on historical experience and are continually evaluated taking in consideration other factors including expectations of future events that are believed to be reasonable under the circumstances.

In the opinion of management, the accounting estimates and judgments made in the course of preparing these financial statements are not difficult, subjective or complex to a degree which would warrant their description as critical in terms of the requirements of IAS 1. The Bank's Board believes there are no areas involving a higher degree of judgment that have the most significant effect on the amounts recognised in the financial statements; and there are no key assumptions and other key sources of estimation uncertainty relating to estimates that require management's most difficult, subjective or complex judgments.

3. Interest and similar income

	2007	2006
	Lm'000	Lm'000
Income from:		
Placements with banks	**14,933**	9,306
Available-for-sale investment securities	**16,835**	18,996
Held-to-maturity investment securities	**2,837**	159
Claims on the International Monetary Fund	**1,154**	1,017
Other foreign currency assets	**302**	295
External assets	**36,061**	29,773
Treasury bills and debt securities issued by the Government of Malta	**2,799**	1,394
Other assets	**47**	41
	38,907	31,208

4. Interest expense and similar charges

	2007	2006
	Lm'000	Lm'000
Expense on:		
Bank deposits	**8,644**	4,834
Liabilities arising from monetary policy instruments	**4,837**	4,054
Government deposits	**3,808**	2,408
Other deposits	**242**	54
	17,531	11,350

5. Net losses from foreign exchange activities

	2007 **Lm'000**	2006 Lm'000
Amounts recognised in the profit and loss account	**(2,891)**	(3,507)

This comprises foreign exchange translation gains and losses, together with gains and losses from forward foreign exchange contracts and currency swaps which are principally used by the Bank to hedge its exposure to currency movements.

Subsequent to the entry of the Maltese lira into the Exchange Rate Mechanism II (ERM II), the Bank enters into foreign exchange transactions for the forward purchase of euro and simultaneous forward sale of sterling or US dollars for the purposes of hedging against foreign exchange movements (see Note 33 on 'Currency risk'). During the current year, the Bank incurred costs of Lm2.9 million (2006: Lm3.7 million) specifically in respect of the premium paid on the interest rate differential relating to these transactions. These costs are offset by the additional interest earned by the Bank on holdings in the currencies sold forward in accordance with its hedging policy. This additional income is presented in "Interest and similar income" in the profit and loss account.

6. Other net trading (losses)/gains

	2007 **Lm'000**	2006 Lm'000
Net fair value losses on held for trading foreign currency securities	**(26)**	(6)
Net fair value gains on other derivative contracts (Note 18)	**16**	13
	(10)	7

7. Gains less losses on disposal of available-for-sale financial assets

	2007 **Lm'000**	2006 Lm'000
Net (losses)/gains on disposal of:		
Foreign currency investment securities	**(49)**	143
Treasury bills and debt securities issued by the Government of Malta	**(70)**	(34)
	(119)	109

8. Administrative expenses

	2007	2006
	Lm'000	Lm'000
Staff salaries	**2,972**	2,783
Other staff costs	**366**	322
Training, welfare and other related expenditure	**407**	311
Market information and communication expenses	**386**	386
Other administrative expenses	**1,183**	1,034
	5,314	4,836

Other administrative expenses mainly comprise maintenance expenditure, professional fees, travelling costs and other services or expense items which are incurred in the course of the Bank's operations. Auditors' remuneration for the current financial year amounted to Lm25,000 (2006: Lm25,000).

Compensation to the members of the Board of Directors for the financial year under review amounted to Lm88,471 (2006: Lm88,130). The Governor and Deputy Governor are entitled to such benefits as the use of a leased motor vehicle, health insurance cover and refund of certain other expenses. The other members of the Board of Directors are entitled to health insurance cover and refund of certain other expenses.

The average number of persons employed by the Bank during the year was as follows:

	2007	2006
	Number	Number
Governors	**2**	2
Divisional Directors	**5**	5
Heads and Executives	**89**	75
Supervisory and clerical staff	**196**	199
Non-clerical staff	**35**	39
	327	320

9. Currency issue expenses

These expenses represent costs incurred in relation to the purchase of notes and coins for the purposes of domestic circulation.

10. Cash and balances with banks

	2007 Lm'000	2006 Lm'000
Cash in hand	**432**	298
Balances with banks - repayable on call and at short notice	**55,494**	10,740
Included in cash and cash equivalents (Note 32)	**55,926**	11,038

Balances with banks amounting to Lm16.7 million are secured by US Treasury bills which the Bank accepted as collateral under repurchase agreements. These balances are subject to floating interest rates.

11. Placements with banks

	2007 Lm'000	2006 Lm'000
Placements subject to fixed interest rates, by remaining maturity		
- One year or less but over three months	**-**	12,879
- Three months or less but over one month	**60,664**	62,249
- One month or less	**520,933**	266,856
	581,597	341,984

Placements with a contractual maturity of three months or less are included in cash equivalents for the purposes of the cash flow statement (Note 32).

12. Investment securities

	2007 Lm'000	2006 Lm'000
Available-for-sale investment securities – at fair value		
Debt securities principally subject to fixed interest rates, by remaining maturity		
- Over five years	**37,690**	63,092
- Five years or less but over two years	**110,713**	137,919
- Two years or less but over one year	**48,464**	94,400
- One year or less but over three months	**61,097**	176,258
- Three months or less	**44,563**	55,506
	302,527	527,175

12. Investment securities - continued

Held-to-maturity investment securities – at amortised cost	**2007**	2006
Debt securities subject to fixed interest rates, by remaining maturity	**Lm'000**	Lm'000
- Over five years	**53,501**	10,946
- Five years or less but over one year	**41,279**	8,657
- One year or less but over three months	**7,703**	6,453
- Three months or less	**2,144**	4,435
	104,627	30,491

The Bank's portfolio of investment securities is composed of listed foreign currency debt securities issued mainly by foreign governments and international financial institutions. As at 31 December 2007, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of USD45 million or Lm13 million approximately (2006: USD45 million or Lm16 million approximately). No amounts were borrowed under these facilities at the balance sheet dates. As at 31 December 2007, the fair value of held-to-maturity investment securities, based on quoted market prices, amounted to Lm103,870,250 (2006: Lm30,282,000).

13. Claims on the International Monetary Fund

	2007	2006
	Lm'000	Lm'000
Reserve Tranche Position	**18,562**	19,729
Special Drawing Rights	**17,449**	16,680
	36,011	36,409

Malta's membership subscription to the International Monetary Fund amounts to SDR102,000,000 (2006: SDR102,000,000).

The Bank's position with the International Monetary Fund at 31 December 2007 is reflected in the balance sheet as follows:

(a) Reserve Tranche Position included above is equivalent to SDR40,259,007. This amount is a claim on the International Monetary Fund and represents the difference between the quota of SDR102,000,000 and the Fund's Maltese lira holdings.

13. Claims on the International Monetary Fund - continued

(b) Special Drawing Rights included above are equivalent to SDR37,845,473. These represent the Special Drawing Rights allocated to Malta amounting to SDR11,288,000, to which a corresponding liability exists in the form of a restricted demand deposit of the Government of Malta included under 'Other deposits' (see Note 25), together with other Special Drawing Rights acquired in accordance with International Monetary Fund requirements and procedures. Special Drawing Rights allocated to Malta cannot be withdrawn unless such advice is received from the Fund. Other Special Drawing Rights have no specified maturity.

