BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

FORTY-SEVENTH ANNUAL REPORT*
AND
STATEMENT OF ACCOUNTS
2014

* This Annual Report incorporates developments in the fourth quarter, previously covered in a separate publication.

Address
Pjazza Kastilja
Valletta VLT 1060
Malta

Telephone
(+356) 2550 0000

Fax
(+356) 2550 2500

Website
http://www.centralbankmalta.org

E-mail
info@centralbankmalta.org

Printed by
Gutenberg Press Ltd
Gudja Road
Tarxien GXQ 2902
Malta

The cut-off date for information published in this Report is 27 February 2015 except where otherwise indicated. Figures in tables may not add up due to rounding.

This edition of the Annual Report incorporates an analysis of economic and financial developments that would otherwise have appeared in the Quarterly Review 2014:4. The latter issue of the Quarterly Review is not being published separately.

ISSN 0577-0653 (print)
ISSN 1811-1262 (online)

MISSION STATEMENT

The Central Bank of Malta is an independent institution, which forms an integral part of the Eurosystem and, as a member of the European System of Central Banks (ESCB), has the primary objective of maintaining price stability. The Bank is entrusted with all major central banking tasks, particularly that of ensuring the stability of the financial system.

It seeks to carry out its statutory responsibilities in the public interest and is committed to performing its functions effectively, efficiently and economically to the highest level of integrity, competence and transparency. In this regard it will continue to:

i. **undertake economic and financial analysis and research** to support the Governor's participation in the decision-making process of the Governing Council of the European Central Bank (ECB) and provide independent advice to the Government on economic and financial policy issues;

ii. **implement the ECB's monetary policy** through market operations conducted within the operational framework of the Eurosystem;

iii. **contribute effectively to the stability of the financial system** by identifying and assessing systemic risks and imbalances, and making the appropriate policy recommendations;

iv. **formulate and implement a macro-prudential policy** to fulfil the tasks of the Bank as the national macro-prudential authority;

v. **promote and support the development and integration of financial markets** in Malta through oversight of market infrastructures and by ensuring the availability of cost-efficient securities settlement and payment systems;

vi. **provide an adequate supply of banknotes and coin (the latter on behalf of Government)** to meet the demands of the public, while ensuring high quality and authenticity of the currency in circulation;

vii. **collect, compile and publish economic and financial statistics** in line with international standards;

viii. **act as banker to Government and to the banking system;**

ix. **hold and actively manage financial assets** with the aim of optimising returns, subject to prudent risk management practices;

x. **actively participate in the ESCB, the Eurosystem and other relevant European Union bodies, including their sub-structures.**

Finally, as a member of the Eurosystem, the Bank continues to subscribe to the Eurosystem's mission, strategic intents and organisational principles.

BOARD OF DIRECTORS*

Professor Josef Bonnici
Governor & Chairman

Mr Alfred DeMarco
Deputy Governor

Mr Alexander Demarco
Deputy Governor

Mr Victor Busuttil *Director*
Ms Philomena Meli *Director*
Mr Peter J. Baldacchino *Director*
Dr Romina Cuschieri *Director*

Policy Advisory Committee*

Professor Josef Bonnici
Governor & Chairman

Mr Alfred DeMarco
Deputy Governor

Mr Alexander Demarco
Deputy Governor

Mr Oliver Bonello
Director
Financial Stability & Information Systems

Mr Raymond A. Bonnici
Director
Corporate Services

Mr Anthony P. Cortis
Director
Statistics & Risk Management

Mr Raymond Filletti
Director
Market Operations

Mr Paul R. Muscat
Director
Financial Services

Dr Bernard Gauci
Advisor to the Governor

Audit Committee*

Mr Victor Busuttil
Chairman

Mr Alfred DeMarco
Member

Mr Peter J. Baldacchino
Member

Investments Policy Committee*

Professor Josef Bonnici
Governor & Chairman

Mr Alfred DeMarco
Deputy Governor

Mr Alexander Demarco
Deputy Governor

Mr Raymond A. Bonnici
Director
Corporate Services

Mr Raymond Filletti
Director
Market Operations

Dr Bernard Gauci
Advisor to the Governor

Mr Mario Bugeja
Head
Reserves Management

Mr Robert Caruana
Head
Financial Control

Ms Angele Camilleri Agius
Manager
Investments Office

Mr Kevin J. Vassallo
Manager
Middle Office

Management Committee*

Heads of Departments

Mr Francis Bugeja *(Chairman)*
Internal Audit

Mr Stephen Attard
Communications

Mr Alexander Borg
EU & International Relations

Mr Mario Bugeja
Reserves Management

Mr Saviour Busuttil
Information Systems

Mr John Caruana
Economics & Monetary Analysis

Mr Robert Caruana
Financial Control

Mr Herman Ciappara
Payments & Banking

Mr Paul Farrugia
Human Resources & Administration

Mr Silvio Galea
Monetary Operations & Government Securities

Mr Jesmond Gatt
Knowledge Management & Information Security

Dr Aaron George Grech
Modelling & Research

Mr Denis Micallef
Strategy, Planning & Risk

Dr Bernadette Muscat
Legal

Mr Jesmond Pulé
Statistics

Mr Peter Paul Tabone
Currency Services & Security

**as at 31 December 2014*

THE BOARD OF DIRECTORS*

(left to right)

Standing: Dr Bernadette Muscat (Secretary), Mr Victor Busuttil (Director), Mr Peter J. Baldacchino (Director), Dr Romina Cuschieri (Director), Ms Philomena Meli (Director),

Seated: Mr Alfred DeMarco (Deputy Governor), Professor Josef Bonnici (Governor & Chairman), Mr Alexander Demarco (Deputy Governor).

**as at 31 December 2014*

ORGANISATION CHART*

- Governor
  Professor Josef Bonnici
  - Governors' Office
    Dr Bernard Gauci
    - Internal Audit Department
    - Legal Department
    - Economic and Monetary Analysis Department
    - Modelling and Research Department
    - Communications Department
    - EU and International Relations Department
  - Deputy Governor Monetary Policy
    Mr Alfred DeMarco
  - Deputy Governor Financial Stability
    Mr Alexander Demarco

- Financial Stability and Information Systems Directorate
  Mr Oliver Bonello
  - Financial Stability Department
    - Financial Stability Surveillance and Assessment
    - Policy, Crisis Management and Stress Testing
  - Information Systems Department
    - Technology Services
    - Projects and Applications Development
  - Knowledge Management and Information Security Department

- Market Operations Directorate
  Mr Raymond Filletti
  - Reserves Management Department
    - Market Analysis
    - Investments
    - Middle Office
  - Monetary Operations and Government Securities Department
    - Monetary Operations and Collateral Management
    - Government Securities

- Financial Services Directorate
  Mr Paul R. Muscat
  - Currency Services and Security Department
    - Currency Operations
    - Security Control
  - Payments and Banking Department
    - Payment and Banking Operations
    - Regulation and Oversight

- Statistics and Risk Management Directorate
  Mr Anthony P. Cortis
  - Statistics Department
    - Monetary, Financial and External Statistics
    - General Economic Statistics, Securities and Data Management
  - Strategy, Planning and Risk Department

- Corporate Services Directorate
  Mr Raymond A. Bonnici
  - Financial Control Department
  - Human Resources and Administration Department
    - Human Resources
    - Administration

**as at 31 December 2014*

Bank Ċentrali ta' Malta
Eurosistema
Il-Gvernatur

Central Bank of Malta
Eurosystem
The Governor

30 March 2015

The Hon Professor Edward Scicluna
Minister for Finance
Maison Demandols
South Street
Valletta VLT 1102

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 2014.

Yours sincerely

Professor Josef Bonnici

CONTENTS

ABBREVIATIONS

EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EONIA	Euro OverNight Index Average
ERM II	Exchange Rate Mechanism II
ESCB	European System of Central Banks
ETC	Employment and Training Corporation
EU	European Union
EUR	euro
EURIBOR	Euro Interbank Offered Rate
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
LFS	Labour Force Survey
LTRO	long-term refinancing operation
MFI	monetary financial institution
MFSA	Malta Financial Services Authority
MGS	Malta Government Stock
MRO	main refinancing operation
MSE	Malta Stock Exchange
NCB	national central bank
NFC	non-financial corporation
NPISH	non-profit institutions serving households
NSO	National Statistics Office
RPI	Retail Price Index
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
TLTRO	targeted longer-term refinancing operation
ULC	unit labour costs

GOVERNOR'S STATEMENT

The economy of the euro area showed signs of a modest recovery in 2014, with output rising by 0.9% on the back of a gradual strengthening in private consumption and investment. This followed a contraction of 0.5% in 2013. The European Central Bank (ECB) projects the euro area economy to grow by 1.5% in 2015 and 1.9% in 2016, mainly driven by higher domestic demand. Still, recovery in the euro area remains weak in comparison with other advanced economies, such as the United States, which reported a growth rate of 2.4% in 2014. Moreover, there is a large divergence among the Member States in terms of the macroeconomic indicators.

Falling oil prices, which also signify an improvement in the terms of trade, carry the risk of taking the inflation rate further below the ECB's price-stability objective, especially if combined with the slow pace of the recovery. In fact, the annual rate of the Harmonised Index of Consumer Price (HICP) inflation in the euro area turned negative in December 2014, for the first time since October 2009. A prolonged period of low or negative inflation could trigger second-round effects on wages and prices, and the de-anchoring of expected long-term inflation.

In line with its price stability mandate, the ECB has pursued an accommodative monetary policy. This has included resort to non-standard measures and forward guidance – the conditional commitment by the ECB on the future path of policy interest rates. Non-standard measures have included purchases of asset-backed securities and covered bonds. In addition, targeted longer-term refinancing operations provide longer-term funding to banks for new business loans. These new measures demonstrate the ECB's determination to expand significantly the size of its balance sheet.

In January 2015 the ECB announced an extended asset-purchase programme, involving the large scale purchase of bonds issued by euro area central governments, agencies and European institutions. The pass-through of this programme goes beyond the interest rate and bank credit channels, and can be seen as taking the form of sequential portfolio adjustments across various components of the balance sheets of the financial and non-financial private sectors. The multi-faceted stimulus should support investment and consumption, and ultimately lift the inflation rate closer to the 2% target. The expected increase in liquidity also places downward pressure on the exchange rate, providing short-term gains in the euro area's competitiveness.

Despite the still uncertain external background and the openness of the Maltese economy, growth continued to outpace the euro area average. At the same time, inflation has declined along with the euro area trend, but remains above zero.

The Maltese economy expanded by 3.5% in 2014 – one of the highest growth rates in the currency union – with the main impetus coming from domestic demand. In turn, domestic demand was sustained by investment, and by both private and government consumption. Investment rose by 14.0% and increased in all categories, except for residential construction. Inbound tourism continued to register steady growth, while the performance of the manufacturing sector was somewhat weaker than in 2013.

Going forward, the Central Bank of Malta, in its March 2015 forecasts, projects a gross domestic product (GDP) growth rate of 3.4% in 2015. The Bank's projections call for private consumption to maintain a positive momentum in 2015 and 2016, growing by 3.2% and 3.0%, respectively, as lower energy prices and higher employment levels support aggregate household spending and, in turn, domestic demand.

Developments in the labour market echo the positive performance of the Maltese economy. Labour Force Survey data for the first three quarters of 2014 indicate that the number of persons in employment rose by 2.2% on the same period of the year before. The average employment rate rose by 1.4 percentage points to 62.0%, driven by a higher female employment rate. Administrative records compiled by the Employment and Training Corporation similarly point to positive developments. The gainfully occupied population continued to increase, reaching the highest level on record, up by 3.6% in the first nine months of 2014.

Unemployment declined to a historical low, and remains among the lowest in the euro area. Eurostat's seasonally adjusted unemployment rate went down to 5.9% during 2014, from 6.4% a year earlier and remained considerably below the euro area average of 11.6%. This cut in the jobless rate occurred despite a steady increase in labour supply, which is, in turn, mainly driven by higher female participation rates and, to a lesser extent, by inward migration.

The Bank projects a broadly stable unemployment rate. Employment is expected to grow by 2.1% and 1.8%, in 2015 and 2016, respectively.

On the fiscal side, the current situation and projected developments point to an ongoing process of consolidation. The general government debt-to-GDP ratio is estimated at 68.4% at end-2014. According to the March 2015 forecasts by the Bank, this ratio is projected to fall to 67.3% in 2015 and to 65.9% in 2016. The deficit-to-GDP ratio, which is estimated at 2.2% of GDP as at end-2014, is set to decline to 1.8% of GDP in 2015 and then to 1.6% in 2016.

As global debt markets generally stabilised, the spread paid on domestic government securities over the benchmark ten-year German bund continued on a downward trajectory and declined to 1.35 percentage points in December 2014. During the year, Maltese government securities have attracted more than €1,086.2 million in bids in the primary market, out of which €649.8 million was accepted by the Treasury. In fact, the bid-to-cover ratio for government bonds (the ratio of the bid amount to the total allotment) has averaged around 1.9 in 2014. The highest bid-to-cover ratio of 2.7 was reached in October, the last auction of 2014.

This strong demand must be seen in the perspective of an all-time low yields scenario in which the ten-year yield at end-2014 was 1.87%, down by 135 basis points from end-2013. These indicators suggest ample private liquidity and robust domestic investor demand for government securities.

Meanwhile, the funding requirement for 2015, at €500.0 million, was €150.0 million lower than in 2014.

The extended asset-purchase programme is expected to dampen sovereign debt yields, cutting the interest burden on newly issued debt. In addition, ECB purchases of government debt provide banks with the opportunity to anticipate regulatory restrictions on their asset concentration. Specifically, these bond purchases reduce the banks' exposure to sovereign risk and they also free up banks' balance sheets, enabling them to extend more credit at easier terms to the private sector.

The Maltese economy stands to benefit also from the ensuing downward pressure on the value of the euro, making the economy more competitive vis-à-vis countries outside the euro area. Still, it is important that accommodative policy measures should not be allowed to distract the authorities from pursuing other determinants of competitiveness, essential structural reforms and the appropriate fiscal consolidation.

ECB's comprehensive assessment

In November 2014 the ECB published the results of its Comprehensive Assessment of the 130 largest banks in the euro area and of another 20 non-euro area banks. The assessment consisted of an Asset Quality Review and a Stress Test. Of the 130 banks across the euro area, 25 failed the test, with the combined capital shortfall amounting to €24.6 billion, a result which was positively received by the markets as the numbers passing exceeded expectations.

In Malta the Common Equity Tier 1 ratios of the three examined banks remained above the baseline and adverse thresholds, which were set at 8.0% and 5.5%, respectively. With the advent of the Single Supervisory Mechanism in November 2014, the three banks under review were placed under the direct supervision of the ECB.

The banking sector

The resilience of the Maltese economy can be partly attributed to its sound banking sector. Malta continues to host a relatively large financial sector without exposure to excessive risk. In terms of the soundness of its banks, Malta ranked in 10th place worldwide according to the World Economic Forum 2014.

Financial soundness indicators show that the Maltese banking sector compares very well with European averages. The Capital Adequacy Ratio of Maltese banks remains well above the 8.0% regulatory minimum. On the funding side, Maltese banks remain characterised by stable funding with the loan-to-deposit ratio for core domestic banks standing at 61.7%, compared with 103.3% in the euro area. The low ratio reflects continued reliance on retail funding sources. Both interbank funding and Eurosystem funding remained very modest at 0.8% and 0.5% of total liabilities, respectively.

On the asset side, aggregate credit growth extended by core domestic banks picked up in 2014 and stood at 4.5%. This was mainly driven by the mortgage market, which continued to expand by 9.1%, while the volume of loans to the business sector increased by 1.9%. Lending rates were relatively higher, particularly for small and medium enterprises (SME), when compared with other euro area countries. This is an indication of the incomplete pass-through of accommodative monetary policy measures. However, during 2014 there was some degree of responsiveness as bank lending rates went down slightly. The banks also participated in initiatives and schemes to encourage SME lending and exports. The eventual establishment of a development bank would complement the commercial banks' activities by providing broader access to finance, especially for SMEs.

The Maltese banking sector is profitable, with core domestic banks reporting an average return on equity of 10.0%, which is significantly higher than the 3.1% average for euro area domestic banks. At 0.7%, return on assets also exceeds the 0.2% reported for the euro area domestic banks average.

Bank's policies and operations

As a member of the Eurosystem, through the Governor's participation in the Governing Council of the ECB, and also through the contribution of staff members in various ESCB Committees, the Bank provides input into the formulation of monetary policy in the euro area. The Bank is also responsible for the implementation in Malta of the single monetary policy as determined by the Governing Council.

The Bank's contribution to monetary policy decisions – as well as its role in the promotion of an informed debate on economic and financial issues – stands to benefit from an enhanced research and forecasting capacity, along with an upgrade of the Bank's publications. To this end, incentives were introduced for published research and analysis across the Bank. In addition, the objectives and tasks of the Economics & Research Department were devolved into two departments, allowing a greater degree of specialisation. In the new set-up, the Economic & Monetary Analysis Department focuses on economic forecasts, monetary policy issues and the Bank's regular publications. The Modelling & Research Department concentrates on quantitative research, including the maintenance and revision of the Bank's econometric models. The Bank's website and printed publications now contain an enlarged collection of analysis and research findings.

The reduction in yields across financial markets prompted a modification in the Bank's financial strategy. The fall in yields generates one-off capital gains but it also poses the challenge of reinvestment at lower yields. To compensate, the Bank took on a more active investment policy that involved an expansion of its investment assets, to €3.8 billion at end-2014 from €3.3 billion a year earlier. While interest income declined from €78.4 million in 2013 to €67.7 million in 2014, operating profit levels rose over the same period from €66.7 million to €71.8 million. In the light of the enlarged portfolio of investment assets, and in the context of the continuing uncertainty in financial markets, the Bank enhanced its provisions by a further €15.0 million, to €33.9 million, and also transferred €8.8 million to reserves. Consistent with these augmented buffers, the Bank passed on €48.0 million to the Government of Malta.

On behalf of the Board of Directors, I would like to thank the Bank's staff for their dedication and hard work, which contributed to the outcomes that are presented in this *Annual Report*.

Professor Josef Bonnici

PART I

FINANCIAL AND

ECONOMIC DEVELOPMENTS

1. INTERNATIONAL ECONOMIC DEVELOPMENTS AND THE EURO AREA ECONOMY[1]

The global economy showed resilience throughout 2014, though the pace of economic activity differed substantially across the major economies. In the industrial countries, growth generally picked up, with a steady recovery in the United States and a notable acceleration in the United Kingdom. The euro area economy was marked by a tentative recovery from recession, whereas in Japan there was clear evidence of an economic slowdown. With regard to emerging market economies, China registered slower growth, albeit still at a high level. Many other emerging economies were severely hit by financial volatility, particularly those with higher exposure to conditions in commodity and international financial markets.

In the latter part of the year, prices of crude oil and other commodities declined sharply, feeding into lower inflation across the world. Against this backdrop of low inflation, monetary policy in advanced economies remained accommodative, though the Federal Reserve ended its asset buying programme towards the end of the year. The European Central Bank (ECB) eased its monetary policy stance further, while the central bank of Japan announced additional quantitative easing measures in an aggressive pursuit of its inflation target. This generally accommodative monetary policy stance had an impact on global financial markets. Most stock prices rallied while bond yields fell. Spreads between sovereign-bond yields narrowed further in 2014, particularly those in the euro area periphery.

In the euro area growth in gross domestic product (GDP) remained subdued in 2014. However, activity recovered on a year earlier. Inflation weakened mostly in response to lower energy prices. In this context, the ECB reduced its key interest rates in both June and September, with the rate on the main refinancing operations (MRO) lowered to a historical minimum of 0.05%. In September the Eurosystem conducted the first in a series of targeted longer-term refinancing operations (TLTRO) to improve bank lending to the euro area non-financial private sector. Towards the end of the year it started to purchase a portfolio of asset-backed securities and covered bonds. At the beginning of 2015, the ECB also announced an expansion of its asset-purchase programme to include sovereign bonds.

The international economy

United States economy retains its momentum

The US economic recovery gathered pace in 2014, with real GDP growing by 2.4%, up slightly from the 2.2% registered in 2013 (see Table 1.1).

This pick-up reflected an acceleration in non-residential fixed investment, a more positive contribution from government spending, higher private sector stockbuilding and rising personal consumption expenditures. These developments were partly offset by an increase in imports, on the back of a strengthening

Table 1.1
GDP GROWTH IN ADVANCED ECONOMIES(1)
Percentage changes over preceding period

	2014				2011	2012	2013	2014
	Q1	Q2	Q3	Q4				
United States	-0.5	1.1	1.2	0.7	1.6	2.3	2.2	2.4
Euro area	0.3	0.1	0.2	0.3	1.6	-0.8	-0.5	0.9
United Kingdom	0.6	0.8	0.7	0.5	1.6	0.7	1.7	2.6
Japan	2.4	-0.4	-1.4	-0.5	-0.5	1.8	1.6	0.0

(1) Chain-linked volumes; quarterly figures are seasonally and working day adjusted.
Sources: Eurostat; Japan Statistics Bureau.