(c) Currency Subscription included with 'Other assets' (see Note 19) is stated at Lm28,466,763 and represents the balance of the quota paid in Maltese liri. A corresponding liability included with 'Other liabilities' (see Note 26) exists in the form of IMF current accounts of Lm28,466,763 or SDR61,740,993.

The Reserve Tranche Position, Special Drawing Rights and SDR allocation (Note 25) are subject to floating interest rates determined by reference to the official rate quoted by the Fund on a weekly basis. The effective interest rate applicable to the interest-bearing instruments as at the balance sheet date was 4.05% (2006: 4.07%). The Currency Subscription and IMF current accounts are not subject to interest.

14. Participating interest in the European Central Bank

On 1 May 2004 Malta joined the European Union (EU) and consequently the Bank became a member of the European System of Central Banks (ESCB). In accordance with article 28 of the Statute of the ESCB and the European Central Bank (ECB), the Bank became a subscriber to the capital of the ECB. This balance represents the Bank's participating interest in the ECB. Subscriptions depend on shares which are fixed in accordance with article 29.1 of the ESCB Statute and which must be adjusted every five years and every time that a new member state joins the EU in accordance with article 49.3. The share of Malta in the ECB's capital on 1 May 2004 was 0.0647% and was calculated in accordance with article 29 of the Statute of the ESCB, on the basis of population and GDP data provided by the European Commission. With effect from 1 January 2007, Malta's share in the ECB's capital was determined at 0.0622% pursuant to the decision of the ECB of 15 December 2006. As Malta did not participate in the euro area until 1 January 2008, the transitional provisions of article 48 of the Statute applied. Consequently, the Bank was required to pay-up a minimal contribution of 7% of its allocated share capital in the ECB upon entry into the ESCB on 1 May 2004 amounting to EUR252,024, which was adjusted to EUR250,819 on 1 January 2007. Appendix 1 to these financial statements on pages A-54 and A-55 includes detailed disclosures of participating interests held by euro area and non-euro area National Central Banks (NCBs).

15. External reserve ratio

The ratio of external assets to notes and coins issued, excluding coins issued for numismatic purposes, and deposit liabilities is 98.17% (2006: 104.10%). In accordance with article 19(1) of the Central Bank of Malta Act (Cap. 204), the minimum ratio in this respect is 60%.

16. Available-for-sale Treasury bills

The Bank's holdings of Malta Government Treasury bills, which are non interest-bearing but are acquired at discounted amounts, include:

	2007	2006
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**75**	2
- Three months or less but over one month	**116**	2,441
- One month or less	**715**	902
	906	3,345

The weighted average effective interest rate as at the balance sheet date was 4.04% (2006: 3.79%). Treasury bills with a contractual maturity of three months or less from the date of acquisition are included in cash equivalents (Note 32).

17. Available-for-sale domestic debt securities

The Bank's holdings of domestic debt securities, consisting of Malta Government Stocks subject to fixed interest rates listed on the Malta Stock Exchange, include:

	2007	2006
	Lm'000	Lm'000
By remaining maturity		
- Over five years	**34,586**	1,251
- Five years or less but over one year	**36,517**	18,408
- One year or less	**15,402**	7,265
	86,505	26,924

The weighted average effective interest rate as at the balance sheet date was 5.83% (2006: 6.48%).

18. Derivative financial instruments

At the balance sheet dates, the fair values of the Bank's derivative contracts, consisting of forward foreign exchange contracts, currency swaps and cross-currency interest rate swaps, are as follows:

	Assets	
	2007	2006
	Lm'000	Lm'000
Foreign exchange and other derivatives held for trading:		
Foreign exchange contracts maturing within six months from the balance sheet date		
- forward purchase of EUR225 million (2006: EUR80 million) against USD	**1,767**	553
- forward purchase of EUR8 million against JPY	**-**	70
- forward purchase of EUR217 million (2006: EUR158 million) against GBP	**3,186**	57
Foreign exchange contract originally expiring in 2010		
- forward sale of EUR13.6 million against Lm	**-**	302
Other derivative contracts maturing in 2009		
- cross-currency interest rate swaps with principal amounts of Lm10 million (2006: Lm10 million)	**129**	136
	5,082	1,118

During the current financial year, the forward contract entered into with a company owned by the Government of Malta, which originally expired in 2010, was terminated. Settlement of this forward contract was also guaranteed by the Government.

	Liabilities	
	2007	2006
	Lm'000	Lm'000
Foreign exchange and other derivatives held for trading:		
Foreign exchange contracts maturing within six months from the balance sheet date		
- forward purchase of EUR178.5 million against GBP	**-**	508
- forward purchase of EUR115 million (2006: EUR81.8 million) against USD	**128**	208
Other derivative contracts maturing in 2009		
- cross-currency interest rate swap with principal amount of Lm10 million (2006: Lm10 million)	**217**	210
	345	926

18. Derivative financial instruments - continued

In prior years, the Bank has entered into a cross-currency interest rate swap arrangement with an international financial institution whereby the Bank has undertaken to purchase upon inception and sell forward, the principal amount of Lm10 million against EUR, at the same exchange rate. The Bank will pay fixed interest amounts on the Lm principal amount annually and will receive variable interest amounts at quarterly intervals, based on reset floating interest rates linked to 3 month EURIBOR, computed by reference to the EUR principal amount. For the purposes of managing its exposures from this arrangement, the Bank entered into similar swap agreements, offsetting the contract mentioned above, with two local financial institutions. Under each agreement the Bank has undertaken to sell upon inception and buy forward Lm5 million against EUR at the same exchange rate for each respective contract. During the term of these contracts, the Bank will receive fixed interest amounts on the Lm principal amount on an annual basis, and will pay variable interest amounts at quarterly intervals based on 3 month EURIBOR determined by reference to the EUR principal amount. With effect from 1 January 2008, since Malta became a member of the Economic and Monetary Union (EMU), the obligations of all parties to pay amounts denominated in Maltese lira will be discharged by payment in euro, with the conversion carried out at the irrevocably fixed conversion rate.

19. Other assets

	2007	2006
	Lm'000	Lm'000
International Monetary Fund Currency Subscription (see Note 13)	**28,467**	30,256
Others	**4,225**	4,355
	32,692	34,611

20. Property, plant and equipment

	Freehold property Lm'000	Leasehold property Lm'000	Assets in course of construction Lm'000	Others Lm'000	Total Lm'000
At 1 January 2006					
Cost	5,642	3,191	-	2,708	11,541
Accumulated depreciation	(104)	(285)	-	(2,398)	(2,787)
Net book amount	5,538	2,906	-	310	8,754
Year ended 31 December 2006					
Opening net book amount	5,538	2,906	-	310	8,754
Additions	16	5	173	113	307
Depreciation charge for the year	(33)	(47)	-	(175)	(255)
Closing net book amount	5,521	2,864	173	248	8,806
At 31 December 2006					
Cost	5,658	3,196	173	2,821	11,848
Accumulated depreciation	(137)	(332)	-	(2,573)	(3,042)
Net book amount	5,521	2,864	173	248	8,806
Year ended 31 December 2007					
Opening net book amount	5,521	2,864	173	248	8,806
Additions	24	112	598	846	1,580
Cost of assets written off	-	-	-	(2,232)	(2,232)
Reclassification	-	771	(771)	-	-
Depreciation charge for the year	(33)	(149)	-	(326)	(508)
Depreciation released on assets written off	-	-	-	2,232	2,232
Closing net book amount	**5,512**	**3,598**	**-**	**768**	**9,878**
At 31 December 2007					
Cost	5,682	4,079	-	1,435	11,196
Accumulated depreciation	(170)	(481)	-	(667)	(1,318)
Net book amount	**5,512**	**3,598**	**-**	**768**	**9,878**

Assets in the course of construction consisted of capital expenditure incurred by the Bank in respect of the construction of a coin depot on land owned by the Government of Malta.

21. Notes and coins in circulation

	2007	2006
	Lm'000	Lm'000
Notes	**272,263**	483,124
Coins	**18,714**	20,852
	290,977	503,976

22. Central bank deposits

Deposits by central banks are denominated in Maltese lira, are repayable on demand and are included in cash equivalents (Note 32) accordingly.

23. Bank deposits

	2007	2006
	Lm'000	Lm'000
Reserve deposits held in terms of article 37 of the Central Bank of Malta Act (Cap. 204)	**414,034**	176,930
Deposits held under the Overnight deposit facility	**35,100**	-
Other deposits from local banks	**21**	19
Liabilities arising from monetary policy instruments	**142,300**	106,700
Deposits held in terms of the Special Registration Scheme	**23,496**	-
	614,951	283,649

Up to the financial year-end, reserve deposits held in terms of article 37 of the Central Bank of Malta Act (Cap. 204), denominated in Maltese lira, were subject to variable interest rates linked to the Bank's Central Intervention Rate which at the balance sheet date was 4% (2006: 3.75%). Up to the balance sheet date reserve deposits denominated in euro were subject to floating interest rates linked to the ECB's minimum bid rate which at the financial year-end was 4% (2006: 3.5%). As at the balance sheet date, the effective interest rate applied to reserve deposits denominated in Maltese lira was 4% (2006: 3.5%), and the effective interest rate applied to reserve deposits denominated in euro was 4% (2006: 3.25%). With effect from 1 January 2008, all reserve deposits are denominated in euro and are subject to variable interest rates equivalent to the ECB's MRO marginal rate.

Deposits effected by banks under the Overnight deposit facility are included in cash equivalents (Note 32) and are subject to variable interest rates linked to the Bank's Central Intervention Rate. As at the year-end, the effective interest rate applied to these deposits was 3%. Other deposits from local banks are repayable on demand and are non interest-bearing. These other deposits are included in cash equivalents (Note 32).

Liabilities arising from monetary policy instruments mature within one month from the balance sheet date and are included in cash equivalents (Note 32). The weighted average interest rate applicable to these instruments, based on the Bank's Central Intervention Rate, was 3.95% (2006: 3.7%) as at the balance sheet date.

23. Bank deposits - continued

During the current financial year, the Special Registration Scheme 2007 was launched by the Ministry of Finance with effect from 23 April 2007. The purpose of this Scheme, which expired by the balance sheet date, was to provide individuals residing in Malta with a one-time opportunity to regularise their position in respect of their holdings of eligible assets in those cases where the associated income has not been declared for the purposes of the Income Tax Act. To benefit from this scheme such eligible assets had to be registered with registration agents appointed by the Bank. Deposits effected by banks under this Scheme, disclosed in the table above, have a one year term and are subject to a fixed interest rate of 0.25%.

Amounts include:

	2007	2006
	Lm'000	Lm'000
Bank deposits by currency		
MTL	**357,889**	270,279
EUR	**257,062**	13,370
	614,951	283,649

24. Government deposits

Amounts include:

	2007	2006
	Lm'000	Lm'000
Current accounts by currency		
MTL	**81,773**	62,346
EUR	**19,204**	14,658
USD	**4,360**	4,622
GBP	**1,194**	497
Others	**577**	403
Sinking fund accounts by currency		
MTL	**51,714**	16,859
EUR	**5,763**	5,224
USD	**1,553**	1,860
Others	**105**	100
	166,243	106,569

Government deposits are repayable on demand and are included in cash equivalents (Note 32).

Up to 31 December 2007, current accounts and sinking fund accounts denominated in Maltese lira were subject to floating interest rates linked to the Bank's Central Intervention Rate. With effect from 1 January 2008, these accounts are denominated in euro and are subject to floating interest rates linked to the ECB's minimum bid rate. Current accounts and sinking fund accounts denominated in euro and foreign currencies were principally subject to floating interest rates based on weekly average rates applied to call funds up to the financial year-end. With effect from 1 January 2008, current accounts and sinking fund accounts denominated in euro are subject to variable interest rates linked to the ECB's minimum bid rate.

25. Other deposits

	2007	2006
	Lm'000	Lm'000
Deposits by public sector corporations and similar entities:		
- Repayable on demand (included in cash equivalents - Note 32)	**9,203**	2,509
- Repayable within two months; subject to fixed interest rate of 4.5% (included in cash equivalents - Note 32)	**5,581**	-
International Monetary Fund SDR allocation (see Note 13)	**5,205**	5,532
Others:		
- Repayable on demand (included in cash equivalents - Note 32)	**12,498**	9,553
	32,487	17,594

Amounts include:

	2007	2006
	Lm'000	Lm'000
By currency		
MTL	**2,564**	2,350
EUR	**22,092**	8,910
SDR	**5,205**	5,532
Others	**2,626**	802
	32,487	17,594

Up to 31 December 2007, deposits by public sector corporations and similar entities denominated in Maltese lira, amounting to Lm0.26 million (2006: Lm1.63 million), were mainly subject to variable interest rates linked to the Bank's Central Intervention Rate. With effect from 1 January 2008, these deposits are denominated in euro and are subject to floating interest rates linked to the ECB's minimum bid rate. Up to the financial year-end, deposits by these entities denominated in euro and foreign currencies, amounting to Lm14.2 million (2006: Lm0.88 million), were principally subject to floating interest rates based on weekly average rates applied to call funds. With effect from 1 January 2008, deposits denominated in euro amounting to Lm11.89 million as at the financial year-end are subject to floating interest rates linked to the ECB's minimum bid rate. Other deposits, excluding SDR allocation, are not subject to interest.

26. Other liabilities

	2007	2006
	Lm'000	Lm'000
International Monetary Fund current accounts (see Note 13)	**28,467**	30,256
Others	**3,196**	2,956
	31,663	33,212

An accumulated amount of Lm1,072,000 is included in Other liabilities in respect of staff related risks and compensation payments related to staff retirements.

27. Capital

The capital authorised by article 18(1) of the Central Bank of Malta Act (Cap. 204) is fully paid up and held by the Government of Malta.