1 The cut-off date for data on GDP in this Chapter is 6 March 2015.

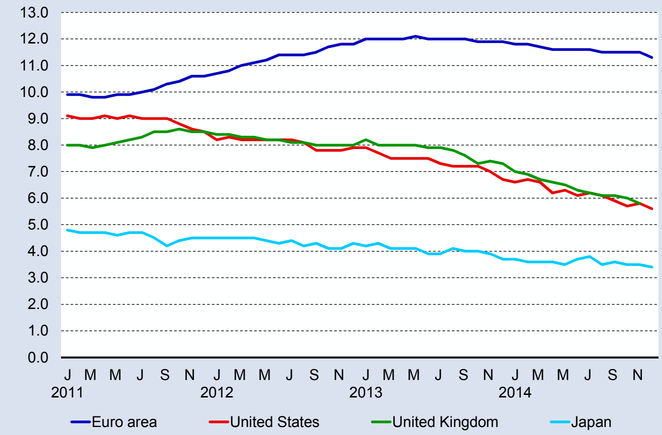
dollar and decelerating residential fixed investment. The economy grew at a more modest pace in the final quarter of the year, as investment in equipment declined. In fact, growth at the end of the year was mostly boosted by higher consumer expenditure, which in turn was underpinned by lower oil prices and a stronger labour market.

In fact, labour market conditions continued to improve in 2014, with the unemployment rate dropping by 1.1 percentage points to 5.6% in December (see Chart 1.1). Employment increased across most sectors of the economy. At the same time, however, labour force participation rates declined, as discouraged workers continued to leave the labour market. Indeed, the US rate of participation fell to 62.7% by December 2014, a level last seen in 1978.

Inflationary pressures in the United States eased significantly in 2014, with the annual rate of Consumer Price Index (CPI) inflation closing the year at 0.8%, 0.7 percentage point lower than the end-2013 level (see Chart 1.2). On the other hand, inflation on food and beverages, along with services, remained buoyant, ending 2014 at 3.3% and 2.4%, respectively. The overall rate of inflation decelerated owing to a dramatic decline in the energy component, which dropped by 10.6% from its level at the end of the previous year. Excluding food and energy, inflation edged down by 0.1 percentage point over the year to 1.6% in December 2014.

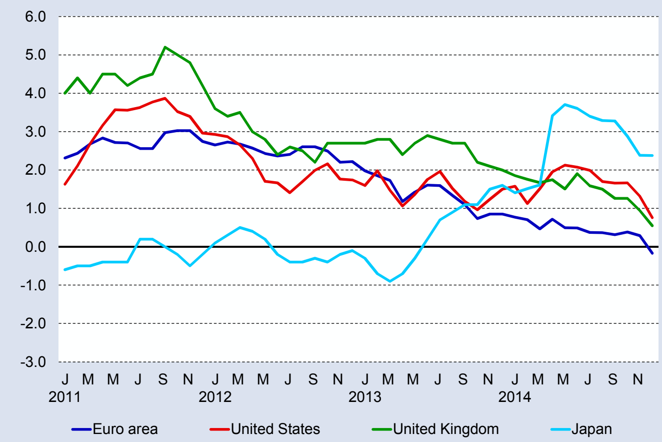
The Federal Reserve maintained an accommodative monetary policy stance throughout 2014, holding the federal funds target rate unchanged in a range between 0.00% and 0.25% throughout 2014 (see Chart 1.3). Additionally, by late October 2014, the Federal

Chart 1.1
UNEMPLOYMENT RATE
(percentage of the labour force; monthly data; seasonally adjusted)



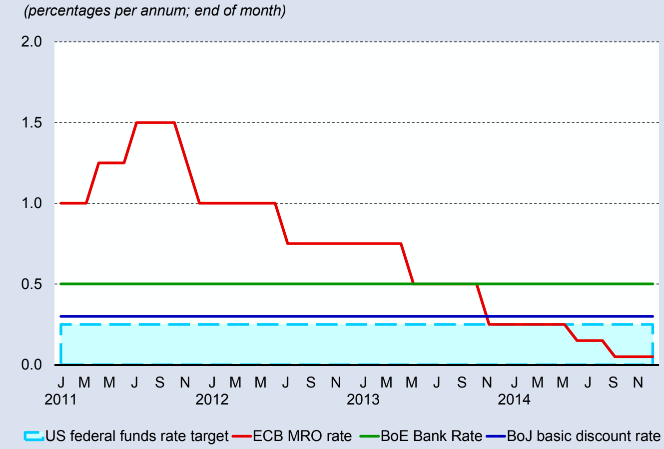
Sources: Eurostat; US Bureau of Labor Statistics; UK Office of National Statistics; Japan Statistics Bureau.

Chart 1.2
CONSUMER PRICE INFLATION
(annual percentage changes)



Sources: Eurostat; US Bureau of Labor Statistics; UK Office of National Statistics; Japan Statistics Bureau.

Chart 1.3
OFFICIAL INTEREST RATES
(percentages per annum; end of month)



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

Reserve concluded its asset-purchase programme on the basis of a significant improvement in the outlook of the broader economy. It reiterated its expectation that it would hold the target range for the federal funds rate at its current levels for a considerable time following the end of the asset-purchase programme, as long as longer-term inflation expectations remained well anchored. Thus, progress towards the Federal Open Market Committee's employment and inflation objectives were expected to dictate the manner in which the Federal Reserve would alter its monetary policy stance.

With regard to fiscal policy, after the rapid tightening carried out between 2011 and 2013, fiscal consolidation proceeded at a slower pace in 2014. Additionally, in February 2014 the US Government's debt limit was suspended until mid-March 2015, helping to reduce the short-term instability, which had characterised much of 2013. The government deficit in the United States was estimated to have reached 4.9% of GDP in 2014, down from 5.6% in 2013.[2]

UK economy expands at its fastest rate since 2007

The UK economy grew by 2.6% during 2014, up from 1.7% in 2013, indicating a sustained return to growth following the financial crisis (see Table 1.1). The strong expansion in output registered in 2014 reflected a very robust recovery by the construction industry and faster growth in the services industry. Moreover, industrial production also rose on a year earlier, with the component returning to growth for the first time in three years as the manufacturing industry continued to recover.

The labour market situation in the United Kingdom improved notably, so that by November the unemployment rate had fallen to 5.8% down from 7.3% at the end of 2013 (see Chart 1.1). With employment growth picking up significantly throughout the year and output growing at a less rapid pace than productivity, the latter continued to decline.

Inflation in the United Kingdom decelerated significantly in 2014, with abating energy price pressures towards the end of the year dampening overall price increases (see Chart 1.2). In December the annual CPI inflation rate stood at 0.5%, down from 2.0% at the end of the previous year. The slowdown in headline inflation was mainly driven by a significant decline in energy price inflation and by a drop in prices of food and beverages. The Bank of England's key monetary policy instruments were again left unchanged during 2014, with the official Bank Rate standing at 0.50% and its stock of asset purchases standing at GBP 375.0 billion at the end of the year (see Chart 1.3). In spite of the sharp drop in unemployment in the first half of the year, the Bank considered that there remained scope to absorb further spare capacity in the economy before raising the Bank Rate.

On the fiscal side, in March the UK Government unveiled its budget for 2014, envisaging a gradual drop in the fiscal deficit, which was forecast to fall from 6.6% in 2013–14 to 5.5% of GDP in 2014–15, with a return to balance by 2018–19.

The Japanese economy grinds to a halt

The Japanese economy showed no growth over 2014 as a whole, as against a real GDP growth rate of 1.6% in the previous year (see Table 1.1). Strong growth in the first quarter was supported by a temporary boost to private consumption in anticipation of a consumption tax increase in April. In the two successive quarters, the Japanese economy contracted, before reviving modestly in the final quarter of the year. Over the year as a whole, private consumption and private residential investment had a negative impact on GDP growth, which was offset by positive contributions from private non-residential and public investment, and inventories. While exports rose more than imports, their net contribution to GDP growth was negligible.

The Japanese unemployment rate declined gradually over the year, with the jobless rate standing at 3.4% in December from 3.7% 12 months before (see Chart 1.1).

[2] General government deficit estimates in this Chapter are sourced from the European Commission's Winter 2015 *Economic Forecasts*.

Meanwhile, price pressures continued to accelerate during 2014, with the overall annual inflation rate rising to 2.4% in December from 1.6% in 2013 (see Chart 1.2). Faster price growth mainly reflected developments in prices of imported items, such as food and energy, partly due to the weakening of the Japanese yen following the Bank of Japan's aggressive accommodative policy measures. The consumption tax hike in April also boosted inflation temporarily.

With regard to monetary policy, in 2014 the Bank of Japan retained its commitment to pursue monetary easing to achieve its price stability target. The Bank's quantitative and qualitative easing programme was kept in place unchanged until end-October, when the annual pace of expansion in the monetary base was raised to 80.0 trillion yen. On the fiscal front, government revenues were boosted by the consumption tax hike. However, the general government deficit, although lower on a year earlier, still amounted to an estimated 7.7% of GDP in 2014.

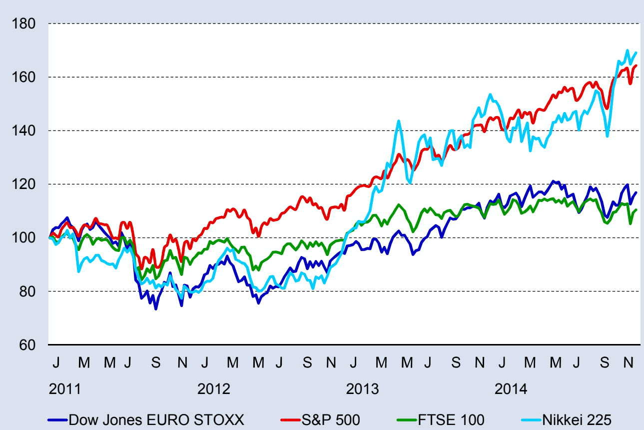
Weak activity in most emerging markets
Economic activity in major emerging economies slowed down further during 2014. GDP growth in China rose by 7.4%, down from 7.8% in the previous year. While external demand was stable, the weak housing market weighed heavily on Chinese economic activity.

Economic growth also weakened in other major emerging economies. The Russian economy stalled under the impact of lower prices of its energy exports and the imposition of trade sanctions by the European Union and the United States, following Russia's annexation of Crimea. Brazil's economy faced a recession in the first half of the year on the back of adverse weather conditions, low investment and weakness in the country's infrastructures. Inflation in these two economies remained high, as the Russian rouble experienced a substantial depreciation, while in Brazil administered price increases pushed the inflation rate strongly upwards. In India economic activity increased at a faster pace in 2014. However, very low corporate spending and a rise in bad debt levels hindered economic growth.

International financial markets

Mixed developments on stock markets during 2014
Equity prices in advanced economies generally rose over the course of 2014, in some markets extending a rally that had begun in 2012 (see Chart 1.4). Share prices in the United States (S&P500) and Japan (Nikkei 225) rose by 11.4% and 7.1%, respectively, while share prices in the euro area, as measured by the DJ EUROSTOXX Index, rose by 1.7%. In the United Kingdom, in contrast, the FTSE100 Index lost 2.7% in value, reflecting the Index's relatively high exposure to commodity producers, marked fallout from lower oil prices and waning global growth prospects.

Chart 1.4
STOCK PRICE INDICES
(end of week index; Jan. 2011=100)

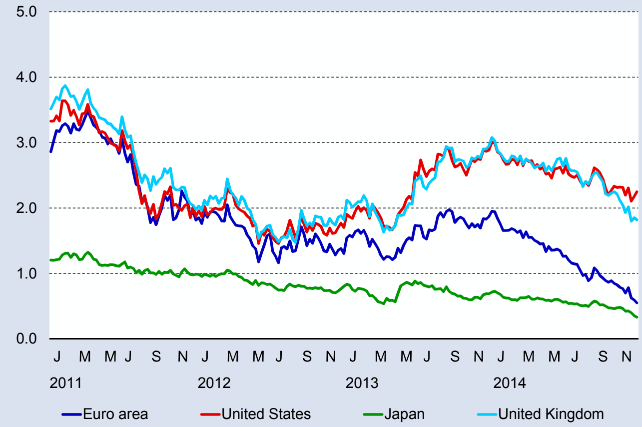


Source: Reuters.

Bond yields fall across advanced economies
Ten-year sovereign bond yields in most advanced economies fell during 2014, reflecting the continued accommodative monetary policy stance across developed economies, the subdued global economy and the low inflation environment (see Chart 1.5). The relatively strong economic performance of the United States and the United Kingdom ensured continued demand for

US Treasury notes and British gilts, driving yields lower. Yields on ten-year US sovereign debt dropped by 83 basis points to 2.20%, while those on the corresponding British debt fell 128 basis points to 1.70%.

Chart 1.5
TEN-YEAR GOVERNMENT BOND YIELDS
(percentages per annum; end of week)



Source: Reuters.

Similarly, ten-year yields on German bonds fell 140 basis points to end the year at 0.50%. The drop in yields mirrored risks of deflation and slow growth across many European economies. Demand for German bonds was also buoyed by their "safe-haven" status.

In Japan ten-year government bond yields dropped by 41 basis points during 2014, ending the year at 0.20%. The main driver continued to be the Bank of Japan's government bond-purchase programme. The accommodative monetary policy stance in major economies across the world, along with low global inflation expectations, led to a substantial decline in short-term bond rates. In some countries yields fell to zero or turned negative.

Commodities

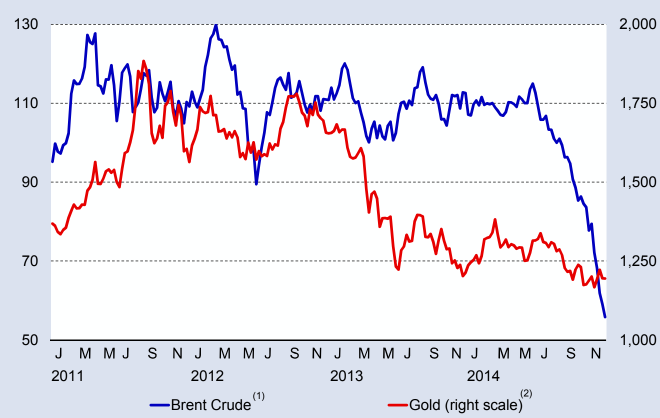
Oil price falls significantly in 2014

The price of Brent crude oil stood at USD 55.5 per barrel at the end of 2014, 49.8% lower than its value 12 months earlier (see Chart 1.6). This remarkable halving of oil prices followed a long period of relative stability. In fact, Brent spot prices peaked in June 2014 at USD 115.6, on the back of unrest in a number of oil exporting countries and rising tensions in North Africa, the Middle East and Ukraine. However, fragile demand from advanced economies in the wake of weakening global growth prospects, coupled with higher output by oil-producing countries, including the United States from its unconventional shale oil production, led to an easing in oil prices in the third quarter. Furthermore, in November the Organisation of the Petroleum Exporting Countries decided to maintain their oil production targets stable and defend market share, rather than curtail output and raise prices. By the end of the year, oil prices had plummeted to levels last observed in May 2009.

Gold price down marginally

In 2014 the price of gold was generally steady, holding the level it had reached in 2013 following the downward shift that began in mid-2012. Gold prices fell by just 1.8% over the year, reaching USD 1,183.6 per troy ounce by the end of December 2014 (see Chart 1.6). While prices remained broadly stable, sustained by retreating geopolitical worries in the first half of the year, concerns about the economic outlook led to renewed downward pressure towards the end of 2014. Throughout the year gold prices were supported by purchases for investment purposes.

Chart 1.6
OIL AND GOLD PRICES
(end of week)

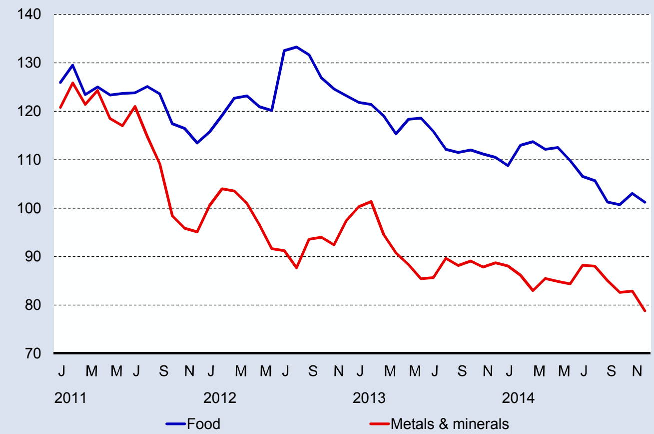


(1) US dollars per barrel; (2) US dollars per troy ounce.
Source: Reuters.

Metal prices drop during 2014
Prices of metals dropped again during 2014, with the World Bank's Metals and Minerals Index falling by 11.2% after a decrease of 8.9% in 2013 (see Chart 1.7). The drop in prices was more pronounced in the second half of the year, reflecting slowing global demand and particularly low metal imports by China.

Looking at specific commodities, an expansion in low-cost production by Brazil and Australia in a market characterised by oversupply led to a drop in iron ore prices. The same market forces fuelled a drop in tin prices, while weak demand from China lowered lead and copper prices.

Chart 1.7
COMMODITY PRICES
(monthly indices; 2005 = 100)



Source: World Bank.

Continued abundant supply pushes down food prices
Food prices extended their downward trend in 2014, with the World Bank's Food Index losing 8.4% of its value (see Chart 1.7). Falling grain prices were the main driver behind the overall decrease, with an improvement in crop prospects in the European Union and Russia offsetting downward adjustments in supply by the United States, Brazil and Turkey. Edible oil prices also dropped in 2014, reflecting record expansion in soybean production and historically high crop yields.

Economic and financial developments in the euro area

Listless economic growth in the euro area
The euro area economy expanded over 2014, with early estimates showing that real GDP grew by 0.9% following a 0.5% drop in 2013 (see Table 1.2). The recovery in GDP was pushed by higher private consump-

Table 1.2
REAL GDP GROWTH IN THE EURO AREA
Chain linked volumes

	2011	2012	2013	2014
		Annual percentage changes		
Private consumption	0.2	-1.3	-0.7	1.0
Government consumption	-0.2	-0.1	0.3	0.7
Gross fixed capital formation	1.6	-3.7	-2.5	1.0
Exports	6.6	2.4	2.0	3.7
Imports	4.3	-1.1	1.2	3.8
GDP	**1.6**	**-0.8**	**-0.5**	**0.9**
		Percentage point contributions		
Private consumption	0.1	-0.7	-0.4	0.5
Government consumption	0.0	0.0	0.1	0.1
Gross fixed capital formation	0.3	-0.8	-0.5	0.2
Exports	2.5	1.0	0.9	1.6
Imports	-1.6	0.4	-0.5	-1.5
GDP	**1.6**	**-0.8**	**-0.5**	**0.9**

Source: Eurostat.

tion expenditure and a recovery in gross fixed capital formation, which rose following two years of negative growth rates. Exports also rose, although a marked increase in imports dampened the external sector's contribution to growth.

The annual growth rate of GDP, however, remained low when compared with historic standards, highlighting the fragility of the euro area economy. Nonetheless, on a quarterly basis, GDP growth accelerated over the last half of the year, with indications that growth prospects would continue to improve.

Annual inflation turns negative

Inflation weakened considerably during 2014, with the Harmonised Index of Consumer Price (HICP) inflation rate decelerating throughout the year (see Chart 1.8). Consequently, in December it contracted to stand at -0.2% as against 0.8% at the end of 2013. The disinflationary trend was driven by lower energy prices, especially in the latter half of the year. However, in an economic environment characterised by a significant and persistent degree of slack, underlying inflation was also subdued, with the annual rate of change of HICP excluding food and energy prices rising marginally from 0.7% in December 2013 to 0.8% 12 months later. The drop in price pressures was broad-based, with only the services component rising from 1.0% in December 2013 to 1.2% by end-2014.

Tentative recovery in the labour market

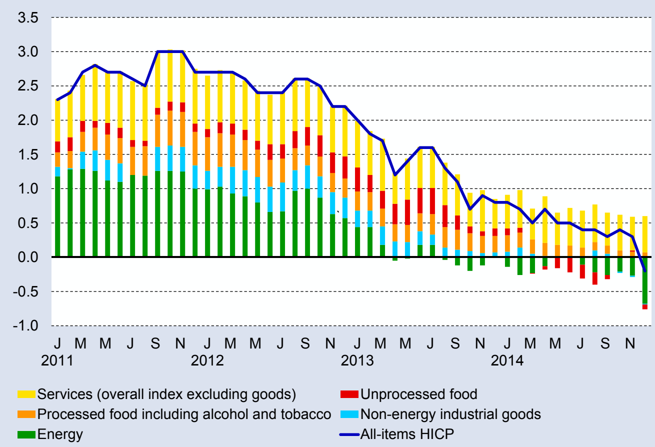
Labour market conditions remained fragile in 2014 but showed a slight improvement as employment grew modestly during the first three quarters of the year while the unemployment rate declined marginally. The latter, which had begun to ease towards the end of 2013, fell from 11.8% in December 2013 to 11.3% by December 2014 (see Chart 1.9).

The modest improvement concealed significant cross-country divergences. Particularly, a low and decreasing unemployment rate in Germany contrasted with high and increasing unemployment levels in Greece, and high and decreasing levels in Spain. This heterogeneity can be accounted for by differences in economic performance, net migration and labour market rigidities between euro area countries.

ECB cuts rates and commences asset-purchase programmes

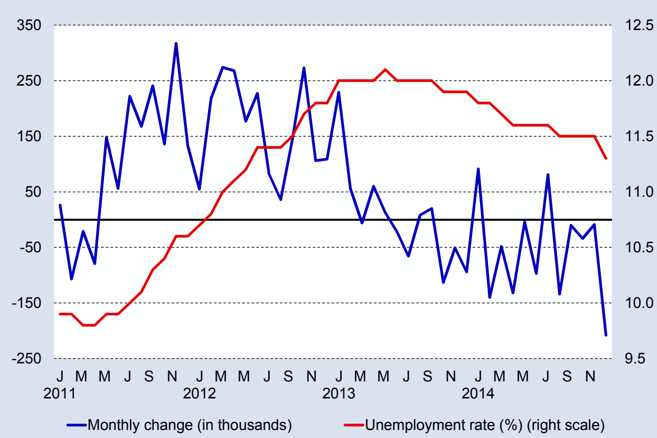
The Governing Council of the ECB lowered key interest rates twice during 2014, in June and in September (see Chart 1.3). In each

Chart 1.8
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION IN THE EURO AREA
(percentage points; annual percentage change)



Source: Eurostat.

Chart 1.9
UNEMPLOYMENT IN THE EURO AREA
(monthly data; seasonally adjusted)



Source: Eurostat.

case, the interest rate on the MROs was cut by 10 basis points to end the year at a historical low of 0.05%. Moreover, the rate on the marginal lending facility was reduced by 35 basis points in June and by 10 basis points in September to end 2014 at 0.30%. The deposit facility rate was also cut to -0.10% in June, moving into negative territory for the first time, and fell again to -0.20% in September.

The ECB's Governing Council lowered interest rates after taking into account the subdued outlook for inflation, the weakening in the euro area economy's growth momentum, and restrained monetary and credit dynamics. In particular, euro area inflation was expected to remain considerably below the 2.0% level for a prolonged period, prompting additional monetary accommodation to ensure price stability over the medium term.

With key interest rates reaching the zero lower bound, the ECB also introduced a package of non-standard monetary policy measures, in the form of TLTROs and asset purchases, as outlined in more detail in the Financial Policy Calendar shown in this *Report*.

Monetary and credit dynamics on gradual recovery path

Monetary conditions within the euro area improved moderately over 2014. Thus, in December 2014 the annual growth rate of M3, a measure of broad money, picked up to 3.6% from 1.0% a year earlier (see Table 1.3). The recovery in M3 growth was broad-based across sectors and countries, reflecting relatively high inflows into overnight deposits held by both non-financial corporations (NFC) and households. Annual growth in M1, which is a measure of the most liquid forms of money, stood at 7.8% in December. This rather strong demand for liquidity confirms the small opportunity cost of holding narrow money in an environment characterised by very low interest rates.

With regard to the counterparts of M3, total credit in the euro area declined marginally, despite the accommodative monetary policy stance. However, as the year progressed, the negative trend in lending slowed, so that in December 2014 it stood at a negative 0.2% from -2.0% a year earlier.

The contraction in private sector credit was less pronounced and it ended the year -0.7% lower from -2.3% 12 months earlier. Meanwhile, the annual rate of change of credit to government, on the other hand, turned positive towards the end of the year. The decline in loans to NFCs continued to moderate in 2014, while the growth of loans to households appeared to have stabilised at a slightly negative level (see Chart 1.10). The contraction in credit took place despite a broad-based and ample reduction in lending rates since mid-2014. Deleveraging in some economic sectors and subdued economic prospects are likely to have weakened demand for credit, while bank balance sheet consolidation may have constrained credit supply.

In contrast, the net external assets of euro area monetary financial institutions (MFI) in general rose during the year, supporting monetary growth. The increase in net foreign assets reflected the current account

Table 1.3
EURO AREA MONETARY AGGREGATES
Annual percentage changes

	2013	2014			
	Dec.	Mar.	June	Sep.	Dec.
Currency in circulation	5.2	6.5	5.6	6.0	6.4
Overnight deposits	5.8	5.5	5.4	6.2	8.1
M1	**5.7**	**5.6**	**5.4**	**6.2**	**7.8**
Time deposits	-1.7	-2.4	-1.8	-1.5	-2.6
M2	**2.5**	**2.2**	**2.4**	**3.0**	**3.5**
Marketable instruments	-16.2	-13.5	-8.8	-4.4	4.7
M3	**1.0**	**1.0**	**1.6**	**2.5**	**3.6**

Source: ECB.

surpluses registered by most euro area countries and the additional interest of international investors in euro area assets.

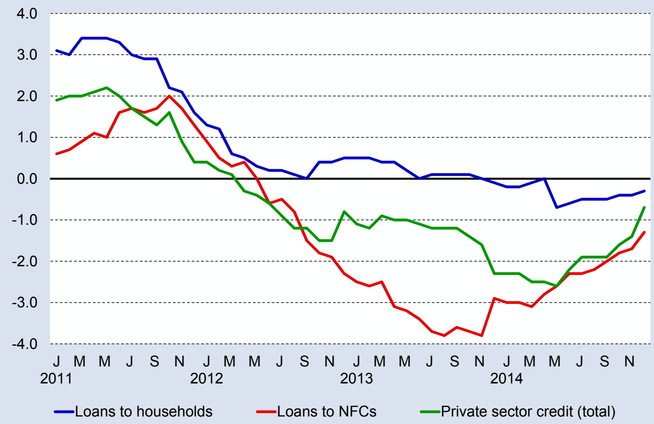
Money market rates stable at low levels

Money market rates fell further in an environment marked by excess liquidity, with some also registering new historic lows. The three-month EURIBOR, along with the 12-month EURIBOR and the EONIA deposit rate, remained at low levels during 2014.[3] They increased marginally until the second quarter, reflecting expectations of a tighter monetary policy stance in the United States, before declining close to the zero level in the final months of the year. The EONIA deposit rate, in fact, ended the year in negative territory. These low levels reflected the accommodative monetary policy stance of the ECB, which resulted in a major increase in excess liquidity, especially in the wake of the introduction of TLTRO operations, the first two of which were carried out in September and December. The spread between the ECB's MRO rate and the three-month EURIBOR remained narrow throughout 2014 (see Chart 1.11). In December the spread was marginally negative but close to zero and almost unchanged on a year earlier.

Peripheral yield spreads narrow further

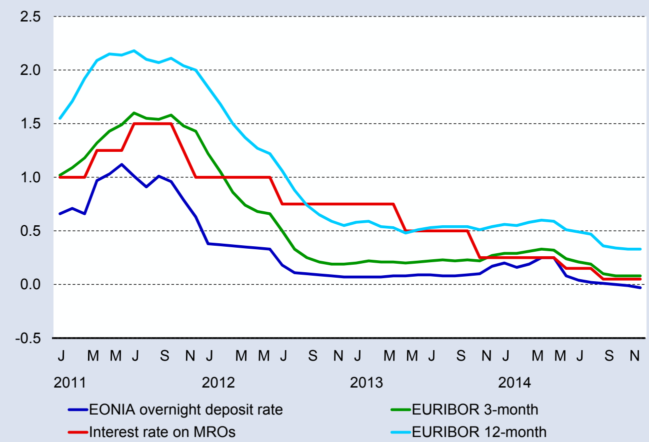
Yields on ten-year government bonds were generally lower during 2014. Within the euro area, spreads between yields on ten-year German bonds and those issued by other governments continued to narrow further (see Chart 1.12). This contraction was particularly evident in the latter half of the year, in anticipation of additional monetary policy easing measures by the ECB. This led to further substantial investment

Chart 1.10
MFI CREDIT TO THE PRIVATE SECTOR IN THE EURO AREA
(annual percentage changes)



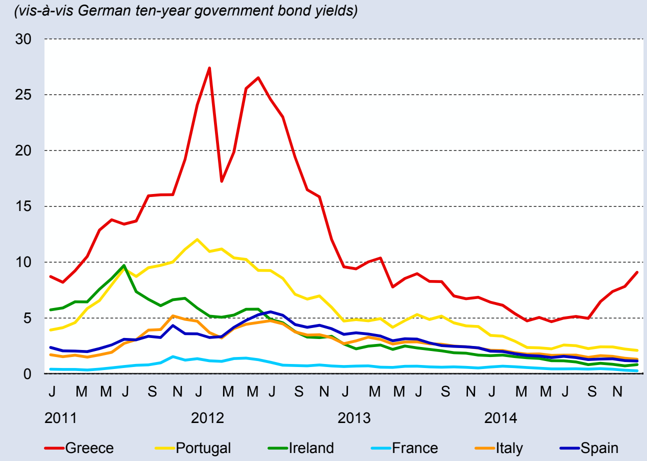
Source: ECB.

Chart 1.11
KEY INTEREST RATES
(percentages per annum; monthly averages)



Source: Central Bank of Malta.

Chart 1.12
EURO AREA TEN-YEAR GOVERNMENT BOND YIELD SPREADS
(vis-à-vis German ten-year government bond yields)



Source: ECB.

[3] EURIBOR is an interest rate benchmark indicating the average rate at which principal European banks lend unsecured funds on the interbank market in euro for a given period. The EONIA (Euro OverNight Index Average) is an effective overnight interest rate, measured as the weighted average of all overnight unsecured lending transactions on the euro area interbank market.

demand for bonds of the peripheral countries of the euro area. The only exception was Greece, where rising political uncertainty led to a widening of the spread towards the end of the year.

Monetary policy divergence between the ECB, the Federal Reserve and the Bank of Japan had a strong influence on sovereign bond markets in the euro area during the year. The expected unwinding of the Fed's quantitative easing (QE) programme, a more expansionary monetary policy stance in Japan and uncertainty about the timing of further easing measures by the ECB contributed to volatility in yields across the euro area bond markets.

Following the ECB's announcement on the expanded asset-purchase programme in late January 2015, most sovereign bond yields across the euro area recorded further falls, with spreads vis-à-vis the German Bund narrowing across many peripheral countries.

The euro weakens during 2014

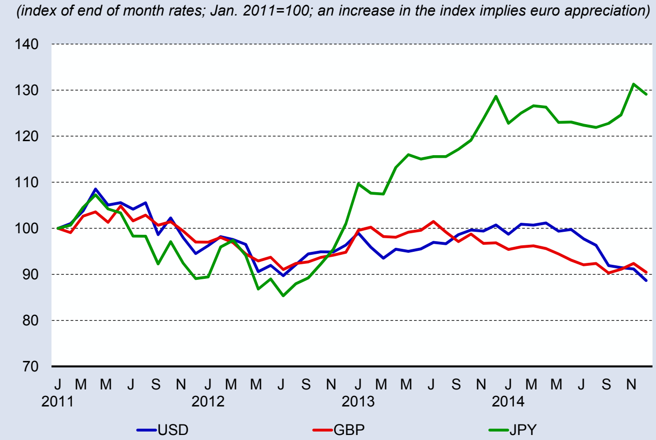
After remaining broadly stable for the first five months of 2014, the euro exchange rate depreciated substantially over the remainder of the year, with the nominal effective exchange rate losing 5.0% by December 2014 (see Chart 1.13). This weakening generally reflected the bleak outlook for the euro area economy and the persistent fall in euro area interest rates as a result of the ECB's accommodative monetary policy measures. The single currency, however, was buoyed by receding risks of a break-up of the euro area, as well as by the aggressive monetary policy easing followed by some other central banks outside the euro area for most of the year.

Chart 1.13
EURO NOMINAL EFFECTIVE EXCHANGE RATE
(index of daily effective exchange rate; Q1 1999=100)

Source: ECB.

On a bilateral basis the euro strengthened by 0.4% against the Japanese yen during 2014, which had weakened in foreign markets owing to the aggressive expansionary monetary policy steps taken by the Bank of Japan (see Chart 1.14). Although the euro gained ground against the US dollar for the first eight months of the year, it weakened subsequently as the Federal Reserve proceeded to unwind its QE programme. At the end of the year, the US dollar/euro exchange rate stood at USD1.2141, 12.0% below its level at end-2013.

Chart 1.14
EXCHANGE RATE MOVEMENTS OF THE EURO AGAINST OTHER MAJOR CURRENCIES
(index of end of month rates; Jan. 2011=100; an increase in the index implies euro appreciation)



Source: Eurostat.

The euro lost ground against the pound sterling over most of the year, though its fall was more pronounced towards the middle of the year. Over 2014 as a whole, the euro dropped by 6.6%. This depreciation mainly mirrored a stronger UK economic performance and increased expectations that monetary policy in the United Kingdom and the euro area would diverge further.

The ECB's announcement of the public sector purchasing programme at the beginning of 2015 led to a further weakening of the euro against other major currencies.

2. MONETARY AND FINANCIAL DEVELOPMENTS

Deposits remained the main source of banks' funding during 2014, with balances belonging to residents of Malta growing at double-digit rates. On the other hand, credit granted to residents declined, as modest growth in credit to general government failed to offset a contraction in credit to the remaining sectors.

Domestic primary money market yields fell further during 2014, following reductions in the European Central Bank's (ECB) key interest rates. Meanwhile, in the domestic capital market, yields on five-year and ten-year government bonds extended their downward trend. The spread over benchmark euro area government securities narrowed in the case of the five-year tenor, but widened for the ten-year bonds. During the year, the Malta Stock Exchange (MSE) share index fell significantly.

Core domestic banks' total assets

The total assets belonging to core domestic banks rose during 2014 by €2.9 billion, or 5.4%.

Total assets belonging to the domestically relevant banking system rose from 200% of gross domestic product (GDP) at end-December 2013 to 213% at the end of 2014 (see Chart 2.1).[1,2]

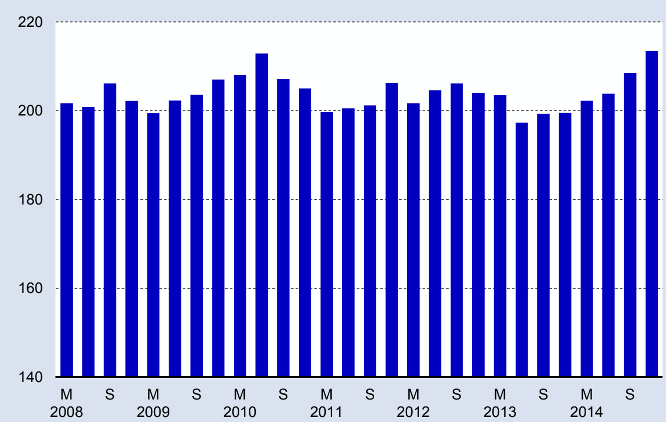
Residents' deposits[3]

During 2014 residents' deposits held with all monetary financial institutions (MFI) in Malta gained considerable momentum. They expanded by 14.6% during the year, up from 9.0% in the previous year.

In particular, overnight deposits continued to grow rapidly, increasing by €1.9 billion, or 29.0% in 2014 from 13.7% in 2013 (see Table 2.1). As in previous years, balances belonging to households and non-financial corporations (NFC) accounted for most of the increase. Deposits belonging to non-bank financial intermediaries also went up significantly during the year.

This strong preference for liquid assets may reflect several factors, in particular the fact that interest rates on deposits with a fixed term to maturity declined, thus reducing the opportunity cost of investing in overnight deposits. However, the increase in overnight balances may have also reflected higher uncertainty abroad and a lack of attractive investment opportunities. The significant rise in such deposits in the final quarter of the year also coincided with the extension period of the investment registration scheme, when some beneficiaries of the scheme repatriated funds to Malta. A build-up of liquid balances by investors could also have taken place in view of the anticipated issue of Malta Government Stocks (MGS) early in 2015 at relatively attractive yields.

Chart 2.1
TOTAL ASSETS/LIABILITIES OF CORE DOMESTIC BANKS
(% of GDP; GDP data are four-quarter moving sums)



Sources: Central Bank of Malta; NSO.

1 The domestically relevant banks, or "core" domestic banks, are APS Bank Ltd, Banif Bank (Malta) plc, Bank of Valletta plc, HSBC Bank Malta plc and Lombard Bank Malta plc.

2 GDP statistics are sourced from NSO *News Release* 046/2015 issued on 9 March 2015.

3 During 2014 monetary data were revised following the introduction of the new ESA 2010 methodology. All past data from June 2010 onwards were also revised. The major impact of the change to the new methodology is the reclassification of special purpose entities (SPE). SPEs are legal entities which are set up to fulfil specific objectives. They are characterised by a limited physical presence in their country of operation, the low number of staff they employ and the absence on their balance sheet of non-financial assets. SPEs are now considered to be residents of Malta and are mainly included within the other financial corporations sector. Consequently, residents' deposits, as well as loans to residents, were revised upwards. The revisions also affect the dynamics of these variables.

Table 2.1
DEPOSITS OF MALTESE RESIDENTS
Annual percentage changes; EUR millions

	2012 Dec.	2013 Dec.	2014 Dec.	2014 Amount outstanding	2014 Absolute change
Overnight deposits	**11.9**	**13.7**	**29.0**	**8,413.7**	**1,891.4**
of which					
Households	10.2	12.0	25.4	4,528.4	918.3
Non-financial corporations	5.5	22.0	24.0	2,249.8	435.3
Deposits redeemable at notice up to 3 months	**23.8**	**-25.0**	**9.3**	**124.4**	**10.6**
of which					
Households	-5.3	-2.1	7.8	103.5	7.4
Non-financial corporations	187.0	-70.3	10.9	17.5	1.7
Deposits with agreed maturity up to 2 years	**1.3**	**2.8**	**-2.0**	**3,914.2**	**-79.2**
of which					
Households	1.2	2.2	-0.7	3,037.9	-77.1
Non-financial corporations	-5.2	-5.6	-16.0	340.4	-108.6
Deposits with agreed maturity above 2 years	**5.5**	**10.8**	**-3.0**	**1,498.1**	**-45.7**
of which					
Households	5.0	10.1	-5.1	1,383.3	9.2
Non-financial corporations	18.3	21.6	14.0	74.9	-73.8
Total residents' deposits[(1)]	**7.3**	**9.0**	**14.6**	**13,950.4**	**1,777.2**

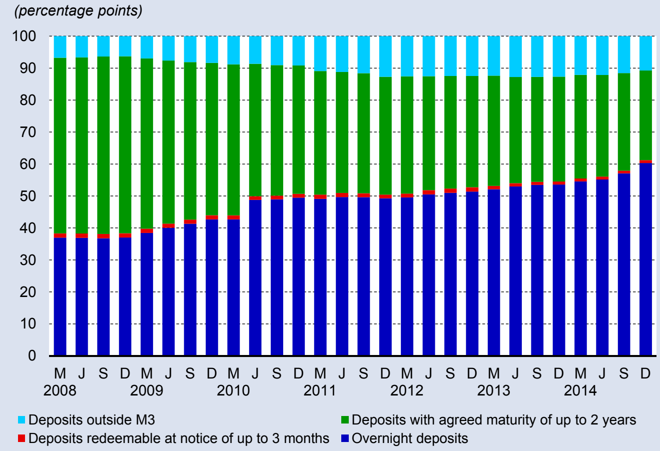
[(1)] Total resident deposits exclude deposits belonging to Central Government.
Source: Central Bank of Malta.

Households' overnight deposits grew by 25.4% during the year, up from 12.0% in the previous year. At the same time, the annual growth rate of overnight deposits held by NFCs rose to 24.0% from 22.0% in 2013, as firms appeared to have maintained a high level of liquid balances.

In contrast, time deposits contracted during the year, with those with an agreed maturity of up to two years falling by 2.0% following an expansion of 2.8% in the previous year. The decrease was broad-based across different categories of deposit holders. Similarly, deposits with an agreed maturity of over two years, which are excluded from the broad money aggregate (M3), declined by 3.0% following a 10.8% rise in the previous year. The decline stemmed from lower balances belonging to households.

Reflecting these movements, the share of overnight deposits in the total rose further during the year, to stand at over 60% at the end of 2014 (see Chart 2.2). Meanwhile, deposits with an agreed maturity of up to two years again lost ground. Similarly, the share of longer-term time deposits in total deposits fell to 10.7% from 12.7% in 2013.

Chart 2.2
DISTRIBUTION OF TOTAL RESIDENT DEPOSITS[(1)]
(percentage points)



[(1)] Deposits outside M3 exclude deposits belonging to central government.
Source: Central Bank of Malta.

Table 2.2

INTEREST RATES ON OUTSTANDING DEPOSITS BELONGING TO RESIDENTS OF MALTA[(1)]

Percentages per annum; weighted average rates as at end of period

	2012 Dec.	2013 Dec.	2014 Dec.
Total deposits belonging to households and non-financial corporations	**1.42**	**1.41**	**1.03**
Overnight deposits			
Households	0.32	0.35	0.17
Non-financial corporations	0.28	0.30	0.18
Time deposits with agreed maturity up to 2 years			
Households	2.07	2.07	1.73
Non-financial corporations	1.99	1.91	1.44
Time deposits with agreed maturity over 2 years			
Households	3.42	3.55	3.44
Non-financial corporations	3.06	3.12	2.84

(1) Annualised agreed rates on euro-denominated deposits.

Source: Central Bank of Malta.

Interest rates on residents' deposits

Interest rates on residents' deposits, which were largely unchanged in 2013, trended lower during 2014. The weighted average interest rate paid by MFIs on all deposits belonging to households and NFCs resident in Malta declined to 1.03% in December 2014, from 1.41% a year earlier (see Table 2.2).[4]

Rates on households' overnight deposits fell by 18 basis points to 0.17%, while those on similar deposits belonging to NFCs went down by 12 basis points. Similarly, rates on deposits with an agreed maturity of up to two years fell by 34 basis points for households and 47 basis points for NFCs, to stand at 1.73% and 1.44%, respectively. At the same time, rates on longer-time deposits went down by 11 basis points for households' balances and by 28 basis points for those of NFCs.