28. Reserve funds

Reserves are maintained in terms of article 18(2) and (3) of the Central Bank of Malta Act (Cap. 204). The General Reserve is held to strengthen the capital base of the Bank and is available for any purpose as may be determined by the Board of Directors. In accordance with article 24(2) of the Central Bank of Malta Act (Cap. 204), profits or losses attributable to any revaluation of the Bank's net external assets or liabilities, arising from an adjustment of the external value of the Maltese lira, were accounted for in the Special Reserve. The balance of the Special Reserve fund is dealt with as determined by the Bank's Board of Directors.

29. Reserves for risks and contingencies

Reserves for risks and contingencies are maintained in terms of article 24 of the Central Bank of Malta Act (Cap. 204) to cover the broad range of risks to which the Bank is exposed. The major risks in this regard arise from: losses which could result from pursuing monetary policy objectives, potential movements in market values of the Bank's holdings of domestic and foreign securities and other investments, losses which could arise from support of the financial system in the Bank's role as a lender of last resort, and other non-insured losses. The Bank's Board of Directors had resolved that reserves for risks and contingencies are also maintained for the purposes of funding expenditure incurred in the preparation for the euro changeover including, but not limited to, costs for the issue of currency and expenditure in connection with operational changes that were necessary. Transfers to the reserves have been made in recent years for this purpose.

30. Fair value reserve

Gains and losses arising from the change in the fair value of available-for-sale assets are recognised directly in equity through the fair value reserve following the accounting policy disclosed in Note 1(f) to the financial statements. When the assets are disposed of, the related accumulated fair value adjustments deferred in equity, including the amount of the adjustment on initial application of IAS 39, are transferred to the profit and loss account as gains and losses from available-for-sale assets.

	Available-for-sale investment securities Lm'000	Available-for-sale local assets Lm'000
At 1 January 2006	(1,529)	74
Net losses from changes in fair value	(5,770)	(698)
Net (gains)/losses transferred to profit on disposal	(143)	34
At 31 December 2006	(7,442)	(590)
Net gains from changes in fair value	1,281	508
Net losses transferred to profit on disposal	49	70
At 31 December 2007	**(6,112)**	**(12)**

This reserve is not considered to be available for distribution by the Directors.

31. Capital contribution

This reserve represents the capital contribution made by the Government of Malta to the Bank in respect of the agency arrangement with Government relating to the issuance of euro coins. The Bank shall act as agent of Government and shall retain full responsibility for procurement, storage and issuance of euro coins. This reserve represents seignorage revenue that arises on the difference between the face value of the euro coins issued and the cost of producing, distributing and eventually retiring from circulation such coins. The Government has agreed not to withdraw any seignorage gains arising from the issue of euro coins and accordingly these amounts are deemed to constitute capital contributions to the Bank by the Government in terms of the agency arrangement. Such seignorage gains shall accumulate in a reserve account held at the Bank.

32. Cash and cash equivalents

For the purposes of the cash flow statement, the year-end cash and cash equivalents represent the following:

	2007	2006
	Lm'000	Lm'000
Cash and balances with banks (Note 10)	**55,926**	11,038
Treasury bills maturing within three months (Note 16)	**40**	3,339
Placements with banks maturing within three months (Note 11)	**528,741**	277,589
Deposits maturing within three months (Notes 22, 23, 24 and 25)	**(371,391)**	(225,365)
	213,316	66,601

Treasury bills, placements with banks and deposits with a contractual period to maturity of three months or less are treated as cash equivalents as they represent the Bank's principal liquidity. The effect of exchange rate changes on cash and cash equivalents was not deemed sufficiently material for the purposes of disclosure in the cash flow statement.

33. Financial risk management

The Bank's policy in the investment of its financial assets is primarily directed towards providing a ready flow of realisable assets to meet its day-to-day liquidity obligations. Considerations relating to the maximisation of income come into play only after the Bank is satisfied with the credit risk it is assuming on its investments.

The nature of the Bank's operations implies that financial instruments, including derivatives, are extensively used in the course of its activities. The Bank is exposed to a range of financial risks and its operations involve the analysis, evaluation, acceptance and management of some degree of risk. Accordingly, the Bank operates a risk management strategy with the objective of controlling its exposures in this respect.

The Bank's risk management policies are designed to identify and analyse these risks, to set appropriate limits and controls, and to monitor the risks and adherence to limits by means of reliable and updated information systems. The Bank regularly reviews its risk management policies and systems to reflect changes in operations and procedures. Risk management is carried out by the Bank's operational functions under policies approved by the Board of Directors. The Bank's operational functions identify, evaluate and hedge financial risks. The Board approves written principles for overall risk management, as well as written policies covering specific areas, such as foreign exchange risk, interest rate risk, credit risk, use of derivative financial instruments and non-derivative financial instruments. The most important types of risk are credit risk, liquidity risk, market risk and other operational risk. Market risk includes currency risk, interest rate and other price risk.

33. Financial risk management - continued

i) Credit risk

The Bank takes on exposure to credit risk, which is the risk that a counterparty will cause a financial loss for the Bank by failing to discharge an obligation. The Bank's exposures to credit risk arise principally in investment activities that bring placements with banks, debt securities, derivative financial instruments and other instruments into the Bank's asset portfolio. There is also credit risk in off-balance sheet financial instruments. Overall credit risk management and control is the responsibility of the Bank's operational functions and of a distinct monitoring function within the Bank, and is reported to the Board of Directors and management regularly.

The Bank has in place internal control structures to assess and monitor credit exposures and risk thresholds. The Bank manages, limits and controls concentrations of credit risk where they are identified; in particular, to individual financial institutions or counterparties and groups of financial institutions classified by country of origin. The Bank places limits on the level of credit risk undertaken in relation to any single financial institution or counterparty. The exposure to a counterparty is restricted by specific sub-limits, by amount and term, for exposures arising from the different classes of investments and transactions, covering on- and off-balance sheet exposures. The limits are assigned in accordance with external ratings based on Fitch's ratings or on those of other major rating agencies. Such risks are monitored on an ongoing basis and are subject to frequent review, when considered necessary. The limits on the level of credit risk are reviewed on a regular basis and are approved by the Board of Directors at regular intervals. Actual exposures are monitored against limits on a daily basis.

The Bank places funds and enters into foreign currency transactions, including derivative instruments, with authorised financial institutions having credit ratings within approved thresholds. The Bank enters into security transactions only with such authorised counterparties and it invests only in securities or paper with credit quality that falls within specific approved parameters. As outlined above, external ratings such as Fitch's ratings or those of other major rating agencies are used by the Bank for management of the credit risk exposures with a view to gaining an adequate credit quality mapping.

In respect of derivative financial instruments, the amount subject to credit risk is limited to the current fair value of contracts that are favourable to the Bank (derivatives where their fair value is positive), which in relation to such instruments is only a small fraction of the notional amounts of the contract. Settlement risk arises in any situation where a payment in cash or securities is made in the expectation of a corresponding receipt in cash or securities. Settlement risk in respect of security transactions is mitigated by effecting payment in cash or securities on a delivery versus payment (DVP) basis. Foreign currency settlement risk exposures are restricted by sub-limits on spot and forward foreign exchange contracts assigned to eligible counterparties.

33. Financial risk management - continued

The primary purpose of the Bank's off-balance sheet instruments referred to in Note 34 to the financial statements is to ensure that funds are available to a customer as required. Guarantees and standby letters of credit carry the same credit risk as investments. Credit risk with respect to such off-balance sheet exposures is limited since the Bank's customers are mainly public sector corporations and other entities owned by the Government.