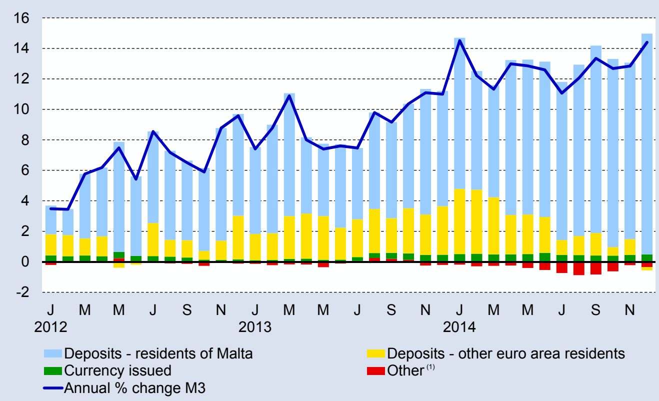
Contribution to euro area M3

The contribution of Maltese MFIs to euro area M3 rose by 14.4% during 2014, up from 11.0% in 2013. Deposits belonging to residents of Malta were the main driving force behind the expansion. In contrast, contributions from the remaining components, which include currency issued and deposits belonging to other euro area residents, were substantially smaller (see Chart 2.3).[5]

Chart 2.3

CONTRIBUTIONS OF RESIDENT MFIs TO EURO AREA MONETARY AGGREGATES

(percentage points; annual percentage change)



(1) The "other" category consists of loans granted to resident MFIs, repurchase agreements, money market fund shares/units and debt securities with a maturity of up to and including two years issued by MFIs.

Source: Central Bank of Malta.

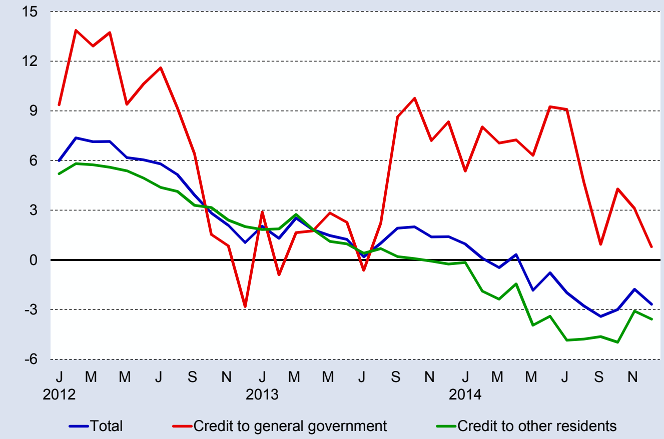
4 Data on interest rates on outstanding amounts shown in Table 2.2 cover MFI euro-denominated deposits belonging to households and NFCs resident in Malta. The household sector also includes Non-Profit Institutions Serving Households (NPISH). NFCs include all enterprises except banks, insurance companies and other financial institutions.

5 The contribution of Maltese MFIs to euro area monetary aggregates comprises the notional issue of euro currency attributed to the Central Bank of Malta, deposits held by Maltese and other euro area residents (except those belonging to central governments and interbank deposits) with resident MFIs, having terms to maturity of up to two years, as well as other monetary liabilities of Maltese MFIs towards euro area residents.

Credit to residents

During 2014 credit to Maltese residents contracted by 2.7% following a 1.4% increase in the previous year (see Chart 2.4). This reflected a drop in aggregate credit to the "other residents" category as credit to general government registered modest growth. As a result, credit in Malta contracted at a faster pace than in the euro area.

Chart 2.4
CREDIT TO RESIDENTS OF MALTA
(annual percentage changes)



Source: Central Bank of Malta.

Credit to general government grew by 0.8% during the year, down from 8.3% in the previous year. Although banks continued to add to their holdings of government debt securities, the increase was significantly smaller than in the previous year. In fact, resident credit institutions bought fewer MGS on the primary market in 2014 than in 2013, while their holdings of Treasury bills declined, in line with a drop in such issues by Government.

On the other hand, credit to residents other than general government contracted by 3.6%, following a 0.2% decrease in 2013. The decline stemmed primarily from a drop in equity issued by non-bank financial intermediaries, which include SPEs, and held by a non-core domestic bank. This decrease offset an increase in loans to households and NFCs.

Bank lending to NFCs

Bank lending to NFCs, which had contracted by 4.5% during 2013, recovered during the year under review, rising by 2.0%. The turnaround was driven by loans to public sector NFCs. At the same time, loans granted to private NFCs continued to fall.

With regard to bank credit to private NFCs, despite growth in economic activity, demand for credit by enterprises decreased, particularly in the second half of the year as indicated by bank survey results. To some extent, the contraction in credit was due to the fact that several firms tapped the bond market for the first time in 2014, thus reducing their need for bank loans. At the same time, the corporate sector in general was building its liquid balances throughout the year. Moreover, although bank lending rates edged down during the year, they remained relatively high, and this could have dampened demand for loans. On the

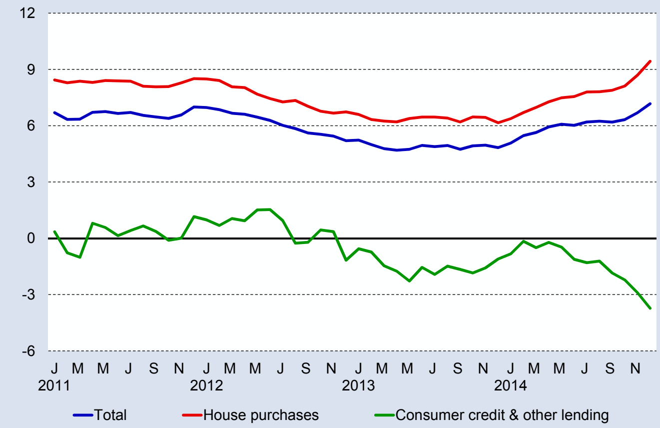
Table 2.3
LOANS TO NFCs BY SECTOR
Contributions in percentage points; annual percentage changes

	2012 Dec.	2013 Dec.	2014 Dec.
Accommodation and food service activities	0.2	-0.1	-0.7
Construction	-1.5	-3.0	-2.3
Manufacturing	0.6	-0.3	-0.2
Real estate activities	0.6	0.6	1.3
Transportation and storage	-0.6	-0.6	-0.1
Wholesale and retail trade	-0.4	-1.1	1.7
Other	-5.2	0.0	2.3
Total	**-6.3**	**-4.5**	**2.0**

Source: Central Bank of Malta.

supply side, results from bank surveys indicate that banks' credit standards remained unchanged during 2014. However, a relatively high stock of non-performing loans may be influencing credit dynamics in certain sectors.

Chart 2.5
LOANS TO HOUSEHOLDS
(annual percentage changes)



Source: Central Bank of Malta.

A sectoral breakdown of loans extended to NFCs shows that the wholesale & retail trade sector and real estate activities accounted for a significant share of the overall growth during the year (see Table 2.3). Lending to firms in the "other" category also increased, driven by the energy sector. On the other hand, loans to the construction sector continued to contract, though at a slower pace than in the previous year. Credit to firms in the accommodation & food services, manufacturing and transportation & storage sectors also decreased during 2014, though to a lesser extent than credit to the construction sector.

Bank lending to households

Bank lending to households, the other major component of credit to the private sector, grew strongly during 2014, with the annual growth rate rising to 7.2% from 4.8% in 2013 (see Chart 2.5). The increase was driven by higher borrowing for house purchases and partly reflected greater demand from first-time buyers in the light of measures announced in the 2014 Budget to stimulate the housing market. Lending for house purchases accounted for 85% of bank lending to households at the end of 2014. In contrast, consumer credit and other lending to households contracted more significantly than in the previous year, with a decline of 3.7% during 2014 as opposed to a drop of 1.1% in 2013. Growth in lending to households in Malta was stronger than in the euro area as a whole, which remained weak.

Interest rates on loans to Maltese residents

The weighted average interest rate charged by MFIs on outstanding loans to resident households and NFCs fell by 22 basis points during 2014, ending the year at 4.02% (see Table 2.4).[6] This decline was

Table 2.4
MFI INTEREST RATES ON OUTSTANDING LOANS TO MALTESE RESIDENTS[(1)]
Percentages per annum; weighted average rates as at end of period

	2012 Dec.	2013 Dec.	2014 Dec.
Total loans to households and non-financial corporations	**4.32**	**4.24**	**4.02**
Households and NPISH	3.95	3.86	3.70
Lending for house purchases	3.40	3.34	3.22
Consumer credit and other lending[(2)]	5.59	5.55	5.47
Non-financial corporations[(2)]	4.73	4.70	4.41

[(1)] Annualised agreed rates on euro-denominated loans to households and non-financial corporations.
[(2)] Includes bank overdrafts.
Source: Central Bank of Malta.

[6] Data on interest rates on outstanding amounts shown in Table 2.4 cover MFI euro-denominated loans granted to households and NFCs resident in Malta. These statistics do not cover all sectors of the economy.

smaller than that registered on deposits. Consequently, the spread between the lending and deposit rate continued to widen and ended the year at 299 basis points, compared with 283 basis points in 2013.

Rates paid by households on mortgages fell by 12 basis points to 3.22%, while rates charged to households on consumer credit and other lending went down by a lesser extent, dropping by 8 basis points to 5.47%. Lending rates charged to firms also decreased, going down by 29 basis points, to 4.41%.

Banks' credit standards

Credit market conditions continued to be monitored through the Bank Lending Survey (BLS) during 2014.[7] Survey results revealed that credit standards applied on lending to enterprises and to households for house purchases remained unchanged during 2014. Slight changes in credit standards with respect to consumer credit were, however, recorded in the March quarter, when one bank reported an easing of credit standards. In contrast, in the December quarter, another bank reported a tightening in standards.

With regard to demand for loans, there was a divergence between loans demanded by firms and households. Two banks reported a decline in demand for loans by enterprises in the second half of the year, following an earlier rise. On the other hand, three out of the four banks surveyed reported greater demand for loans by households for house purchases.

The BLS also included questions about the impact of the targeted longer-term refinancing operations (TLTRO) to be conducted by the Eurosystem between September 2014 and June 2016.[8] One bank participated in the TLTRO held in September 2014 while another bank participated in the TLTRO held in December 2014. The two banks indicated that their participation was motivated by the attractive conditions of TLTROs and that they intended to use the funds for the provision of additional credit to NFCs.

Credit granted to euro area residents outside Malta

Credit granted by resident MFIs to residents of euro area countries outside Malta rose in the period under review, expanding by €742.5 million, or 18.4% following a drop of €1.3 billion in the previous year when a number of international banks had reduced their operations in Malta. The increase mainly reflected higher lending to non-bank financial intermediaries and NFCs, as well as additional holdings of securities issued by other euro area sovereigns.

[7] The BLS gauges credit demand and supply conditions. It is carried out as a quarterly exercise by all national central banks in the Eurosystem, thus covering banks in the entire euro area.

[8] The TLTROs are designed to enhance the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy.

BOX 1: SURVEY ON ACCESS TO FINANCE (SAFE)[1]

Small and medium-sized enterprises (SME) form the backbone of the European economy. SMEs are typically defined as firms with less than 250 employees.[2] In the case of Malta there were approximately 30,500 SMEs actively operating in the country in 2013, representing around 99.8% of all enterprises and employing around 98,000 people, or 78% of the total workforce.[3]

The structure and characteristics of SMEs are given serious consideration by central banks when formulating monetary policy since the transmission mechanism may differ for SMEs and large firms, given the higher dependency of small firms on bank financing. In fact, the monetary transmission mechanism in the euro area has been adversely affected by the recent financial and sovereign debt crisis, and this has had a large negative impact on SMEs. This can be inferred, for instance, from heterogeneous developments in retail interest rates and from the supply of credit to the non-financial private sector in euro area countries. Studies show that SMEs usually have a harder time obtaining credit from banks than larger firms, mainly owing to their inability to provide high quality collateral and to the lack of relevant information on their creditworthiness.[4] The latter is evidenced by the relatively low survival rate of SME start-ups, which hinders their ability to develop lasting banking relationships or a credit related track record. This exacerbates the asymmetric information problem, which could lead to credit rationing and sub-optimal lending to viable SMEs. This negative state of affairs could have been reinforced by the recent financial crisis in the euro area. Thus, in periods of tight credit conditions, there is strong demand from policy makers for more detailed information about the financing conditions of SMEs.

Despite the importance of this category of firms, however, harmonised and timely statistics on SMEs have been relatively scarce. To address this gap, the European Commission and the ECB have, since 2008, commissioned regular surveys on access to finance of enterprises (SAFE) in the European Union. The survey covers micro, small, medium-sized and also large firms. It thus provides evidence on the financing conditions faced by SMEs compared with those of larger firms.[5] Since 2013 the European Commission's survey has been carried out on an annual basis, instead of biennially. In contrast, the ECB carries out biannual waves of the survey for the largest euro area economies only.[6]

This article provides an overview of the key results that were obtained from Maltese firms from the SAFE that was conducted between April and September 2014.[7] When appropriate, comparisons are made with results registered in previous waves of the survey or by other European economies.

---

[1] Prepared by Brian Micallef. Mr Micallef is a Senior Research Economist in the Bank's Modelling and Research Department. The views expressed are those of the author and do not necessarily reflect the views of the Central Bank of Malta. Any errors are the author's own.

[2] In addition, according to the European Commission, to fully qualify as an SME a firm's turnover has to be below €50 million or its total assets have to be below €43 million.

[3] Source: "Annual Report on European SMEs 2013/2014", published by the *European Commission*. This information differs from the Business Register of the National Statistics Office since it includes only NACE sectors B to J and L to N (i.e. it excludes agriculture, finance, public administration, health and education and some service activities, including arts and entertainment). This means that the number of SMEs is higher in the Business Register, amounting to 68,275 entities in 2013, when excluding public administration, education and health.

[4] Ayadi, R. and Gadi, S., "Access by MSMEs to finance in southern and eastern Mediterranean: what role for credit guarantee schemes?" *Technical Report* No 35/2013, European Commission, MEDPRO, 2013.

[5] Micro-enterprises are enterprises with one to nine employees, while small enterprises are those with ten to 49 employees, medium-sized enterprises have 50 to 249 employees and large enterprises have more than 250 employees. SMEs comprise micro-enterprises, small and medium-sized enterprises. Further information on the European Commission's SME Access to Finance Index (SMAF) is available at http://ec.europa.eu/enterprise/policies/finance/data/index_en.htm.

[6] The biannual surveys conducted by the ECB cover the euro area countries, except Cyprus, Estonia, Latvia, Luxembourg, Malta, Slovakia and Slovenia.

[7] A total of 17,075 firms have participated in the survey, which covers all 28 EU Member States, together with Iceland and Montenegro. The Maltese results are based on the replies of 100 firms from industry, construction, trade and services.

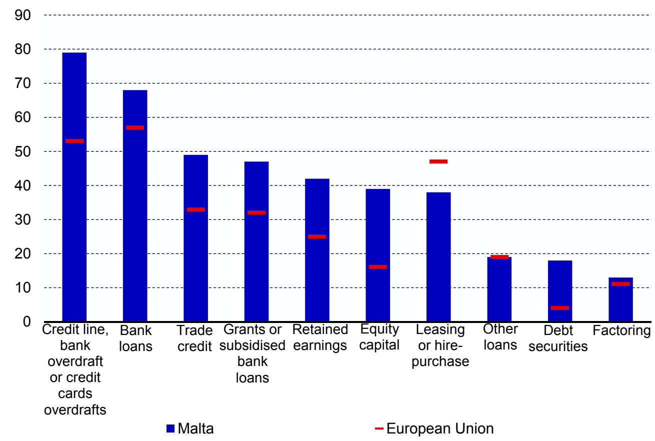
Financing sources used by SMEs

Charts 1 and 2 rank the importance of various funding sources for domestic and European SMEs. The first chart shows the sources that SMEs have used in the past or that they expect to use in future, while the second one shows the sources they have actually used in 2014.

As expected, the main similarity between Maltese and other European SMEs is their reliance on bank financing, with bank loans, overdrafts and credit lines being the most relevant sources of financing. Other sources, such as equity, factoring and debt securities, are used much less frequently by SMEs in both Maltese and European economies.

However, the survey also highlights differences between the importance attached by local and European SMEs to various sources of financing. Domestic SMEs are considerably more dependent than their European counterparts on bank overdrafts, credit lines or credit card facilities: in 2014 more than 70% of Maltese SMEs used these types of financing compared with around 37% in the European Union. This heavy reliance by domestic SMEs on overdrafts and credit cards could be sub-optimal since banks typically charge higher interest rates on these forms of financing compared with bank loans.[8]

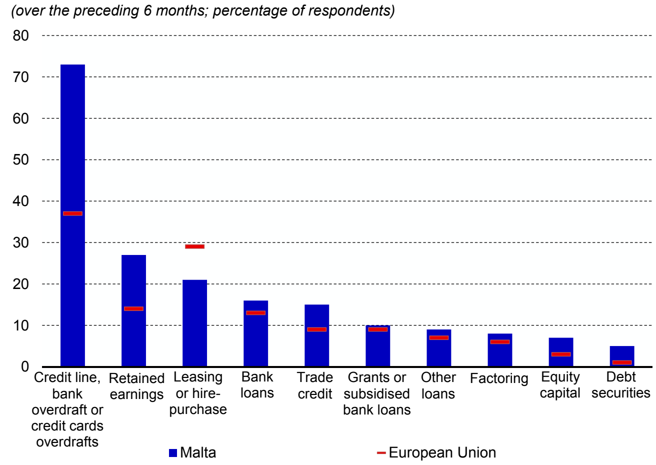
Chart 1
SOURCES OF FINANCE USED BY SMEs
(used in the past or consider using in the future; percentage of respondents)



Source: SAFE (2014).

Compared with their European counterparts, domestic SMEs also stand out as the most dependent on internal financing, more specifically, retained earnings or proceeds from the sale of assets. The survey reveals substantial differences across countries, with more than one quarter of SMEs in Malta, Ireland and Estonia financing their operations and investments in 2014 from retained earnings while, at the other end of the spectrum, less than 2% of firms in Portugal used

Chart 2
SOURCES OF FINANCE USED BY SMEs IN 2014
(over the preceding 6 months; percentage of respondents)



Source: SAFE (2014).

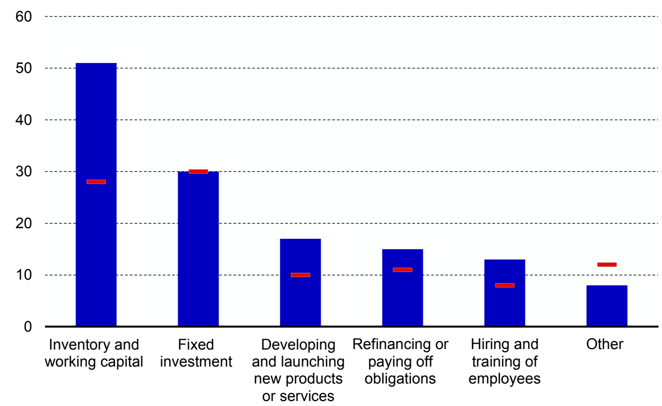
[8] According to MFI interest rate statistics, the interest rates charged by domestic banks to non-financial corporations on revolving loans and overdrafts averaged 5.1% between April and September 2014, compared with 4.6% on total bank loans to NFCs.

this source of finance. On the contrary, domestic SMEs are much less reliant on leasing or hire purchase facilities than the average European SME.

The survey suggests that the use of internal financing increases steadily with firm size and is more frequently resorted to by innovative firms compared with less innovative ones. This could be linked to the risky nature of these enterprises, which makes it more difficult to obtain external finance owing to the uncertain nature of the business venture and, ultimately, the profits outcome. According to the survey, Maltese SMEs perform strongly when innovation is concerned: 45.0% of them have introduced a new or significantly improved product or service in the market during the previous year, compared with 32.0% for SMEs in the European Union as a whole. Domestic SMEs also rank more favourably than the European average SME in terms of improvements in production processes or methods and in new management organisation.

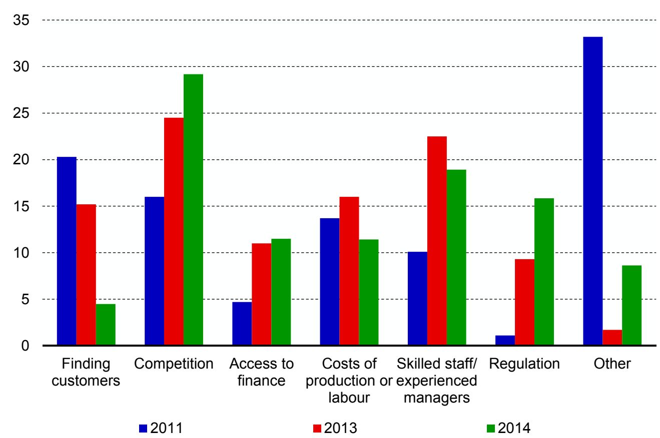
With regard to the use of external financing, the survey reveals that in Malta, as well as in the European Union as a whole, inventory, working capital and fixed investment are the most important factors affecting the demand for external financing, though the relative importance that a local or an European SME gives to these factors differs (see Chart 3). Thus, in the case of Malta SMEs are much more reliant on external financing for inventory and working capital, while in the European Union this is less so. Maltese SMEs are also more likely than the average EU SME to use such funding to develop or launch new products, refinance or pay off their debts, or utilise for hiring and training of employees.

Chart 3
USES OF EXTERNAL FINANCE
(over the preceding 6 months; per cent of respondents)



Source: SAFE (2014).

Chart 4
MOST PRESSING PROBLEM FACING FIRMS
(percentage of respondents)



Source: SAFE.

Most pressing problems facing SMEs

The survey ranks competitive pressures as the most serious problem facing domestic SMEs in 2014, followed by difficulties in attracting skilled staff and abiding by regulations (see Chart 4). The percentage of domestic SMEs that consider competition as the priority concern has gradually increased over time, from around 16% in 2011 to slightly less than 29% in 2014. Other challenges that have attracted attention over the past three years are access to finance and costs of production or labour. For most European SMEs, finding customers ranks as the most pressing problem, whereas locally, its relative importance has been gradually declining since 2011.

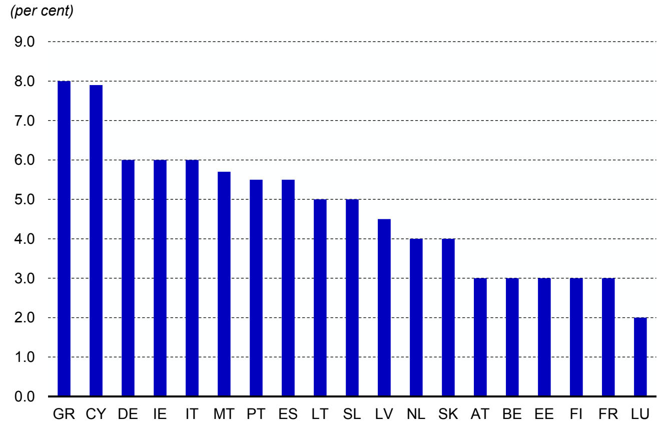
Access to finance is another important problem highlighted by domestic firms in the latest survey. Compared with previous waves, the percentage of domestic firms that mentioned access to finance as their most pressing problem has increased from 4.7% in 2011 to 11.5% in 2014. This, however, remains below the EU average of 14.0%. Across EU countries, the divergence in replies appears to be large when participants were asked to assess the significance of access to finance. A total of 45.0% of firms in Cyprus and 32.0% in Greece consider access to finance as their most pressing problem, given the financial crises these countries have experienced in recent years. At the other end of the spectrum, less than 10% of firms in Austria, Luxembourg and Germany consider it as their main problem.

Terms and conditions of bank loan financing

Chart 5 provides information on the costs of using a bank overdraft or a credit line. Thus, in the European Union as a whole, SMEs were charged a median interest rate of 5.00% between April and September 2014. On the other hand, interest rates on these facilities for local SMEs stood at 5.70% during this period, which is at the higher end of the European range. Once again, interest rate developments differed significantly between countries, with the median interest rate being the highest in Greece and Cyprus, at around 8%, and the lowest in Luxembourg, at 2.00%. SMEs in Austria, Belgium, Estonia, Finland and France also paid a relatively low interest rate, with the median level standing at 3.00%.

Survey questions also focus on changes in the terms and conditions of bank loan financing, such as the level of interest rates or costs of financing other than interest rates, and how they have evolved over the preceding six months (see Table 1). In the case of responding firms in Malta, 23.0% reported an increase in interest rates in 2014, while only 14.0% reported a decrease and, for the remaining 62.0%, interest rates remained unchanged. Developments in this regard involving firms in the European Union contrast sharply with those prevailing in Malta. Thus, the percentage of firms that reported a rise in interest rates declined notably over the three-year period, while those benefitting from lower interest rates rose substantially, reflecting the monetary easing measures by the ECB and other central banks in the European Union. This result broadly corresponds to the conclusions of a recent study that show that the interest rate pass-through in Malta is sluggish and that the transmission of changes in policy rates to the retail rates charged by banks has weakened even further after the crisis.[9]

Chart 5
MEDIAN INTEREST RATE CHARGED FOR CREDIT LINE OR BANK OVERDRAFT
(per cent)



Source: SAFE (2014).

9 Micallef, B. and Gauci, T., "Interest rate pass-through in Malta", article published in *Quarterly Review* 2014:1, Central Bank of Malta.

Table 1
LEVEL OF INTEREST RATES AND COST OF FINANCING OTHER THAN INTEREST RATES
Over the preceding 6 months; per cent of responding firms

	Malta			EU		
	2011	2013	2014	2011	2013	2014
Level of interest rates						
increased	6	9	23	52	34	23
unchanged	73	85	62	33	41	40
decreased	21	0	14	8	20	32
Level of cost of financing other than interest rates (e.g. charges, fees, commissions)						
increased	16	35	44	48	43	39
unchanged	84	60	47	43	46	48
decreased	0	0	7	4	5	9

Source: SAFE.

Similar results emerge from replies by domestic firms on the level of the cost of financing, other than interest rates, such as charges, fees and commissions. In 2014, 44.0 % of domestic firms reported an increase in such costs, while only 7.0% reported a decline. In contrast, 39.0% of firms in the European Union reported a rise in financing costs compared with the preceding year, while 9.0% reported a decrease in costs.

Credit demand and supply

The survey also focuses on demand and supply for financing. A decline in bank credit to NFCs has been observed in the European Union, including Malta, in the aftermath of the economic and financial crisis of 2009 and, more recently, after the sovereign debt crisis of 2012. This reflects a combination of both demand and supply-side factors.

Demand for financing instruments most commonly used by Maltese SMEs has picked up over the last two years. Table 2 shows that the number of firms that have applied for bank loans, trade credit, overdrafts and credit lines has gradually increased from 2011 to 2014. In 2014 between 25.0% and 33.0% of respondent firms applied for one of these types of financing instruments, with trade credit registering the largest demand. Only a small proportion of firms did not apply for some form of credit because they feared possible rejection. The proportion of firms that did not apply for reasons other than the fear of rejection, or because of sufficient internal funds, has also gradually declined.

Table 2
FOR EACH OF THE FOLLOWING WAYS OF FINANCING, COULD YOU PLEASE INDICATE WHETHER YOU:
Over the preceding 6 months; per cent of responding firms

	Bank overdraft, credit line or credit card overdrafts			Bank loans			Trade credit		
	2011	2013	2014	2011	2013	2014	2011	2013	2014
Applied over the past 6 months	15	19	25	6	24	27	6	22	33
Did not apply because of possible rejection	6	1	1	6	0	5	1	0	3
Did not apply because of sufficient internal funds	32	48	45	32	40	38	37	35	39
Did not apply for other reasons	47	30	23	55	37	20	54	43	20

Source: SAFE.

Table 3
OUTCOME OF APPLICATION FOR FINANCING OVER THE PAST SIX MONTHS
Over the preceding six months; per cent of responding firms

	Bank overdraft, credit line or credit card overdrafts			Bank loans			Trade credit		
	2011	2013	2014	2011	2013	2014	2011	2013	2014
Applied and got everything	81	53	74	51	56	71	96	43	54
Applied and got most of it (1)	7	19	17	15	11	10	2	20	12
Applied but only got a limited part of it (2)	7	16	9	19	28	9	0	20	34
Applied but refused because cost too high	0	0	0	0	0	10	0	7	0
Applied but was rejected	0	12	0	0	0	0	2	0	0

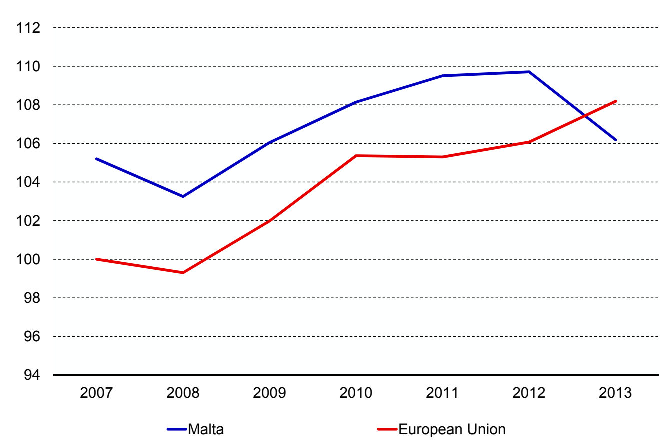
(1) between 75% and 99%.
(2) between 1% and 74%.
Source: SAFE.

With regard to credit supply factors, namely credit standards applied by banks to their customers, the survey included a separate question that requested firms that had applied for various types of financing on whether their application had been accepted or rejected. More important, the question asked whether, if accepted, the firm had got the full amount, just a part of it or whether the firm had refused the offer because the cost had been deemed too high (see Table 3).

Table 3 shows that credit standards were tightened considerably by banks in Malta in 2013 compared with 2011. Thus, there was a significant reduction in the percentage of firms that applied for credit facilities and got everything they requested, especially when these involved overdrafts, credit lines and trade credit. The percentage of firms that applied but did not get the full amount requested significantly increased for all types of financing facilities. In the case of trade credit, a number of firms applied successfully but refused to take up the credit because the cost had been deemed too high. Only a small percentage of firms had their application for bank overdraft or credit line rejected completely. The tightening stance of the banks in 2013 is also confirmed by the movement in the European Commission's index on access to finance to SMEs (see Chart 6). The latter is designed specifically to monitor developments in SMEs' access to financial resources by combining debt, equity and survey information.[10] According to the index, the access of domestic SMEs to finance declined in 2013 compared with the previous year, which is in contrast to developments in most other EU economies.

An improvement in credit supply conditions was registered in 2014, with a rise in the percentage of firms that applied and got everything in all the three types of finance categories, compared with

Chart 6
SMEs ACCESS TO FINANCE INDEX
(index EU=100 in 2007)



Source: European Commission.

[10] Further information on the European Commission's SMAF is available at http://ec.europa.eu/enterprise/policies/finance/data/enterprise-finance-index/index_en.htm

2013. Meanwhile, the percentage of firms that only had a fraction of their original loan accepted fell slightly. In some categories, however, mostly relating to trade credit and, to a lesser extent, to bank overdrafts and credit lines, the supply conditions in 2014 were still somewhat tighter than those prevailing in 2011. A small percentage of firms also refused to take up a bank loan offer because costs were deemed to be too high.

Conclusion

The use of surveys and their input in policy analysis has increased in importance in recent years. The SAFE, together with other surveys, such as the ECB's BLS and Wage Dynamics Survey, are used by the Central Bank of Malta in its analysis of local economic, monetary and financial stability developments.

The SAFE has filled an essential gap in the availability of timely information on the financial situation of SMEs in various EU Member States. This is especially important given that the financial requirements of SMEs may differ markedly from those of larger enterprises, hence necessitating a different policy response aimed at fostering a more effective functioning financial market for SMEs.

The survey enables policy makers and financial analysts to gain a better understanding of the characteristics of domestic SMEs, particularly information about their sources of finance and their most pressing problems. It also provides valuable information on the demand and supply factors that affect the provision of bank credit to the private sector. Furthermore, it facilitates cross-country comparisons across the European Union through harmonised replies to a set of incisive questions, of a qualitative and quantitative nature, that throw light on various aspects related to the financing of SMEs.

A drawback of the SAFE is that it is only conducted once a year. To address this gap, from a local perspective the Central Bank of Malta, in collaboration with the Malta Chamber of Commerce, Enterprise and Industry, decided to launch a survey on a quarterly basis, similar to the SAFE but more selective in its approach. Thus, information collected is limited to loan applications, interest rates charged on loans and overdrafts, and banks' credit conditions. Going forward, such additional information should provide more timely statistics on the demand for, and supply of, credit to domestic firms.

The money market

During 2014 the ECB cut the interest rate on its main refinancing operations (MRO) twice, in June and September, by a total of 20 basis points. As a result, the MRO was lowered to 0.05% by the end of 2014 (see Chart 2.6). The primary market yield on domestic three-month Treasury bills mirrored the movements in the MRO rate and declined over the year. The yield ended 2014 at 0.08%, 31 basis points lower than a year earlier.

Chart 2.6
MONEY MARKET INTEREST RATES
(percentages per annum; daily rates)

Sources: Central Bank of Malta; ECB; Reuters.

Money market activity in Malta continued to be dominated by trading in Treasury bills. Primary market activity declined, however, as Government sought to take advantage of historically low interest rates by issuing debt securities with longer terms to maturity. Indeed, during 2014, the value of maturing Treasury bills exceeded new issues so that the amount of outstanding bills declined. In fact, the Treasury issued €910.2 million worth of bills, €211.7 million less than in the previous year.

The majority of bills issued had a maturity of three months or six months. Resident banks participated actively in the primary market, buying around 90% of the total. Money market funds bought most of the remainder. In the secondary market, turnover for Treasury bills remained low, but rose slightly to €10.1 million in 2014 from €9.3 million a year earlier. All transactions involved the Central Bank of Malta in its capacity as market-maker.

Secondary market yields on domestic three-month bills followed those in the primary market and fell by 37 basis points during the year, ending December at 0.03% (see Chart 2.6). Meanwhile, the three-month benchmark euro area yield fell by 34 basis points and turned negative, reaching -0.32%.[9] Consequently, the spread between the domestic rate and the euro area benchmark rate narrowed by 3 basis points to 36 basis points at the end of 2014.

The capital market

The bond market

Net issues of long-term debt securities on the domestic primary market more than doubled during 2014, reaching €528.3 million as against €209.8 million in the previous year (see Table 2.5).

On a net basis, issues of long-term government debt rose by €34.5 million to €291.5 million. Although the value of new issues of MGS decreased, even less long-term government debt was redeemed.

Total gross issues of long-term government debt amounted to €648.8 million, €128.3 million less than in the previous year. New government bond issues took place in March, April, June, August and October. These had terms to maturity varying between four years and 20 years, and were all over subscribed. Retail investors, mainly resident households and stockbrokers acting on behalf of their clients, bought almost three-fourths of the amount issued at fixed prices. The remainder was auctioned and taken up by resident credit institutions and investment funds.

[9] The benchmark euro area yield is the secondary market yield on three-month securities issued by Germany.

Table 2.5
ISSUES OF LONG-TERM DEBT SECURITIES[(1)]
EUR millions [(2)]

	2012	2013	2014
Government			
Total issues[(3)]	792.4	777.1	648.8
Redemptions[(4)]	495.8	520.1	357.3
Net issues	296.6	257.0	291.5
Corporate sector			
Total issues	80.0	58.0	298.5
Redemptions[(5)]	28.1	105.2	61.7
Net issues	51.9	-47.2	236.8
Total net issues	**348.5**	**209.8**	**528.3**

[(1)] Banks, non-monetary financial institutions and public NFCs are included with corporate issuers. Long-term securities are those with an original term to maturity exceeding one year, and include preference shares.

[(2)] Amounts denominated in foreign currency are converted to euro according to the exchange rate prevailing on the day of transactions.

[(3)] Data exclude MGS that were issued directly to the Foundation for Church Schools. These amounted to €1.3 million in 2012, €2.4 million in 2013 and €5.1 million in 2014. Data include the creation of MGS as part of the MGS Switch Auction Programme. These include the creation of €20.2 million 3.75% MGS 2017 (IV) and €121.4 million 3.85% MGS 2018 (V) in 2012. For 2013 data include the creation of €83.7 million 3.20% MGS 2019 (V) and €64.0 million 3.35% MGS 2020.

[(4)] Redemptions include debt securities bought back by the issuer but exclude the redemption of MGS that were issued directly to the Foundation for Church Schools. Data include the cancellation of €146.5 million 3.6% MGS 2013 (IV) and €150.0 million 5.1% MGS 2014 (III) for 2012 and 2013, respectively, as part of the MGS Switch Auction Programme.

[(5)] Redemptions include debt securities bought back by the issuer.

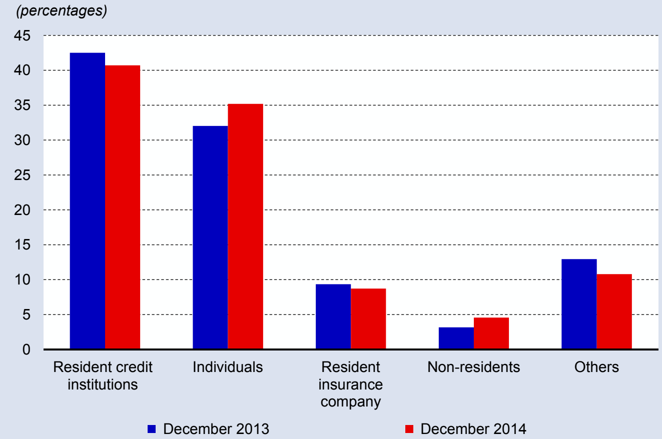
Sources: Central Bank of Malta; MSE; Treasury.

The share of outstanding MGS held by individuals increased further during the year. Apart from the favourable conditions offered to retail investors in the primary market, the relatively high interest rates carried by MGS in comparison with those paid by banks on fixed-term bank deposits may have induced more households to invest in these securities. Furthermore, rising prices of MGS in 2014 led to capital gains for bondholders that may have stimulated additional demand. On the other hand, the share held by resident credit institutions declined in 2014, reflecting to a large extent the smaller amount allocated to banks in the primary market as referred to above (see Chart 2.7).

Turnover in the secondary government bond market surged in 2014, growing by 23.2% to €836.4 million. The Central Bank of Malta, acting as market-maker, accounted for almost four-fifths of the value traded in the market.

In general, domestic government yields moved in line with benchmark euro area yields along the whole spectrum of the maturity curve.[10] With bond prices rallying in response to the ECB's announcement of cuts in its official interest rates and the introduction of non-standard monetary policy measures, yields fell significantly across all maturities. Thus, during 2014 the yield on five-

Chart 2.7
OUTSTANDING MGS BY INVESTOR BASE[(1)]
(percentages)



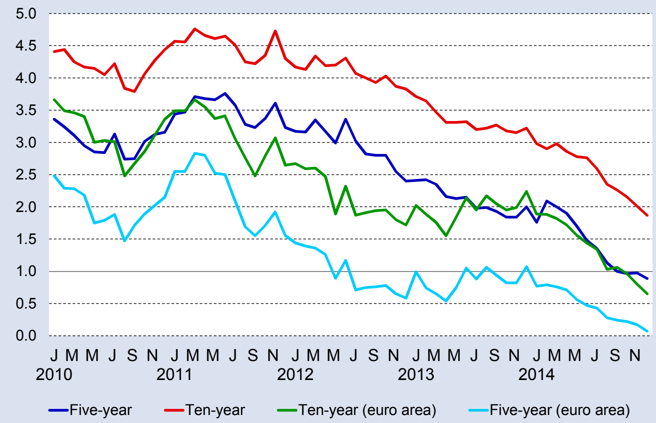
[(1)] Incorporates both fixed-rate and floating-rate MGS.

Sources: Central Bank of Malta; MSE.

[10] Benchmark euro area yields are based on AAA-rated central government bonds.

year domestic government securities fell by 111 basis points to 0.89% while the corresponding benchmark euro area government bond yield fell by 100 basis points and closed the year at 0.07% (see Chart 2.8). As a result, the spread on five-year debt narrowed by 11 basis points to 0.82% by end-2014.

Chart 2.8
GOVERNMENT BOND YIELDS
(percentages per annum; end of month)



Sources: Central Bank of Malta; ECB.

Similarly, ten-year domestic government bond yields extended their downward trend. They fell by 135 basis points during 2014, reaching 1.87% in December. The benchmark ten-year yield in the euro area fell by 159 basis points over the same period, ending December at 0.65%. Consequently, the ten-year sovereign spread between local bonds and the euro area benchmark widened by 24 basis points to 1.22%.

Following the announcement in January 2015 that the ECB would extend its asset-purchase programme to include sovereign bonds, domestic bond yields fell further, with those on ten-year maturities dropping to 1.44% by end-February.

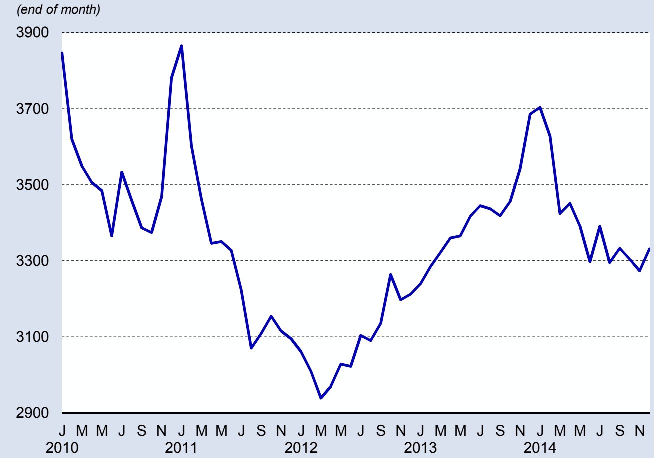
Activity in the corporate bond market picked up strongly during 2014 with the value of primary market issues climbing to €298.5 million. This development reflected the fact that in the current low yield environment companies were eager to tap the capital market to diversify their funding base. Apart from one bank, the bonds were launched by 11 different NFCs involved in several economic sectors, such as tourism, real estate and the wholesale & retail sector. Demand for all corporate bonds was substantial.

Turnover in the secondary market for corporate bonds rose by €9.8 million, or almost 30%, to €43.2 million. More than 70% of transactions were concentrated in bonds issued by companies involved in the tourism, financial and real estate sectors.

The equity market

During 2014 no new firms sought a listing on the MSE. In the secondary equity market, turnover amounted to €50.8 million, marginally less than in the previous year. Slightly more than half of the trading revolved around equities issued by two major banks.

Chart 2.9
MALTA STOCK EXCHANGE SHARE INDEX
(end of month)



Source: MSE.

The fall in turnover mirrored a decline in the number of shares traded on the Exchange. Although the majority of shares performed positively during 2014 – driven by firms operating in the telecommunications, IT and property sectors – banks' share prices fell. Consequently, the MSE index declined during 2014 and closed the year at 3,331.1, 9.9% lower than its level a year earlier (see Chart 2.9).

3. OUTPUT, EMPLOYMENT AND PRICES[1]

The Maltese economy grew at a faster pace in 2014, compared with the previous year, driven by a strong increase in domestic demand. Investment and private consumption grew substantially and the annual rate of change of government consumption turned positive. Conversely, a decline in net exports had a negative impact on economic growth.