The Bank's credit risk exposures relating to on-balance sheet assets by IAS 39 categorisation, reflecting the maximum exposure to credit risk before collateral held or other credit enhancements, are as follows:

	As at 31 December	
	2007 **Lm'000**	2006 Lm'000
Loans and receivables:		
Cash and balances with banks	**55,926**	11,038
Gold balances	**3,795**	1,150
Placements with banks	**581,597**	341,984
Claims on the International Monetary Fund	**36,011**	36,409
Other foreign currency assets	**319**	854
Other assets (principally International Monetary Fund Currency Subscription)	**32,692**	34,611
Prepayments and accrued income	**12,748**	12,968
	723,088	439,014
Available-for-sale financial assets:		
Foreign currency investment securities	**302,527**	527,175
Malta Government Treasury bills	**906**	3,345
Domestic debt securities – Malta Government Stocks	**86,505**	26,924
	389,938	557,444
Held-to-maturity financial assets:		
Foreign currency investment securities	**104,627**	30,491
Financial assets at fair value through profit or loss:		
Derivative financial instruments (see Note 18)	**5,082**	1,118

33. Financial risk management - continued

The exposures set out in the table above are based on carrying amounts as reported in the balance sheet. The table represents a worse case scenario of credit risk exposure to the Bank at 31 December 2007 and 2006, without taking account of any collateral held or other credit enhancements attached. However, as at the balance sheet dates the Bank did not hold any collateral or other credit enhancements in respect of the principal categories of financial assets.

As at 31 December 2007 and 2006, the Bank did not hold any past due or impaired financial assets.

Credit risk exposures relating to off-balance sheet items, such as contingent liabilities and financial commitments, are disclosed in Note 34 to the financial statements. The maximum exposure to credit risk in this respect is the maximum amount the Bank could have to pay if the related customer defaults, which amounts are disclosed in the Note referred to previously.

The Bank's exposures to credit risk as at the balance sheet dates are analysed in the tables below, which present an analysis of the principal categories of financial assets by rating agency designation based on Fitch's ratings or their equivalent.

2007

Financial asset category	**AAA %**	**AA+ %**	**AA %**	**A %**	**Carrying amount Lm'000**
Investment securities					
Available-for-sale	77	11	11	1	302,527
Held-to-maturity	91	9	-	-	104,627

	AAA %	**AA+ %**	**AA %**	**AA- %**	**A+ %**	**A %**	**Other %**	
Balances with banks	97	-	1	2	-	-	-	59,198
Placements with banks	-	25	25	39	7	4	-	581,597
Derivative financial instruments	-	28	48	19	2	-	3	5,082

33. Financial risk management - continued

2006

Financial asset category	**AAA** %	**AA+** %	**AA** %	**AA-** %	**A** %	**Carrying amount Lm'000**
Investment securities						
Available-for-sale	76	9	11	2	2	527,175
Held-to-maturity	100	-	-	-	-	30,491

	AAA %	**AA+** %	**AA** %	**AA-** %	**A+** %	**A** %	**A-** %	**Other** %	
Balances with banks	64	-	9	22	1	-	4	-	11,889
Placements with banks	-	26	8	63	-	-	3	-	341,984
Derivative financial instruments	-	58	3	-	-	27	-	12	1,118

Derivative transactions (cross-currency interest rate swaps) entered into with other counterparties, as reflected in the tables above, relate to contracts with local financial institution clients.

Note 39 to the financial statements presents an analysis of the Bank's placements with banks by exposure country and of the Bank's foreign currency investment securities by issuer category. Whilst no significant concentration is present with respect to the former, the issuers of the Bank's securities are mainly Governments and monetary financial institutions.

ii) Market risk

The Bank takes on exposure to market risk, which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices or rates. This is a key risk relating to a central bank's role as referred to in Note 29 above. Market risks arise from open positions in interest rate, currency and equity products, all of which are exposed to general and specific market movements and changes in the level of volatility of market rates or prices such as interest rates, credit spreads, foreign exchange rates and equity prices. The Bank does not hold equity instruments and is not exposed to fluctuations in equity prices.

33. Financial risk management - continued

Currency risk

The Bank takes on exposure to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. The Board sets limits on the level of net exposure or deviation in net holdings, including contracted amounts under foreign exchange derivatives, by currency for both overnight and intra-day positions, which are monitored on an ongoing basis. The Maltese lira entered the Exchange Rate Mechanism II (ERM II) with a central parity rate of MTL/EUR 0.4293 on 2 May 2005 and the MTL/EUR rate was kept unchanged at the central parity level during the ERM II phase. Prior to the entry of the Maltese lira into the ERM II, the Bank’s net foreign currency positions were held in a mix of currencies which principally reflected their respective weighting in the Maltese lira basket. The Bank’s net balance sheet exposure to currency risk was managed within controlled parameters and deviations. Subsequent to entry into ERM II and the consequential move from a three-currency basket to a 100% euro peg, the Bank’s net external assets are maintained in broad terms in the mix of currencies applied prior to 2 May 2005. As a result, the Bank became exposed to the risk of currency movements in respect of its holdings denominated in foreign currencies other than euro. For macro-hedging purposes, the Bank uses derivative transactions for the forward purchase of euro and simultaneous forward sale of sterling or US dollar with a view to eliminating foreign currency exposures from holding sterling and US dollar, such that the Bank’s net balance sheet exposure is substantially denominated in euro.

At 31 December, the Bank’s net foreign currency holdings determined by reference to transaction amounts, including contracted amounts arising from derivative financial instruments but excluding claims on the International Monetary Fund, were in the following currencies:

	2007	2006
	%	%
EUR	**99.12**	99.49
GBP	**0.17**	0.40
USD	**0.16**	(0.03)
Others	**0.55**	0.14
	100.00	100.00

33. Financial risk management - continued

Information on the Bank's exposures to currency risk in respect of its assets is disclosed in Note 39 to these financial statements, whereas information relating to its liabilities is reflected in Notes 23, 24 and 25. Disclosure of exposures to currency risk arising from the Bank's off-balance sheet instruments is presented in Note 34 to the financial statements.

In view of the Bank's policy for managing currency risk, the Board does not deem necessary a sensitivity analysis disclosing how profit or loss and equity would have been affected by changes in foreign exchange rates that were reasonably possible at the balance sheet date.

Interest rate risk

Cash flow interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates.

Whilst the majority of the Bank's assets are interest-bearing, one of the Bank's principal liabilities representing currency in circulation is not subject to interest. The Bank mainly invests in, and places funds under, instruments subject to fixed interest rates. Accordingly, it is not exposed to cash flow interest rate risk in respect of placements with banks, investment securities and local government securities. However the Bank is exposed to fair value interest rate risk particularly in respect of its available-for-sale foreign currency investment securities. The Bank has in place techniques, principally based on the concept of modified duration, to measure the sensitivity of the fair value of its fixed-income instruments to changes in market yields. The Board of Directors sets limits in this respect and reviews such limits frequently. Adherence to these limits is monitored on a regular basis by a distinct monitoring function within the Bank with reporting to the Board and management.