In terms of gross value added (GVA), the contribution of services continued to grow. In absolute terms, the largest annual increases were recorded by the sectors incorporating public administration & defence, professional & scientific activities and wholesale & retail trade.

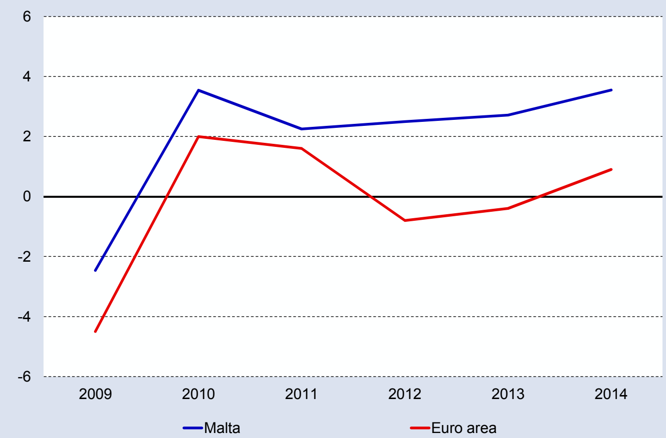
Gross domestic product

Real gross domestic product grows robustly

Real gross domestic product (GDP) growth increased significantly to 3.5% during 2014, from 2.7% in the previous year and 2.5% in 2012. The pace of expansion gained momentum as the year progressed, with the annual growth rate being registered in the fourth quarter at 4.0%.

Economic growth in the local economy continued to exceed that of the euro area although the latter turned positive in 2014 (see Chart 3.1).

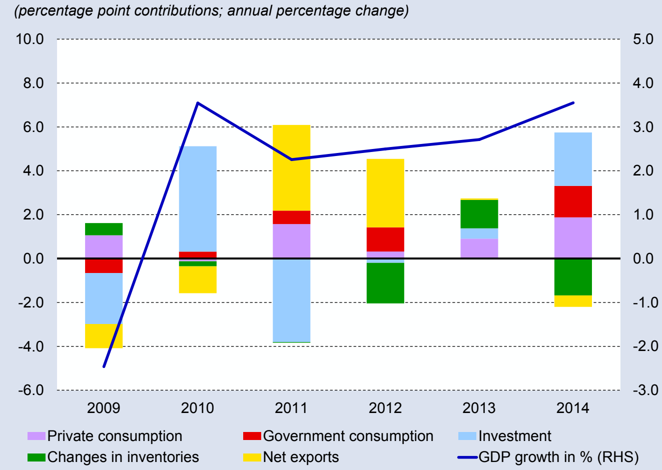
Chart 3.1
REAL GDP GROWTH
(annual percentage change)



Sources: NSO; Eurostat.

In 2014 domestic demand grew robustly, continuing the recovery seen a year earlier. It thus boosted economic growth by 4.1 percentage points. This was mainly due to higher investment, which recovered strongly following modest growth in the previous year. In addition, private consumption continued to accelerate while government consumption rose substantially after recording a small decline in 2013.

Chart 3.2
REAL GDP GROWTH AND ITS COMPONENTS
(percentage point contributions; annual percentage change)



Sources: NSO; Central Bank of Malta calculations.

On the other hand, negative changes in the inventories item (which also includes a statistical discrepancy) dampened GDP growth (see Chart 3.2 and Table 3.1).[2] The external contribution to growth was negative at -0.5%, as exports fell and imports increased modestly on a year earlier.

[1] The cut-off date for data on GDP-related variables in this Chapter, including unit labour costs, is 17 March 2015.

[2] The figure for inventories also includes acquisitions less disposals of valuables, as well as statistical discrepancies. The National Statistics Office estimates GDP using the production approach. The expenditure approach is then reconciled with the production approach, with any resulting statistical discrepancies being allocated to changes in inventories.

Table 3.1
GROSS DOMESTIC PRODUCT[1]

	2010	2011	2012	2013	2014
			Annual percentage changes		
Private final consumption expenditure	-0.2	2.7	0.6	1.6	3.4
Government final consumption expenditure	1.6	3.1	5.7	-0.2	7.3
Gross fixed capital formation	26.4	-17.8	-1.1	2.7	14.0
Domestic demand	**4.7**	**-1.6**	**-0.6**	**2.8**	**4.3**
Exports of goods & services	6.9	2.3	6.6	-1.0	-0.2
Imports of goods & services	7.6	-0.3	4.7	-1.1	0.1
Gross domestic product	**3.5**	**2.3**	**2.5**	**2.7**	**3.5**
			Percentage point contributions		
Private final consumption expenditure	-0.1	1.6	0.3	0.9	1.9
Government final consumption expenditure	0.3	0.6	1.1	0.0	1.4
Gross fixed capital formation	4.8	-3.8	-0.2	0.5	2.4
Changes in inventories	-0.2	0.0	-1.8	1.3	-1.7
Domestic demand	**4.8**	**-1.6**	**-0.6**	**2.6**	**4.1**
Exports of goods & services	10.2	3.5	10.5	-1.7	-0.4
Imports of goods & services	-11.4	0.4	-7.4	1.8	-0.2
Net exports	**-1.2**	**3.9**	**3.1**	**0.1**	**-0.5**
Gross domestic product	**3.5**	**2.3**	**2.5**	**2.7**	**3.5**

[1] Chain-linked volumes, reference year 2010.
Sources: NSO; Central Bank of Malta calculations.

Domestic demand strengthens further

Private final consumption expenditure rose strongly in 2014, more than doubling its growth rate over the previous year. It rose by 3.4%, pushing GDP growth up by 1.9 percentage points. Growth in private consumption was supported by substantially higher employee compensation and lower inflation, which in turn boosted real disposable income. According to the Bank's estimates, real disposable income went up by 4.2%. The rise in private consumption was broad-based across commodity types; however, nominal data sources indicate that the largest increases were registered in categories related to transport and furnishings, household equipment & household maintenance. Spending on transport partly reflected higher expenditure on passenger cars, the latter responding to the additional incentives offered by Government under a car replacement scheme.

Real government consumption expenditure increased by 7.3%, after declining by 0.2% in 2013, thus contributing 1.4 percentage points to overall GDP growth. During the year the intermediate component of government consumption rose strongly after negative growth in 2013. Compensation of employees, notably in public administration & defence, health and education, also registered growth.

Meanwhile, gross fixed capital formation (GFCF) rose by a substantial 14.0% in real terms following an increase of 2.7% in 2013. GFCF contributed 2.4 percentage points to overall GDP growth, making this component the largest contributor to domestic demand. In absolute terms, the increase in capital spending was almost evenly divided between the private sector and Government, with government investment rising strongly in 2014 after the drop registered in 2013. Meanwhile, private investment recorded gains in all categories except residential construction.

Investment spending was buoyed by non-residential construction, which accounted for just over three-fifths of the growth in total GFCF. General government outlays accounted for over half of this increase, reflecting to a large extent infrastructural development projects that are mainly financed from EU funds. Other government investment expenditure was related to transport equipment, which partly reflected the purchase of a helicopter for national security purposes.

In the private sector, buoyant investment activity was attributed to non-residential construction, including works involving Valletta City Gate and the expansion of hotels following a relaxation of restrictions on the height of hotels with at least three stars.

Private sector investment was also allocated to IT development and to the acquisition of machinery & equipment.

Changes in inventories turned negative during 2014, dampening real GDP growth by 1.7 percentage points.[3]

Net exports contribute negatively to GDP

Exports of goods and services fell by 0.2% in 2014 after decreasing by 1.0% in 2013. The decline in exports was attributed to the goods component, which contracted by 2.2% following a drop of 5.4% in the previous year. On the other hand, exports of services increased by 0.4%, following positive growth in 2013.

In nominal terms, exports dropped by 0.5% in 2014. Customs data show that exports of goods decreased across most major categories, except chemicals and beverages & tobacco. The largest declines in absolute terms were in re-exports of machinery & transport equipment, which includes semiconductors. Meanwhile, with regard to developments in service exports, balance of payments data, which cover the first nine months of 2014, show that the increase registered was mainly due to higher earnings from tourism and personal, cultural and recreation services, which include exports from the gaming sector.

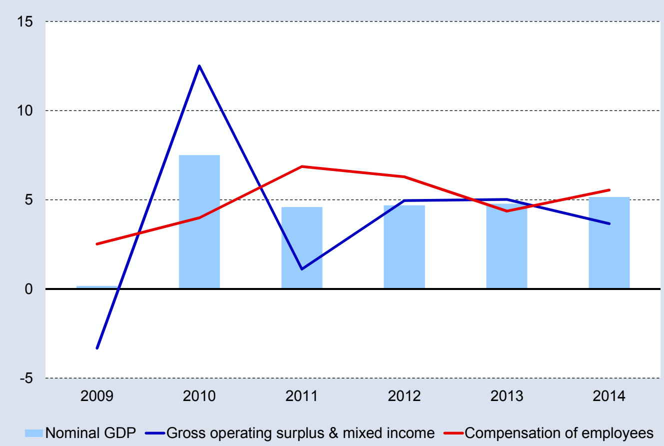
Imports rose by 0.1% in real terms during 2014, following a drop of 1.1% in the previous year. Imports of goods accounted entirely for this increase, up by 2.6%, partly supported by the sustained recovery in private consumption and a strong increase in investment. The latter reflected higher purchases of machinery & equipment. In contrast, imports of services dropped by 1.2%.

Services continue to drive growth in GVA

GDP growth in nominal terms accelerated to 5.2% in 2014 from 4.8% in the previous year. Based on the income approach, growth was boosted by a significant increase in the compensation of employees. This rose by 5.5% compared with 4.4% in 2013. As a result, the wages component contributed 2.5 percentage points to the overall growth rate of nominal GDP. This reflected the rise in employment that was observed almost throughout the year and the more moderate increase in employee compensation seen in almost all job categories. However, the strongest gains in absolute terms were in jobs in public administration & defence, education and health. The increase in compensation to these categories amounted to almost half of the overall rise in employee compensation during 2014. Meanwhile, employee compensation related to professional & scientific activities accounted for a further one-fifth of the increase in total compensation as employment in this category continued to rise substantially. Increases in compensation of employees were also recorded in sectors covering wholesale & retail activities, accommodation, financial and IT services, although these were relatively modest in absolute terms. In contrast, compensation to employees in the agriculture, forestry & fishing category contracted in response to a decline in both employment and average compensation levels in this industry.

During 2014 gross operating surplus & mixed income grew at a slower pace, standing at 3.7% compared with 5.0% a year earlier (see Chart 3.3).[4] In absolute terms, the larg-

Chart 3.3
NOMINAL GDP AND ITS MAIN COMPONENTS
(annual percentage changes)



Source: NSO.

[3] It is not possible to interpret the economic significance of this item given the available data, as the statistical discrepancy is not separated from underlying changes in inventories.

[4] Mixed income is the remuneration for the work carried out by the owner (or members of his family) of an unincorporated enterprise. It cannot be distinguished from the entrepreneurial profit of the owner.

est increases were in the transport & storage sector, particularly land transport. Furthermore, gross operating surplus in the telecommunications & IT related sectors, as well as in those related to professional & scientific activities, showed notable gains. On the other hand, reduced operating surpluses were registered by the financial sector, manufacturing and the utilities.

On the output side, growth in GVA was 4.4% in 2014, slightly lower than in the previous year when the expansion stood at 4.7%. GVA contributed 3.8 percentage points to nominal GDP growth, with the remaining 1.3 percentage points attributable to net taxation on products (see Table 3.2).[5]

Services continued to be the main driver behind GVA growth, adding 4.0 percentage points to the expansion in nominal GDP. GVA in this category increased by 5.6% over 2013, with the public administration & defence & related sectors recording the largest growth in absolute terms. These generated one-third of the total increase in GVA in 2014, and contributed 1.2 percentage points to nominal GDP growth. At the same time, other categories encompassing professional & scientific activities, wholesale & retail and transport and accommodation, on aggregate, contributed another 2.0 percentage points.

Information & communication and arts, entertainment & recreation each added a further half a percentage point to GDP growth while real estate activities had only a small positive effect on GDP. On the other hand, the financial & insurance sectors made a negative contribution of 0.3 percentage point towards nominal GDP growth, reflecting the closure of a financial institution involved in the provision of money brokering services.

Turning to GVA in direct production, this dropped by 1.1% in 2014 compared with an increase of 1.9% in 2013. Meanwhile, the construction sector contributed positively to economic growth as GVA increased, almost fully reversing the decline registered in 2013. However, the agriculture & fishing, manufacturing and utilities categories all recorded a decline in 2014.

Table 3.2
CONTRIBUTION OF SECTORIAL GROSS VALUE ADDED TO NOMINAL GDP GROWTH
Percentage points

	2010	2011	2012	2013	2014
Agriculture, forestry & fishing	0.1	0.0	0.0	0.0	-0.1
Mining & quarrying; utilities	-0.1	-0.9	-0.8	1.2	0.0
Manufacturing	1.0	0.6	0.3	-0.9	-0.1
Construction	0.4	0.2	0.0	-0.1	0.1
Services	5.7	3.6	5.1	3.8	4.0
of which:					
Wholesale & retail trade; repair of motor vehicles; transportation; accommodation & related activities	1.2	0.9	1.4	1.1	1.0
Information & communication	0.5	0.8	0.3	0.6	0.5
Financial & insurance activities	0.9	0.1	1.0	-0.1	-0.3
Real estate activities	-0.1	0.4	0.1	0.1	0.1
Professional, scientific, administrative & related activities	1.1	0.5	0.7	1.0	1.0
Public administration & defence; education; health & related activities	1.0	0.8	1.0	0.9	1.2
Arts, entertainment; household repair & related services	1.0	0.1	0.6	0.2	0.5
Gross value added	**7.1**	**3.5**	**4.7**	**4.1**	**3.8**
Net taxation on products	**0.4**	**1.1**	**0.0**	**0.7**	**1.3**
Annual nominal GDP growth (%)	**7.5**	**4.6**	**4.7**	**4.8**	**5.2**

Source: NSO.

[5] The difference between nominal GDP growth and the GVA contribution is made up of taxes on products, net of subsidies.

Table 3.3
INDUSTRIAL PRODUCTION
Percentages; annual average percentage changes

	Shares	2012	2013	2014
Industrial production	**100.0**	**5.4**	**-4.7**	**-5.0**
Manufacturing	**83.3**	**5.5**	**-5.3**	**-5.6**
Of which:				
Computer, electronic & optical products	18.4	12.5	-10.6	-17.9
Food products	8.1	-7.8	10.6	10.8
Wearing apparel	0.3	2.4	3.6	-3.9
Rubber & plastic products	4.4	-11.8	3.1	1.7
Basic pharmaceutical products & pharmaceutical preparations	10.4	31.8	-26.7	-30.5
Textiles	2.7	-7.0	-22.6	-24.2
Repair & installation of machinery and equipment	2.5	-0.6	-3.4	1.0
Beverages	3.9	4.7	-0.4	7.3
Energy	**16.3**	**4.4**	**-2.0**	**-1.5**
Electricity, gas, steam & air conditioning supply	11.8	4.6	-2.3	-2.0
Water collection, treatment and supply	4.6	4.0	-1.1	-0.4
Mining and quarrying	**0.4**	**29.7**	**6.1**	**-22.7**

Sources: NSO; Eurostat.

Industrial production[6]

Industrial production contracted by 5.0% in 2014, following a decline of 4.7% in 2013 (see Table 3.3). Over the year the manufacturing sector, which accounts for 83.3% of total industrial output, registered a fall of 5.6%, slightly more than the 5.3% drop recorded in 2013. Output in the energy sector also decreased, but at a more moderate pace of 1.5%, which was slightly less than the contraction of 2.0% posted in 2013.

The fall in manufacturing output in 2014 was mainly attributed to lower production by the computer, electronic & optical product, pharmaceutical and textile sub-sectors. The fall in volumes of these sub-sectors was more pronounced when compared with 2013, particularly in the case of firms that manufacture computer, electronic & optical products.

In contrast, growth was observed in the output of firms manufacturing food, beverages and rubber & plastic products. Food production grew by 10.8% during 2014, following an increase of 10.6% in 2013, whereas production of beverages picked up strongly following a mild contraction in 2013. Rubber & plastic products continued to grow, though at a slower pace compared with 2013.

Data on manufacturing sales also point to a further contraction in turnover.[7] At 6.8%, the drop in sales in 2014 was substantially more than the fall of 2.1% recorded in the previous year. This fall in sales was driven by a significant decrease in exports to non-euro area markets, which outweighed a strong recovery in domestic sales and a modest increase in exports to euro area countries.

Tourism

The buoyant performance of the tourism sector persisted for the fifth consecutive year. During 2014 tourist arrivals, nights stayed and expenditure recorded increases when compared with the previous year's levels. Tourist numbers rose by 6.8% to just under 1.7 million visitors. At the same time, nights stayed and the

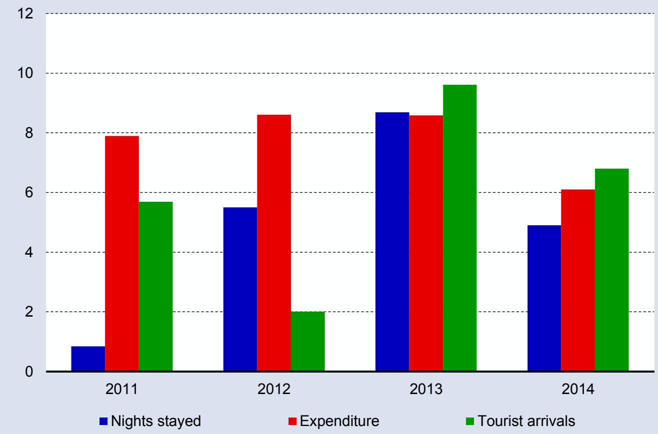
[6] Industrial production data are based on samples of firms engaged in quarrying, manufacturing and energy production. Methodological differences may account for divergences between developments in GVA in the manufacturing sector and industrial production. GVA nets input costs from output to arrive at value added and is expressed in nominal terms. Industrial production measures the volume of output without taking into account input costs. The sectoral coverage also differs, as industrial production data include the output of the energy sector, as well as mining & quarrying.

[7] Data on manufacturing sales are sourced from Eurostat.

aggregate amount of spending went up by 4.9% and 6.1%, respectively.

The pace of expansion measured by these indicators moderated somewhat compared with 2013 (see Chart 3.4).[8] However, 2013 was a record year in tourist arrivals, which increased by over 9%.

Chart 3.4
TOURISM INDICATORS
(annual percentage changes)



Source: NSO.

Malta's performance also compares positively with other competing markets. According to the World Tourism Barometer, the global industry recorded an average growth in arrivals of 4.7%, while in the EU-28, tourist arrivals went up by 5.3%.[9]

The number of non-package tourists climbed by 8.1% and accounted for almost 55% of total arrivals in 2014, while the number of tourists on package holidays went up by 5.1%. Similar to a year earlier, repeat visitors accounted for nearly a third of total tourists.

As in 2013, the vast majority of travellers, around 1.4 million, visited Malta for leisure purposes. This tourist category also accounts for most of the expansion in the number of arrivals, rising by more than 90,000, or 7.0% over 2013 levels. Meanwhile, 130,173 foreigners visited the islands for business and professional purposes, an increase of 10.3% over 2013.

With regard to Malta's tourist markets, during 2014 the United Kingdom remained Malta's most important source market, accounting for 28.9% of total arrivals. Additionally, this market contributed the largest increase in tourist arrivals, with over 33,000, or 7.3% on 2013. This has been mainly attributable to the introduction of British Airways flights to Malta and increased traffic on UK flights by low-cost airlines. At the same time, tourist arrivals from Italy, Malta's second largest source market, increased by 12.3% to 262,631 visitors, raising Italy's market share to 15.5%. Arrivals from France and Scandinavia also went up remarkably. The increase in French tourists is partly driven by the introduction of an additional route by a low-cost carrier during the course of the year. Improvements were also recorded by smaller source markets, mainly Dutch, Swiss, American and Belgian, while the combined number of visitors from other countries also surged.

Conversely, for the fourth year running, arrivals from Spain dropped, reflecting the cessation of some routes by low-cost carriers and possibly the continued weak demand in Spanish outbound leisure tourism. Notable declines were also recorded in the Russian, German and Libyan markets (see Table 3.4). The drop in visitors from Libya reflected the closure of scheduled routes to this country during the course of 2014, owing to the uncertain political situation there.

Malta International Airport data on passenger movements confirm the sustained expansion in tourism activity. The volume of tourist traffic through Malta's airport exceeded 4.2 million, a rise of 6.4% over 2013. This was partly stimulated by increased aircraft movements, reflecting the opening of new routes and additional flights to established destinations, including London, Rome, Brussels and Frankfurt. This led to a 4.8% growth in seat capacity.

Total nights stayed by tourists during 2014 rose by 4.9% on a year earlier. Nonetheless, since nights went up less rapidly than tourist arrivals, the average length of stay dipped marginally to 8.0 nights. When

[8] Figures are based on the National Statistics Office (NSO) survey of inbound tourists.
[9] See United Nations World Tourism Organisation, *World Tourism Barometer* January 2015.

Table 3.4
TOURIST AND CRUISE PASSENGER ARRIVALS
Thousands

	2012	2013	2014
Inbound tourist (1)	**1,443.4**	**1,582.2**	**1,689.8**
United Kingdom	441.3	454.7	487.7
Italy	202.2	233.8	262.6
Germany	137.5	147.1	143.1
France	107.9	116.5	125.5
Scandinavia(2)	97.4	105.1	108.6
Spain	60.2	53.3	42.3
Netherlands	39.2	41.5	44.7
Russia	31.6	40.0	34.2
Libya	17.2	34.6	30.8
Others	309.0	355.6	410.3
Cruise passengers	**555.7**	**424.6**	**465.4**

(1) Includes departures by air and by sea. Cruise passengers are shown separately.
(2) Scandinavia includes Denmark, Finland, Norway and Sweden.
Source: NSO.

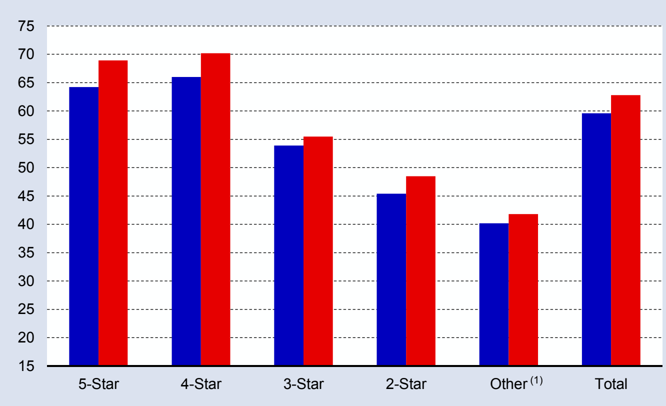
compared with a year earlier, nights stayed in collective and private accommodation during 2014 went up by 2.8% and 9.2%, respectively. Three-quarters of tourist arrivals spent their stay in collective accommodation, including hotels, aparthotels, guesthouses, hostels and tourist villages. The remainder stayed in private accommodation, which comprises self-catering apartments, farmhouses and private residences.

Favourable developments in tourist arrivals and nights stayed were accompanied by an increase in tourist expenditure, which rose by 6.1% over 2013 (see Chart 3.4).[10] Higher tourism spending was spread across all categories of incoming tourists, in particular the non-package holiday category, which advanced by 7.2%. The latter was driven by a rise of 12.0% on accommodation and a 2.9% increase on travel fares. At the same time, spending on package holidays rose by 6.2%, while the "other" component of tourist expenditure went up by 5.3%.

The buoyancy in the tourism sector is also corroborated by quarterly reviews conducted by the Malta Hotels and Restaurants Association. The surveys covering the first nine months of 2014 indicate that occupancy rates and gross operating profits per available room went up in all three main hotel categories.[11] The improvement in profitability in part mirrors the higher average achieved room rates registered by all categories.

NSO data on occupancy rates for the full year confirm these positive developments, as the total average occupancy rate in collective accommodation establishments climbed to 62.8% from 59.6% in 2013 (see Chart 3.5). Although during 2014 all accommodation categories recorded higher occupancy rates, the

Chart 3.5
AVERAGE OCCUPANCY RATES
(per cent)

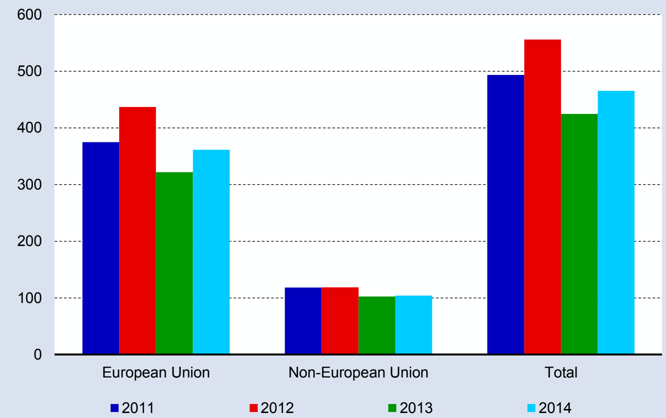


(1) Includes guesthouses, hostels & holiday complexes.
Source: NSO.

[10] Total expenditure is composed of package, non-package and "other". Non-package spending is subdivided into spending on accommodation and travel, while the "other" component captures any additional expenditure that tourists incur during their stay in Malta.
[11] See BOV-MHRA surveys.

improvement was mainly driven by four and five-star hotels. At 70.2% and 68.9%, occupancy rates in these categories were up by 4.2 and 4.7 percentage points, respectively, on their 2013 levels.

Chart 3.6
CRUISE PASSENGERS
(thousands)



Source: NSO.

During 2014 the number of cruise liner calls rose to 303, up by 17 from a year earlier. Concomitantly, the number of foreign passengers increased by 40,807, or 9.6%, when compared with 2013 (see Chart 3.6). The number of cruise passengers from the European Union expanded by 39,368, or 12.2%, whereas visitors from non-EU countries rose modestly by 1,439, or 1.4%. The largest increases were recorded by the German, French, Italian, and Australian markets. Conversely, the number of cruise passengers from the United Kingdom, Spain and the United States declined substantially.

Construction

Over 2014, output in the construction sector reversed its declining trend as it rose by 1.4% in nominal terms compared with a drop of 3.2% in the previous year. Intermediate consumption, which includes purchases of materials for the industry, also recovered, though to a lesser extent. As a result, the GVA of the construction industry rose by 1.6% compared with a decline of 2.0% in 2013. This notwithstanding, in 2014 the sector's share in nominal GDP marginally decreased to 3.6% from 3.7% in 2013 (see Table 3.5).

Within the sector employees' compensation, consisting of wages & salaries and employers' social contributions, rose by 2.6% in 2014 compared with a decline of 2.3% in 2013. Moreover, the profit element rose by 1.0% against a decline of 2.8% in 2013.

In the first nine months of 2014, total employment in construction fell compared with the corresponding period of 2013 (see Table 3.5). The industry's share in the total gainfully occupied population decreased to 5.7% from 7.3% in 2013. This decline, however, was mainly due to a reclassification effect within the public sector. Thus, a number of employees previously classified under construction activity were reclassified under public administration services in August 2013.[12] Within the private sector, 142 jobs were created, equivalent to an increase of 1.6%.

Table 3.5
CONSTRUCTION ACTIVITY INDICATORS[(1)]

	2012	2013	2014
Gross value added (EUR millions)	**286.8**	**281.0**	**285.6**
Share of gross value added in GDP (%)	4.0	3.7	3.6
Total employment	**12,190**	**11,477**	**9,240**
of which private employment	8,723	8,797	8,939
Share in total gainfully occupied population (%)	8.0	7.3	5.7

[(1)] Employment data are averages for the first nine months of the year, and are sourced from administrative records.
Source: NSO.

[12] See NSO *News Release* 007/2014.

Table 3.6
PERMITS ISSUED FOR THE CONSTRUCTION OF DWELLING UNITS BY TYPE

	2011	2012	2013	2014
Apartments	3,276	2,489	2,062	2,221
Maisonettes	401	298	350	414
Terraced houses	191	202	209	204
Other	87	75	84	98
Total	**3,955**	**3,064**	**2,705**	**2,937**

Source: MEPA.

More buoyant activity in the construction industry was also evidenced by developments in GFCF. The construction component in GFCF surged by 21.0% in nominal terms during 2014, compared with a 1.3% decline in the previous year. This substantial increase was due to developments in non-dwelling construction, as dwelling investment fell for the third consecutive year.

Outlays on non-dwelling construction increased strongly, rising by 36.7% over the previous year. This mainly reflected additional government investment, although private sector non-dwelling construction also increased.

On the other hand, expenditure on housing fell further by 4.3% in 2014, following a decline of 1.0% in 2013. This largely mirrored developments in the private sector, which generates most of this type of investment.

The number of permits issued by the Malta Environment & Planning Authority (MEPA) rose by 232, or 8.6% in 2014, reversing some of the decline recorded in previous years (see Table 3.6). This increase was mostly driven by a rise in the largest residential category, namely apartments, which account for just over three-fourths of total permits issued. Permits for this type of property went up by 159, or 7.7% in 2014. On the other hand, permits for construction of the remaining property categories rose by 73 on aggregate.

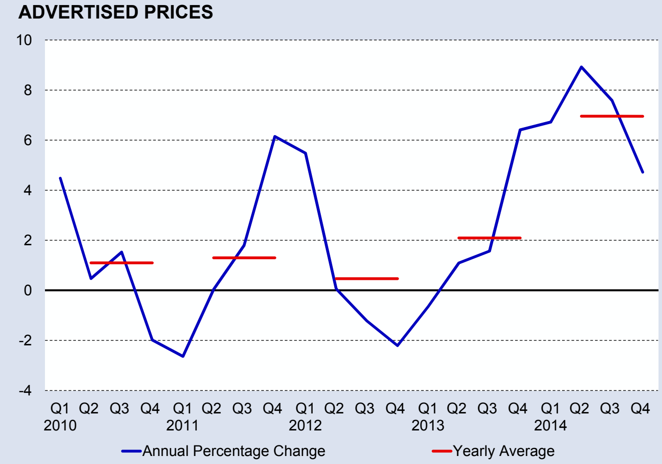
Residential property prices[13]

The Bank's index of advertised residential property prices increased on average by 7.0% in 2014, accelerating from a growth rate of 2.1% in the previous year (see Chart 3.7).[14]

A rise in advertised property prices was evident throughout the whole of 2014, particularly in the first three quarters, when growth averaged 7.7%. The annual rate of change subsequently moderated to 4.7% in the fourth quarter.

The strong annual growth rate observed during 2014 was partly influenced by government policy measures announced in the Government's Budget in November 2013, namely the introduction of the Individual Investor Programme, which encourages high net worth individuals to become citizens of Malta, and a fiscal incentive offered to first-time buyers of residential property.

Chart 3.7
MOVEMENTS IN RESIDENTIAL PROPERTY PRICES BASED ON ADVERTISED PRICES



Source: Central Bank of Malta.

[13] This section takes into account information as at 10 March 2015.

[14] This analysis of property price movements is based on the Central Bank of Malta's residential property price index, which tracks movements in advertised residential property prices compiled from newspaper advertisements sampled each month. The Bank's index is divided into eight dwelling categories.

All major sub-components of the price index, except for maisonettes, posted a rise during 2014. The largest increase was registered in the "other properties" category, for which prices went up by 12.8%.[15] Meanwhile, apartments, which form just over half of the properties surveyed, recorded a price increase of 8.1%. Finally, prices of terraced houses also rose significantly on their 2013 levels, increasing by an average of 5.3%. Maisonettes, on the other hand, registered a decline of 0.5% following a rise of 6.3% in 2013.

The labour market[16]

Labour market statistics for the first nine months of 2014 show that employment continued to rise, with the average annual growth rate during this period considerably higher than in the corresponding period of 2013. According to the Labour Force Survey (LFS), the unemployment rate showed a year-on-year drop, while data based on administrative sources suggest that in December 2014 the number of registered unemployed was around 1,100 less in annual terms.

Employment

LFS data up to the third quarter of 2014 indicate that on average the number of persons employed was 2.2% higher compared with the same period a year earlier (see Table 3.7).[17] As a result, the average employment rate rose by 1.4 percentage points to 62.0%, driven by an increase in the female employment rate.[18]

Table 3.7
LABOUR MARKET INDICATORS BASED ON THE LABOUR FORCE SURVEY[(1)]
Persons; annual percentage changes

	2013 Jan.-Sep.	2014 Jan.-Sep.	Annual change %
Labour force	**187,073**	**190,191**	**1.7**
Employed	175,159	178,985	2.2
By type of employment:			
Full-time	148,316	150,041	1.2
Full-time with reduced hours	4,915	5,074	3.2
Part-time	21,928	23,869	8.9
Unemployed	11,914	11,206	-5.9
Activity rate (%)	**64.8**	**65.9**	
Male	79.3	79.7	
Female	49.8	51.6	
Employment rate (%)	**60.6**	**62.0**	
Male	74.1	74.8	
Female	46.7	48.8	
Unemployment rate (%)	**6.4**	**5.9**	
Male	6.4	6.1	
Female	6.3	5.5	

(1) Figures are based on averages for the first three quarters.
Source: NSO.

15 Terraced houses, houses of character, villas and townhouses.

16 This section draws mainly on labour market statistics from two sources: the LFS, which is a household survey conducted by the NSO four times a year on the basis of definitions set by the International Labour Organization and Eurostat, and administrative records compiled monthly by the Employment and Training Corporation (ETC) according to definitions established by domestic legislation on employment and social security benefits.

17 The LFS defines the labour force as all persons active in the labour market aged 15 and over. This includes those in employment, whether full-time or part-time, and the unemployed, defined as those people without work, actively seeking a job and available for work. The ETC definition of the labour supply is more restricted: it includes the full-time gainfully occupied population and the registered unemployed aged 16 and over.

18 The employment rate measures the number of persons employed on a full-time or part-time basis as a proportion of the working-age population, which is defined as all those aged 15 - 64 years.

The increase in the number of jobs was broad-based in terms of types of employment, with strong growth in both part-time and full-time categories. Part-time employment went up by 1,941 in absolute terms, while full-time jobs increased by 1,725. The number of employees working on reduced hours grew by 159.

Between January and September 2014, the labour force was 1.7% more than its average level in the first nine months of 2013. Growth in the labour force was less than in employment, contributing to a decline in the number of unemployed.[19]

As the labour force expanded, the activity rate went up to 65.9%, adding 1.1 percentage points on a year earlier.[20] Both activity and employment rates reached the highest levels recorded since the survey inception, with rates being particularly high in the third quarter of 2014. The female activity rate posted the strongest gain, although that of males also rose. In fact, the female activity rate increased by 1.8 percentage points to 51.6%, while the male rate rose by 0.4 percentage point to 79.8%.

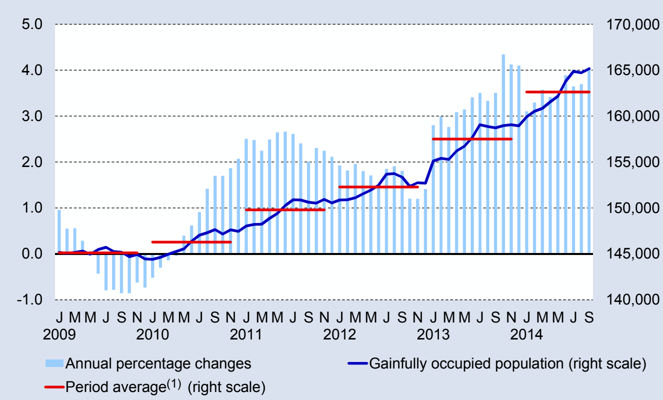
The administrative records of the ETC also point to strong positive developments in the labour market. The gainfully occupied population, defined as all those in full-time employment, continued to increase, reaching the highest level on record (see Chart 3.8). Thus, on average full-time employment rose by 3.6% in the first nine months of 2014. Employment went up in both private and public sectors but, as in previous years, the increase was more pronounced in the former (see Table 3.8). In absolute terms, jobs in the private sector rose by 3,665 while in the public sector they were 1,947 higher.

The increase in full-time private sector employment was mostly propelled by market services, where employment rose by 3,397 or 4.1%. New jobs were created in almost all sectors in this category. The drop in the transport and storage category was a result of the classification of workers in the national bus service from the private to the public sector in January 2014. The biggest increases were registered in real estate, professional & administrative activities, where jobs went up by 1,630 or 9.5%, almost half of the overall increase registered in private market services. The wholesale & retail and information & communication sub-sectors also generated a significant number of new jobs during the first nine months of the year.

In addition, during this period, employment in direct production within the private sector grew by 0.8% on a year earlier. Job growth was observed mainly in the specialised construction activities, which include demolition, installation activities and finishing works, in the repair & installation of machinery & equipment, as well as in "other" manufacturing. The increase in the latter mainly reflected higher employment among firms producing games & toys, as well as medical & dental instruments & supplies.

In the period under review, public sector jobs rose by 1,947 or 4.7%.

Chart 3.8
GAINFULLY OCCUPIED POPULATION BASED ON ETC RECORDS
(annual percentage changes; persons)



(1) Period averages for 2009–13 are based on averages for the whole year, while for 2014 the average is based on data for the first nine months of the year.
Source: NSO.

19 According to the LFS, the unemployed comprise persons above 15 years of age who are without work, available for work and who have actively sought work during the four weeks preceding the survey. In contrast, the number of unemployed on the basis of ETC data includes only those persons registering for work under Part 1 and Part 2 of the unemployment register.

20 The activity rate measures the number of persons in the labour force aged 15 - 64 years (whether employed or seeking work) as a proportion of the working-age population, which is also defined as all those aged 15 - 64 years.

Table 3.8
LABOUR MARKET INDICATORS BASED ON ADMINISTRATIVE RECORDS[1]
Persons; annual percentage changes

	2013 Jan.- Sep.	2014 Jan.- Sep.	Annual change %
Labour supply	**164,338**	**169,785**	**3.3**
Registered unemployed[2]	**7,332**	**7,167**	**-2.3**
Gainfully occupied	**157,006**	**162,618**	**3.6**
Public sector	**41,770**	**43,717**	**4.7**
Private sector	**115,236**	**118,901**	**3.2**
Private direct production[3]	**31,534**	**31,802**	**0.8**
Private market services	**83,702**	**87,099**	**4.1**
Wholesale & retail trade	23,268	23,815	2.4
Transportation & storage	7,079	6,400	-9.6
Accommodation & food service activities	9,942	10,145	2.0
Information & communication	4,920	5,355	8.8
Financial & insurance activities	6,839	7,132	4.3
Real estate, professional & administrative activities [4]	17,126	18,756	9.5
Arts, entertainment & recreation	3,644	3,943	8.2
Education	4,453	4,640	4.2
Other	6,433	6,913	7.5
Part-time employees	**56,038**	**59,454**	**6.1**
Part-time as a primary job	32,710	34,931	6.8
Part-time holding a full-time job	23,328	24,523	5.1

(1) Figures are based on averages for the first nine months.
(2) Statistics for 2014 are available for the number of registered unemployed. The average number dropped by 5.3% between 2013 and 2014.
(3) This also includes employment in agriculture, fishing, mining & quarrying and electricity, gas & water supply.
(4) This includes employment in real estate activities, professional, scientific & technical activities and administrative & support service activities.
Source: NSO.

Within that sector, employment rose significantly in the education and health categories. Meanwhile, the transportation & storage sector also registered an increase, as employees of the national bus service were temporarily transferred to government employment pending the privatisation of the bus transport system. A strong increase in employment was also recorded in public administration & defence mostly due to the reclassification of a number of government employees, who had been previously included under the construction sub-sector. This raised employment in this sector and simultaneously lowered it in the construction sub-sector.

ETC data also show further growth in part-time employment. In the first nine months of 2014, jobs on a part-time basis rose by 3,416 or 6.1%, compared with a year earlier, with these new positions taken mainly by females. The increase was somewhat more pronounced in the number of those holding a part-time job as their only form of employment than among those having both a full-time and a part-time job. The public administration & defence sub-sector services, education services, services related to the tourism sector, as well as wholesale & retail trade, all registered strong increases in the number of part-time workers employed.

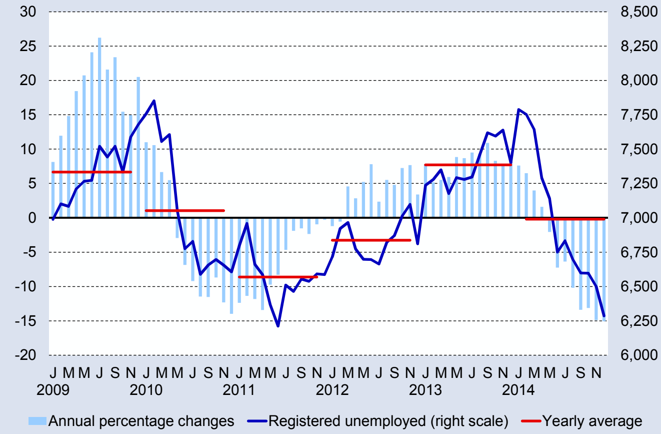
Unemployment

In 2014 the number of unemployed based on ETC data fell by almost 400, or 5.3%, over 2013 (see Chart 3.9). The drop in the number of job seekers was broad-based across age groups, but the greatest fall was seen among those under 25 years of age. In terms of duration of registration, the number of those registering for work for less than a year dropped significantly, particularly among males. On the other hand, a rise was registered among those looking for a job for over a year, particularly in the male category.

LFS data for the first three quarters of 2014 also show a year-on-year drop in the number of unemployed. According to the survey, at 11,206 the number of jobseekers was on average around 700 less when compared with the first nine months of 2013. The unemployment rate averaged 5.9% between January and September 2014, half a percentage point below the level in the same period a year earlier.

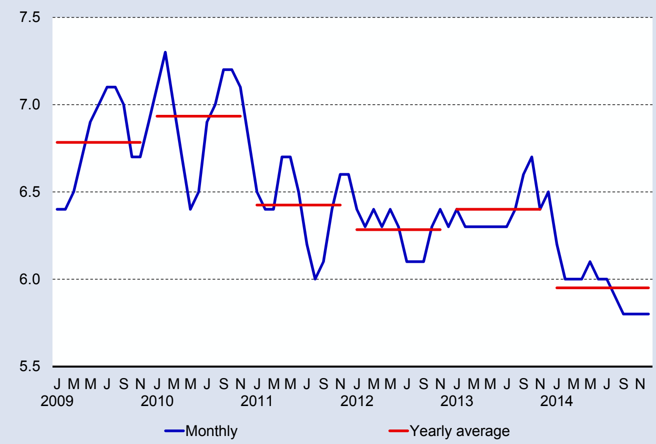
The seasonally adjusted unemployment rate published by Eurostat averaged 5.9% in 2014, significantly lower than the average of 6.4% recorded in 2013 (see Chart 3.10).[21] The rate hovered above or at 6.0% for the first seven months of the year, before dropping to 5.9% in August. Unemployment fell further, to 5.8% in September, and remained at that level until December.