The Bank's measure of its exposure to fair value interest rate risk as at the balance sheet date in respect of fixed interest foreign currency available-for-sale investment securities is analysed below by currency:

	Modified duration	**Shift in fair value with parallel shift of 25 basis points in yields Lm'000**
2007		
EUR	**2.40**	**1,114,000**
GBP	**1.67**	**373,000**
USD	**1.75**	**151,000**
2006		
EUR	1.77	1,694,000
GBP	2.10	634,000
USD	1.96	158,000

33. Financial risk management - continued

Interest rate risk is considered by the Directors to be limited in view of the short periods to maturity of placements with banks and the realisable nature of the Bank's available-for-sale investment securities, as well as prudential limits that restrict interest rate exposures within levels prescribed by management. Moreover, the Bank's interest-bearing deposits, other than reserve deposits, are mainly repayable on demand or within short time periods from the balance sheet date. All deposits are repriceable within short time frames, with floating interest rates linked to the Bank's Central Intervention Rate, the ECB's minimum bid rate, the ECB's MRO marginal rate or reference market interest rates (see Notes 23, 24 and 25). The Bank is exposed to cash flow interest rate risk in respect of deposits. However this exposure is offset intrinsically by the Bank's exposure on income earning assets which in substance reprice within short periods of time, in view of their nature and terms. The Bank actively manages its net interest income on this basis.

Accordingly the Board considers the information disclosed in the respective Notes to be sufficient for an understanding of the potential impact on profit or loss of a defined interest rate shift that is reasonably possible at the balance sheet date attributable to its exposures to cash flow interest rate risk arising from deposits. Presentation of an analysis in tabular format disclosing the Bank's financial instruments by contractual repricing or maturity groupings was not deemed relevant by the Board in disclosing the Bank's policies relating to interest rate risk management.

The table below summarises the effective interest rates by major currencies for the Bank's principal monetary financial instruments as at 31 December:

	Assets			**Liabilities**		
				Government deposits		
	Placements with banks %	**Available-for-sale investment securities** %	**Held-to-maturity investment securities** %	Current accounts %	Sinking fund accounts %	**Other deposits** %
MTL						
2007	**-**	**-**	**-**	**3.50**	**3.50**	**1.00**
2006	-	-	-	3.25	3.25	0.75
EUR						
2007	**4.34**	**3.42**	**4.11**	**3.34**	**3.59**	**3.34**
2006	3.49	3.03	3.69	2.75	3.00	2.75
GBP						
2007	**5.55**	**4.88**	**-**	**4.93**	**5.18**	**4.93**
2006	5.12	4.85	-	4.19	4.44	4.19
USD						
2007	**4.86**	**4.64**	**-**	**3.68**	**3.93**	**3.68**
2006	5.28	4.33	-	4.43	4.68	4.43

33. Financial risk management - continued

iii) Liquidity risk

Liquidity risk is the risk that the Bank is unable to meet its payment obligations associated with its financial liabilities when they fall due.

The Bank's main liabilities consist of currency in circulation and deposits, comprising reserve deposits. Whereas reserve deposits and currency in circulation have no specified contractual maturity, other deposits by banks mature principally within very short periods of time from the balance sheet date (Note 23). Deposits by Government together with public sector corporations and similar entities are mainly repayable on demand (Notes 24 and 25). Accordingly, in view of the adequacy of the disclosures in the respective Notes to the financial statements, presentation of a maturity analysis for financial liabilities that shows the remaining contractual maturities was not deemed necessary.

The Bank's assets which are available to meet liabilities principally include placements with banks, investment securities and local government securities. The Bank places funds with banks for relatively short time periods with varying terms and maturities; for instance at the year-end a significant portion of placements mature within one month from the balance sheet date. The Bank's investment securities consist of highly marketable investments which are readily realisable to meet commitments and funding requirements.

The Bank's liquidity risk is hence relatively insignificant in view of the short-term maturities or realisable nature of the principal categories of its financial assets and due to the nature of the Bank's main liabilities.

The Bank's liquidity management process is carried out by the Bank's operational functions. Liquidity risk monitoring and reporting take the form of cash flow measurement and projections for specified time periods or intervals. The starting point for these measures is information on the contractual maturity of the financial assets and the interaction of this information with an analysis of the expected or projected maturity of the Bank's financial liabilities. The Bank manages the concentration, terms and profile of its assets in accordance with this monitor, subject to internal benchmarks, to ensure that requirements can be met. The Bank also considers the impact of derivative financial instruments and that of contingent liabilities, such as standby letters of credit and guarantees. The Bank's derivative transactions as at the balance sheet date consist mainly of gross settled foreign exchange contracts maturing within six months, whereby the estimated cash outflows of Lm242,018,000 substantially match estimated cash inflows of Lm239,120,000. An analysis of contingent liabilities and financial commitments by maturity date of contractual amounts is disclosed in Note 34 to the financial statements.

33. Financial risk management - continued

The Bank's assets and liabilities are analysed into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date in the respective Notes to the financial statements. Considering the nature and level of liquidity risk managed by the Bank, these disclosures were deemed sufficient by the Board of Directors for the purposes of disclosing the Bank's liquidity risk policy.

iv) Fair values of financial assets and liabilities

The fair value of the Bank's available-for-sale financial assets, which are traded in active markets, is based on quoted market prices (see Notes 12, 16 and 17). Fair values for the Bank's derivative contracts are determined using forward exchange market rates at the balance sheet date for forward foreign exchange contracts and currency swaps (see Notes 5 and 18), and using valuation techniques, including discounted cash flow models, for other derivative contracts (see Notes 6 and 18). The valuation techniques used are supported by observable market prices or rates since their variables include only data from observable markets.

The following financial assets and liabilities include the main categories of instruments not presented on the Bank's balance sheet at their fair value: cash and balances with banks, balances with the International Monetary Fund, placements with banks, held-to-maturity investment securities together with deposits by banks, the Government of Malta, public sector corporations and other similar entities, and currency in circulation. The fair value of held-to-maturity financial assets, based on quoted market prices, is disclosed in Note 12 to the financial statements. The carrying amount of the other instruments referred to above approximates fair value due to their nature or short-term maturity. Deposits by banks mainly comprise reserve deposits. The face value of reserve deposits, balances with the International Monetary Fund and currency in circulation is essentially their fair value in view of the substance of the instruments or arrangements in place. Placements with banks mature principally within a period of three months from the financial year-end. Deposit liabilities, excluding reserve deposits and International Monetary Fund SDR allocation, are mainly repayable within one month from the balance sheet date.

v) Capital management

The Bank's capital is composed of its equity as reflected on the face of the balance sheet. The Bank's capital base consists primarily of capital paid up by the Government of Malta and other capital contributions from the Government, the general and special reserve funds, reserves for risks and contingencies and the fair value reserve. Notes 27, 28, 29, 30 and 31 to the financial statements disclose the Bank's stance and its policy in respect of capital management dealing with the level and quality of capital and reserves maintained. In particular Note 29, relating to reserves for risks and contingencies, reflects the manner in which equity is managed in the context of the operations and activities of the Bank.

34. Contingent liabilities and commitments

	2007 **Lm'000**	2006 Lm'000
Contingent liabilities		
Guarantees and letters of credit	**31,807**	25,606
Financial commitments		
Repayment of foreign loans received by the Bank on behalf of the Government under Financial Conventions	**4,898**	6,658
Total	**36,705**	32,264

By remaining maturity:

Guarantees and letters of credit

	2007 **Lm'000**	2006 Lm'000
- Five years or less but over one year	**39**	66
- One year or less but over three months	**21,142**	1,342
- Three months or less	**10,626**	24,198
	31,807	25,606

Commitments in respect of foreign loans received by the Bank on behalf of the Government under Financial Conventions and repayable in due course from funds to be made available by Government

	2007 **Lm'000**	2006 Lm'000
- Over five years	**38**	621
- Five years or less but over one year	**3,286**	4,378
- One year or less but over three months	**1,445**	1,602
- Three months or less	**129**	57
	4,898	6,658

The Bank's customers with respect to guarantees and letters of credit are mainly public sector corporations, government departments and other entities owned by the Government. The Bank's foreign currency exposure with respect to these contingent liabilities and commitments is principally in US dollar and euro.

In addition to the commitments disclosed in the tables above, at 31 December 2006 the Bank also had capital commitments in respect of property, plant and equipment amounting to Lm700,000. The Bank also has commitments in respect of recurrent expenditure which extend beyond the balance sheet date. In view of the nature and duration of these commitments, their impact on the Bank's financial results and on the assessment of the Bank's state of affairs was not deemed material for disclosure purposes.

35. Related parties

In the course of its operations, the Bank conducts banking transactions with and provides several banking services to the Government of Malta, government departments, public sector corporations and other entities owned by the Government. The Bank holds the principal accounts of the Government and maintains accounts for the other entities. Balances held with the Bank by the Government and the other entities as at the balance sheet dates, together with the terms of such instruments, are disclosed in Notes 24 and 25 to the financial statements. The principal impact of banking transactions entered into with the Government and the entities referred to above, on the Bank's profit and loss account, is interest payable on deposits as disclosed in Note 4 to the financial statements. The Bank provides these entities with foreign exchange and related services, which do not have a significant impact on the Bank's profit and loss account. In this respect, the principal outstanding transactions as at the balance sheet dates are reflected in Notes 18 and 34 to the financial statements. The Bank acts as market maker in Government securities and Treasury bills and ensures their liquidity in the secondary market by being ready to trade in such securities on the initiative of the market (see Notes 16 and 17). Income earned by the Bank from these assets is disclosed in Notes 3 and 7 to the financial statements.

The Bank's key management personnel are deemed to be the members of the Board of Directors. The Bank's transactions with key management personnel consist principally of compensation payable, which has been disclosed in Note 8 to the financial statements.

36. Events subsequent to the balance sheet date

On 1 January 2008 Malta joined the euro area and as a result of the adoption of the euro, the Bank is now a full member of the Eurosystem, with the same rights and obligations as the national central banks of the other EU member states that have adopted the euro. On the same date the Bank paid up the remainder of its subscription to the capital of the ECB and also transferred its contribution to the foreign reserve assets of the ECB.

i) Capital subscription

The completion of the capital subscription payment took place in accordance with article 49 of the Statute of the European System of Central Banks and of the European Central Bank (the Statute), which requires euro area central banks to pay their full share in the ECB's subscribed capital of EUR5,760,652,403. The share of the Bank in the ECB's subscribed capital was determined at 0.0622% pursuant to the decision of the ECB of 15 December 2006 laying down the measures necessary for the paying-up of the participating national central banks' respective capital shares. The subscription of the Bank to the capital of the ECB amounts to EUR3,583,126.

36. Events subsequent to the balance sheet date - continued

The Bank had already paid up 7% of the total capital subscription when Malta joined the European Union in May 2004 (refer to Note 14). Consequently, subsequent to the balance sheet date, the Bank paid the remaining 93% of its capital subscription. This amounted to EUR3,332,307.

ii) Transfer of foreign reserve assets

Articles 30 and 49 of the Statute also require euro area national central banks to transfer to the ECB an amount of foreign reserve assets determined on the basis of the respective national central bank's share in the subscribed capital of the ECB. Accordingly, after the year-end, the Bank transferred to the ECB an amount equivalent to EUR36,553,305, composed of EUR31,070,309 in US dollars (85%) and EUR5,482,996 in gold (15%). These reserve assets will be managed by the Bank on behalf of the ECB in conformity with the investment parameters set by the ECB.

iii) Frontloading of euro banknotes and coins

In view of the adoption of euro as of 1 January 2008, prior to the balance sheet date, the Bank entered into a contractual arrangement with Banca d'Italia for the loan of euro banknotes from the Eurosystem. As at the balance sheet date, the Bank held in custody euro banknotes on behalf of the Eurosystem. These banknotes did not constitute currency in circulation at 31 December 2007 in accordance with the requirements of the ECB Guideline ECB/2006/9 of 14 July 2006 on "certain preparations for the euro cash changeover and on frontloading and sub-frontloading of euro banknotes and coins outside the euro area".

Pursuant to amendments to the Central Bank of Malta Act (Cap. 204), effective from 1 January 2008, whereby the Bank shall issue euro coins in Malta but in doing so shall act as agent for the Government of Malta, the Bank also entered into an agency arrangement with the Government relating to the issuance of euro coins (refer to Note 31). The Bank shall retain full responsibility for procurement, storage and issuance of euro coins. In fact as at 31 December 2007 the Bank held in custody euro coins on behalf of Government as its agent, which coins did not constitute currency in circulation at the balance sheet date.

The Bank had also entered into contractual arrangements with eligible counterparties in Malta for the frontloading of euro banknotes and coins. As at the balance sheet date, the Bank had frontloaded to eligible counterparties euro banknotes with a face value amounting to EUR593,490,000 and euro coins with a face value of EUR20,313,250, which amounts were not currency in circulation at 31 December 2007. The Bank accepted collateral from these eligible counterparties amounting to EUR786,245,635 representing the fair value of Malta Government Stocks, Malta Government Treasury bills, term deposits and foreign currency fixed-income securities pledged as collateral by the counterparties.

37. General

(a) Demonetised currency notes and coins

Demonetised currency notes

During 2007, demonetised currency notes presented for redemption amounted to Lm169,213 (2006: Lm161,617). At 31 December 2006, the value of unpresented demonetised currency notes amounted to Lm2,181,816 (2006: Lm2,351,029) analysed as follows:

	2007	2006
	Lm'000	Lm'000
Ten year period expires in:		
- 2008	**905**	914
- 2010	**1,277**	1,437
	2,182	2,351

(b) Assets held in custody

At 31 December 2007, assets held in custody by the Bank in terms of the Insurance Business Act amounted to Lm16,842,000 (2006: Lm19,531,000).

(c) Management of funds belonging to the Investor and Depositor Compensation Schemes

During the preceding financial years, the Bank had been appointed as investment manager in respect of funds belonging to the Investor and Depositor Compensation Schemes. The Bank manages these funds on a discretionary basis but in accordance with the investment parameters set by the Management Committees of the respective Schemes. The amount of funds belonging to the Schemes, managed by the Bank, is adjusted by the amount of investments so effected. Accordingly as at 31 December 2007, the Investor and Depositor Compensation Schemes had interest-bearing deposits of Lm13,404 (2006: Lm8,079) and Lm7,400 (2006: Lm7,427) respectively, with the Bank.

38. Financial highlights in euro equivalent

In accordance with the requirements of the Legal Notice on Dual Display and Euro Pricing (LN 4 of 2007), the Bank is disclosing the euro equivalent of the key amounts in the financial statements as follows:

	2007 **EUR'000**	2006 EUR'000
Net interest income	**49,793**	46,257
Profit for the financial year	**28,691**	25,977
Total assets	**2,871,468**	2,415,514
Total liabilities	**2,681,526**	2,233,909
Capital and reserves	**189,942**	181,605

All figures have been translated using the irrevocably fixed conversion rate of MTL/EUR 0.4293.

39. Statement of the Bank's investments

The statement of the Bank's external assets below is disclosed in accordance with the requirements of article 23(1)(b) of the Central Bank of Malta Act (Cap. 204).

The exposure country is the country of location of the institution or entity with which the Bank's placements and other financial assets are held. The exposure country in respect of assets held with branches of international banks and financial institutions is usually deemed to be the country of location of the parent. In case of subsidiaries of banks and financial institutions, the exposure country is generally determined on the basis of the location of the subsidiary undertaking.

39. Statement of the Bank's investments - continued

	EUR Lm'000	GBP Lm'000	USD Lm'000	Total Lm'000
Cash and balances with banks				55,926
Gold balances				3,795
Placements with banks by exposure country				
Austria	14,596	-	-	14,596
Australia	5,832	-	-	5,832
Belgium	63,965	-	39,369	103,334
Denmark	30,051	-	-	30,051
France	52,375	-	30,621	82,996
Germany	21,465	-	-	21,465
Ireland	40,354	-	-	40,354
Italy	29,622	-	-	29,622
Japan	13,308	-	-	13,308
Netherlands	42,930	-	8,749	51,679
Sweden	10,733	-	8,749	19,482
Switzerland	21,036	-	-	21,036
United Kingdom	130,507	-	8,749	139,256
United States of America	8,586	-	-	8,586
	485,360	-	96,237	581,597
Available-for-sale investment securities by issuer category				
Government	45,762	6,462	9,639	61,863
Monetary financial institutions	113,212	56,617	21,000	190,829
Other financial institutions	14,955	14,715	1,166	30,836
Supranationals	4,283	-	2,045	6,328
Insurance sector	1,315	9,209	-	10,524
Non-financial institutions	2,147	-	-	2,147
	181,674	87,003	33,850	302,527
Held-to-maturity investment securities by issuer category				
Government	75,253	-	-	75,253
Monetary financial institutions	28,096	-	-	28,096
Supranationals	1,278	-	-	1,278
	104,627	-	-	104,627
Claims on the International Monetary Fund				36,011
Participating interest in the European Central Bank				108
Other foreign currency assets				319
Total external assets				**1,084,910**

Supplementary information to the financial statements:

Appendix 1

ESCB members' percentage share held in the ECB's capital

	From 1 January 2007 %	From 1 May 2004 to 31 December 2006 %
Nationale Bank van België/ Banque Nationale de Belgique	2.4708	2.5502
Deutsche Bundesbank	20.5211	21.1364
Bank of Greece	1.8168	1.8974
Banco de España	7.5498	7.7758
Banque de France	14.3875	14.8712
Central Bank and Financial Services Authority of Ireland	0.8885	0.9219
Banca d'Italia	12.5297	13.0516
Banque centrale du Luxembourg	0.1575	0.1568
De Nederlandsche Bank	3.8937	3.9955
Oesterreichische Nationalbank	2.0159	2.0800
Banco de Portugal	1.7137	1.7653
Banka Slovenije	0.3194	-
Suomen Pankki-Finlands Bank	1.2448	1.2887
Subtotal euro area NCBs	**69.5092**	**71.4908**
Bulgarian National Bank	0.8833	-
Česká národní banka	1.3880	1.4584
Danmarks Nationalbank	1.5138	1.5663
Eesti Pank	0.1703	0.1784
Central Bank of Cyprus	0.1249	0.1300
Latvijas Banka	0.2813	0.2978
Lietuvos bankas	0.4178	0.4425
Magyar Nemzeti Bank	1.3141	1.3884
Central Bank of Malta	0.0622	0.0647
Narodowy Bank Polski	4.8748	5.1380
Banca Națională a României	2.5188	-
Banka Slovenije	-	0.3345
Národná banka Slovenska	0.6765	0.7147
Sveriges Riksbank	2.3313	2.4133
Bank of England	13.9337	14.3822
Subtotal non-euro area NCBs	**30.4908**	**28.5092**
Total euro area and non-euro area NCBs	**100.0000**	**100.0000**

Appendix 1 - continued

ESCB members' subscribed and paid-up capital

	Subscribed capital from 1 January 2007 EUR'000	Subscribed capital from 1 May 2004 up to 31 December 2006 EUR'000	Paid-up capital from 1 January 2007 EUR'000	Paid-up capital from 1 May 2004 up to 31 December 2006 EUR'000
Nationale Bank van België/ Banque Nationale de Belgique	142,334	141,910	142,334	141,910
Deutsche Bundesbank	1,182,149	1,176,171	1,182,149	1,176,171
Bank of Greece	104,660	105,584	104,660	105,584
Banco de España	434,918	432,698	434,918	432,698
Banque de France	828,814	827,533	828,814	827,533
Central Bank and Financial Services Authority of Ireland	51,183	51,301	51,183	51,301
Banca d'Italia	721,792	726,278	721,792	726,278
Banque centrale du Luxembourg	9,073	8,725	9,073	8,725
De Nederlandsche Bank	224,303	222,336	224,303	222,336
Oesterreichische Nationalbank	116,129	115,745	116,129	115,745
Banco de Portugal	98,720	98,233	98,720	98,233
Banka Slovenije	18,400	-	18,400	-
Suomen Pankki-Finlands Bank	71,709	71,712	71,709	71,712
Subtotal euro area NCBs	**4,004,184**	**3,978,226**	**4,004,184**	**3,978,226**
Bulgarian National Bank	50,884	-	3,562	-
Česká národní banka	79,958	81,155	5,597	5,681
Danmarks Nationalbank	87,205	87,159	6,104	6,101
Eesti Pank	9,810	9,927	687	695
Central Bank of Cyprus	7,195	7,234	504	506
Latvijas Banka	16,205	16,572	1,134	1,160
Lietuvos bankas	24,068	24,624	1,685	1,724
Magyar Nemzeti Bank	75,701	77,260	5,299	5,408
Central Bank of Malta	3,583	3,600	251	252
Narodowy Bank Polski	280,820	285,913	19,657	20,014
Banca Națională a României	145,099	-	10,157	-
Banka Slovenije	-	18,614	-	1,303
Národná banka Slovenska	38,971	39,771	2,728	2,784
Sveriges Riksbank	134,298	134,292	9,401	9,400
Bank of England	802,672	800,322	56,187	56,023
Subtotal non-euro area NCBs	**1,756,469**	**1,586,443**	**122,953**	**111,051**
Total euro area and non-euro area NCBs	**5,760,653**	**5,564,669**	**4,127,137**	**4,089,277**