Chart 3.9
REGISTERED UNEMPLOYED
(annual percentage changes; persons)



Source: NSO.

Chart 3.10
UNEMPLOYMENT RATE
(seasonally adjusted; per cent)



Source: Eurostat.

[21] Based on Eurostat calculations.

BOX 2: WAGE DYNAMICS NETWORK SURVEY[1]

In 2014 the Central Bank of Malta carried out a survey as part of the Wage Dynamics Network (WDN) project.[2] This is a collaborative research programme between the European Central Bank and national central banks across the European Union that is studying wage adjustments and price-setting behaviour among EU firms. Since a similar survey was conducted in 2010, the new results allow for an analysis of the recent evolution of the Maltese labour market, specifically on developments between 2010 and 2013.[3] In addition, the use of a harmonised questionnaire among 26 countries participating in this survey will facilitate comparisons across EU countries.

The sample

A total of 271 companies were chosen to take part in the survey. Of these, 60.0% had participated in the previous wave of the survey. Companies were selected from the Business Register of the NSO, while ensuring a stratified representation of each sector and size bracket. As in the 2010 edition, companies with less than ten employees, public corporations and those operating in the agriculture and fisheries sectors were excluded. The fieldwork lasted from May till July 2014 and was carried out using face-to-face interviews.

From the sampled companies, 178 agreed to participate, implying an overall response rate of 66.0%. A response rate of 73.0% was registered among firms that had already participated in the 2010 exercise while the companies that had not participated in the previous wave had a response rate of 55.0%. Around one-third of employees of the target population were employed with businesses that participated in the 2014 survey, with coverage being strongest in financial and insurance activities, and in the manufacturing sector (see Table 1).

Weights were assigned to each company to gross up the survey micro-data to the population aggregates. The results presented in this Box were grossed up using weights based on employment data.[4]

Table 1
SAMPLE RESPONSE RATE AND EMPLOYMENT COVERAGE

	Firm				Employment		
	Population	Gross Sample	Effective Sample	Response Rate (%)	Population	Effective Sample	Coverage (%)
Manufacturing	266	51	32	62.7	17,324	7,395	42.7
Construction	130	20	9	45.0	5,154	1,505	29.2
Wholesale and retail trade	507	40	26	65.0	14,540	1,893	13.0
Accommodation and food service activities	216	31	20	64.5	11,895	2,955	24.8
Financial and insurance activities	91	30	24	80.0	7,762	5,880	75.8
Other Services	661	99	67	67.7	34,888	10,764	30.9
Total	**1,871**	**271**	**178**	**65.7**	**91,563**	**30,392**	**33.2**

Sources: Central Bank of Malta; NSO.

[1] Prepared by Brian Micallef and Karen Caruana. Mr Micallef is a Senior Research Economist in the Modelling and Research Department while Ms Caruana is a Senior Statistician in the Statistics Department of the Central Bank of Malta. The authors would like to thank Dr Bernard Gauci, Dr Aaron G. Grech and Mr Jesmond Pule for helpful comments and suggestions. The views expressed in this paper are those of the authors and do not necessarily reflect those of the Central Bank of Malta. Any errors are the authors' own.

[2] More details can be found at https://www.ecb.europa.eu/home/html/researcher_wdn.en.html

[3] The findings of the previous wave are summarised in "Wage and price setting in Malta", *Quarterly Review* 2010:4, Central Bank of Malta. As the two surveys are not identical, however, it is not always possible to compare results.

[4] Two sets of weights were constructed using information such as the firm size and NACE Rev. 2 classification. One weighting system was based on the number of firms and another on the number of employees.

The economic environment

With the exception of manufacturing and construction, most sectors experienced a favourable economic environment since 2010. Chart 1 shows that close to 60% of firms in services registered increased demand between 2010 and 2013. On the contrary, around 50% of companies in manufacturing and construction reported a decline in demand during the same period. Companies in these two sectors also considered the drop in demand to be permanent, rather than temporary.

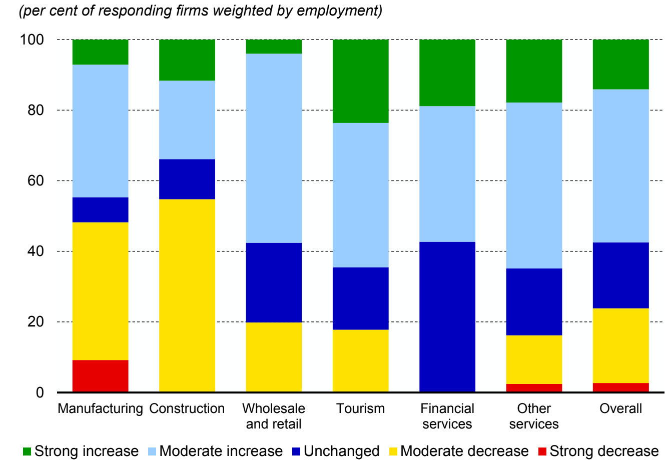
The availability of credit to finance working capital, new investment or rolling over debt were not considered relevant issues for most firms. Some companies, however, felt that while credit was available, the conditions, such as interest rates and other contractual terms, were too onerous. This problem was mainly concentrated in the wholesale and retail sector and, to a lesser extent, in construction. This finding is consistent with other surveys that show that bank credit to domestic firms is available but interest rates charged, especially for businesses, are high compared with those in other euro area economies.[5] Further information about the cost of credit is provided in the responses dealing with costs in general.

All sectors reported an increase in total costs, with 73.0% of firms reporting a "moderate increase" and another 16.0% a "strong increase".[6] Looking in more detail at cost components, the rise in total costs was mainly driven by labour and supplies. Developments in financing costs were more balanced, with around 50% of firms reporting these unchanged. However, 33.0% of firms stated that financing costs had increased, whereas only 18.0% reported a decline. This result supports the findings of a separate study by the Central Bank of Malta that had pointed towards an impaired transmission mechanism of policy rates to domestic bank lending rates, especially for non-financial corporations.[7] Around 20% of firms also reported a rise in other costs related, for instance, to utility tariffs, administrative costs and regulatory fees.

Turning more specifically to labour costs, the large majority of companies reported a rise in base wages. Slightly less than 40% of firms also awarded increases in flexible wage components, such as bonuses or fringe benefits. This form of compensation was mainly concentrated in the services sector, especially in tourism and financial services.

The increase in labour costs also reflected growth in employment. Around 52% of firms stated that higher

Chart 1
EVOLUTION OF DEMAND FOR GOODS AND SERVICES SINCE 2010
(per cent of responding firms weighted by employment)



Source: Central Bank of Malta.

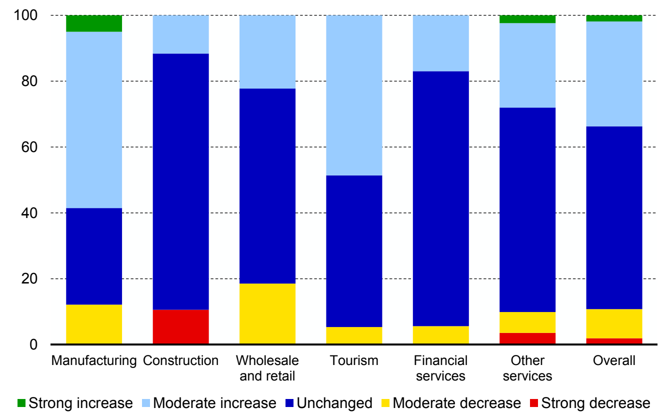
[5] See the European Commission's Survey on Access to Finance for Enterprises (SAFE), details of which are available in Box 1 of this *Annual Report*. Similarly, the relatively high interest rate on loans to businesses in Malta was emphasised by Professor J. Bonnici in a speech entitled "Achieving Malta's potential growth in challenging times", published in *Quarterly Review* 2013:3, Central Bank of Malta.

[6] At a sectoral level, the increase in total costs was slightly more pronounced in the financial, tourism and other service industries compared with construction, manufacturing, wholesale and retail sectors. Some companies in the latter sectors even reported a drop in total costs, especially in the manufacturing sector, possibly reflecting ongoing restructuring efforts to become more competitive.

[7] Micallef, B. and Gauci, T., "Interest rate pass-through in Malta", *Quarterly Review* 2014:1, Central Bank of Malta.

labour costs were also due to a rise in the number of permanent employees, while 33.0% reported additional temporary or fixed-term employees. According to the survey, hours worked per employee remained broadly unchanged during the reference period, although around 20% of firms reported a modest rise in hours. These results provide further evidence of the robust performance of the domestic labour market after the crisis, with average employment growth exceeding pre-crisis growth rates. Employment growth was also broad-based across sectors, with the exception of manufacturing.[8]

Chart 2
AVERAGE PRODUCTIVITY PER EMPLOYEE COMPARED WITH LABOUR COSTS
(per cent of responding firms weighted by employment)



Source: Central Bank of Malta.

Increases in costs, however, were matched or even exceeded by gains in labour productivity (see Chart 2). Around one-third of firms reported that growth in productivity per employee exceeded labour costs, with the improvement in productivity being especially pronounced in manufacturing and tourism. This result is at odds with official statistics that point to a sharp deterioration in labour productivity after the crisis. This could be, to a certain extent, the result of the difficulty of accurately measuring output in an increasingly service-oriented economy.[9]

Labour force adjustments

Around 80% of firms reported that they did not need to significantly reduce their labour input or alter its composition between 2010 and 2013. Manufacturing was the only exception, with half the respondents stating that they were forced to make adjustments to their workforce during the reference period.

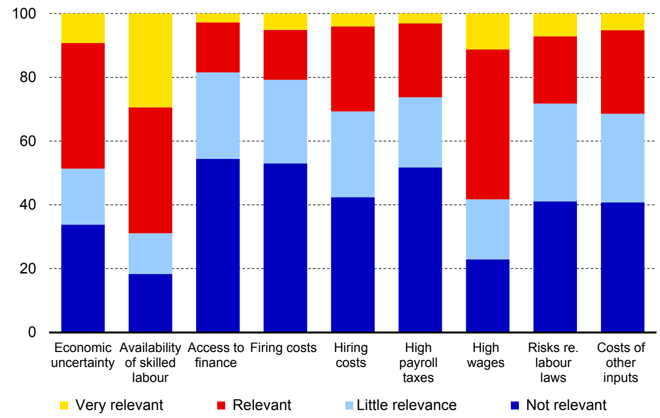
Freezing or reducing new hires were the most commonly used measures by manufacturing firms to adjust their labour force. This approach was used by 85.0% of firms in the sector, with 29.0% of them reporting that they have "strongly" used this option. Other commonly used strategies were the reduction of agency workers and working hours, with both strategies being used either "moderately" or "strongly" by around a third of the firms.[10] Only slightly less than 15% resorted to laying off employees during this period.

The survey also asked firms to determine the main obstacles they faced when hiring workers on a permanent, open-ended contract (see Chart 3). The availability of skilled labour was the most relevant factor, with close to 70% of respondents considering labour shortages as "relevant" or "very relevant". This finding is in line with conclusions in the National Employment Policy published in 2014, which identified the mismatch between demand and supply of skills as one of the main challenges

[8] The decline in employment in manufacturing is a long-term factor that started before the onset of the financial crisis.
[9] Micallef, B., "Labour market resilience in Malta", *Quarterly Review* 2013:1, Central Bank of Malta.
[10] Agency workers are employees that are not on the payroll of the firm, such as consultants or employees that are officially registered with a different company.

facing the Maltese labour market.[11] Other important factors that employers consider when hiring staff are wages and economic uncertainty, with 58.0% and 49.0% of firms, respectively, regarding these two factors as "relevant" or "very relevant". In contrast, most firms do not consider access to finance as a relevant factor in hiring workers, with a further 27.0% claiming that it is only of little relevance.

Chart 3
RELEVANCE OF FACTORS IN HIRING WORKERS WITH PERMANENT OPEN-ENDED CONTRACT
(per cent of firms weighted by employment)



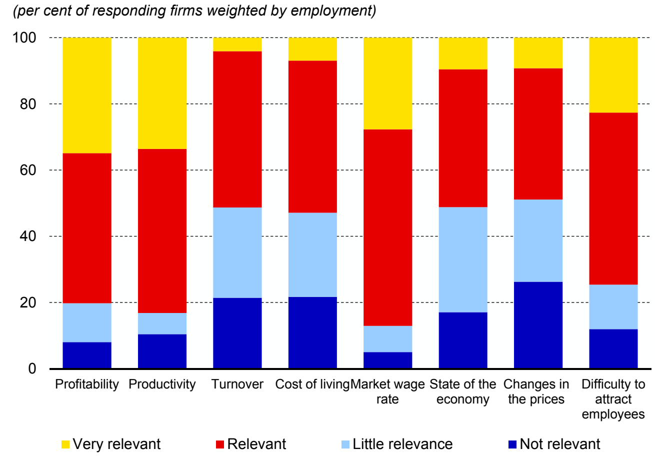
Source: Central Bank of Malta.

Wage setting and wage changes

Respondents were also asked to indicate the frequency and type of wage changes that occurred during the reference period. Wage bargaining takes place at firm level and almost all firms stated that changes occurred annually. This is not surprising given the obligation to implement the statutory cost-of-living adjustment mechanism.[12]

The survey results suggest that around 23% of employees were covered by a collective wage agreement in 2013. This represents a significant decline from the previous WDN survey, which had reported coverage at 28.6% in 2008. This is in line with the decline in trade union membership in recent decades. For instance, a separate study finds that the proportion of private sector employees covered by collective agreements declined from almost 33% in 1995 to 26.7% in 2008.[13] At a sectoral level, the employees covered by a collective agreement are mainly concentrated in manufacturing and financial services.

Chart 4
RELEVANCE FOR WAGE SETTING DECISIONS
(per cent of responding firms weighted by employment)



Source: Central Bank of Malta.

Firms were also asked to assess the relevance of a number of factors which they consider when setting wages (see Chart 4). More than 85% of respondents identified the market wage as a "relevant" or

[11] Further details on the National Employment Policy can be found at: http://education.gov.mt/employment/Documents/EMPLOYMENT%20POLICY%20DOC%20sml.pdf

[12] Only a small percentage of firms, around 2%, change the base wage more than once a year. These were mainly concentrated in the manufacturing and financial sectors.

[13] Baldacchino, G. and Gatt, R., "Thirteen years later: Trade unions in the Maltese private sector revisited", *Review*, No 40, Bank of Valletta, Autumn 2009.

"very relevant" consideration in the wage-setting process, reflecting the need to remain competitive to attract talent. The firm's profitability, labour productivity and difficulties in attracting employees were also very important factors. Other considerations, such as turnover, the cost-of-living, the state of the domestic economy and changes in prices were deemed to be less relevant.

Price setting and price changes

Price-setting behaviour in Malta varies on whether the main market served by the firm is domestic or international. Overall, around 60% of sales were oriented to the domestic market, with the remaining 40% taking place abroad.

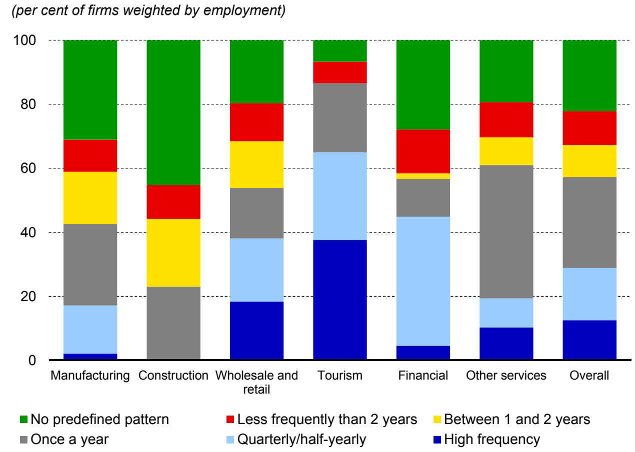
With regard to pricing in the domestic market, around 34% of firms set prices according to costs and a self-determined profit margin. Another 30% set prices following their main competitors while 18.0% negotiate their prices with individual customers.[14]

In contrast, in international markets the share of firms that set prices as a mark-up over costs declines to 24.0%. In addition, around 25% of firms are not autonomous in setting their prices in foreign markets, mostly because prices are set by the parent company. This behaviour is especially common in the manufacturing sector. Negotiating the price with individual customers is another common pricing approach adopted by 26.0% of firms. This strategy is more prevalent in the trading sector. The remaining 25.0% of firms set prices in response to those of competitors.

As expected, respondents reported a high degree of heterogeneity regarding the frequency of price setting, with sector-specific characteristics playing an important role (see Chart 5). For instance, in the tourism industry, more than 30% of respondents change prices at a high frequency, reflecting the prevalence of internet booking for hoteliers. Within this sector, which consists mainly of hotels and restaurants, more than 85% change their prices at least annually. In the wholesale and retail sector, slightly more than 50% of firms also change their prices at least once a year. Around 40% of firms in the financial sector change their prices every quarter or half-yearly, whereas in other market services, 42% of firms change their prices on an annual basis. Around 45% of respondents in the construction industry do not have a consistent pattern, with prices being primarily determined by the local market, or by the degree of competition, or else prices are negotiated at the beginning of the contract. The share of firms reporting no predefined pricing pattern is also relatively large in manufacturing, above 30%, which could be due, for instance, to prices being set by the parent company at irregular intervals.

As in the 2010 edition, most companies stated that they faced strong or severe competition, whereas very few declared that they faced no competition at all. Most companies considered that the degree of competitive price

Chart 5
FREQUENCY OF PRICE CHANGES ON A REGULAR PATTERN
(per cent of firms weighted by employment)



Source: Central Bank of Malta.

[14] A direct comparison with the 2010 edition of the survey is not straightforward since it distinguished pricing for domestic and foreign markets. However, in that wave, setting prices as a mark-up over costs was the most commonly used pricing strategy, with following the main competitors being the second option.

pressures had increased in the relevant market compared with the situation prevailing before 2010. This finding is in line with results of the SAFE, which ranks competition as the most pressing problem facing Maltese firms in 2014.

Conclusion

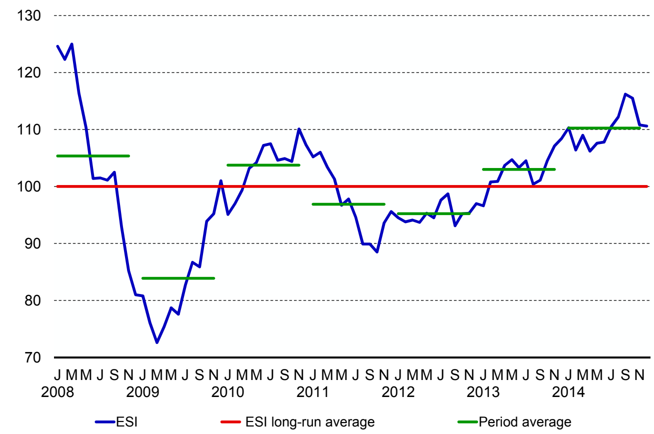
Labour market conditions in European countries have differed significantly over the last few years. A better knowledge of the key features and determinants of the wage-setting process, and of the labour market in general, is important for policy makers. From a central banking perspective, this knowledge is important to gauge the effectiveness of the monetary policy transmission process. The links between wages, prices and productivity are also key determinants of competitiveness, which is conducive to economic growth and job creation.

The WDN survey provides valuable information on characteristics of Maltese firms' wage and price-setting behaviour, and on the main changes in the economic environment after the financial crisis. It allows for a deeper understanding of differences across sectors, for instance, in price-setting practices, and facilitates the identification of trends in the labour market, such as the gradual decline in collective bargaining. The survey also provides an alternative source of information to complement official statistics on selected labour market issues, such as differences in sectoral productivity developments and skill mismatches.

Going forward, the results from this survey, together with those from other EU countries, will be examined to identify key lessons for policy analysis and research purposes. A better understanding of linkages between the financial sector and the labour market, and the identification of factors that could help explain cross-country differences observed in the aftermath of the financial crisis, are promising areas of research.

BOX 3: BUSINESS AND CONSUMER SURVEYS

Chart 1
ECONOMIC SENTIMENT INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

During 2014 economic sentiment generally improved. Firms operating in the service sectors were on average more optimistic than a year earlier. Sentiment also improved significantly in the construction industry and, to a lesser degree, in the manufacturing sector although it remained negative in both cases. Consumer sentiment was also less negative than in 2013, while retailers' assessment was broadly unchanged.

These developments led to a 7.0 percentage point increase in the average economic sentiment indicator (ESI) reading in 2014, with the indicator remaining above its long-term average of 100.0 through to the end of 2014 (see Chart 1).[1,2]

The construction sector recorded the largest gain, although this sector has a small weight in the overall index (see Table 1).

Industrial confidence surveys[3]

Confidence among firms operating in the manufacturing sector generally deteriorated in the first half of 2014. Although sentiment strongly improved during the third quarter of the year, the

Table 1
SENTIMENT INDICATOR BY SECTOR
Annual average; change

	2013	2014	Change
Industrial confidence indicator	-4.2	-0.9	3.3
Services confidence indicator	15.7	24.6	8.9
Construction confidence indicator	-38.1	-21.4	16.7
Consumer confidence indicator	-9.2	-1.1	8.0
Economic sentiment indicator	**103.0**	**110.3**	**7.3**

Source: European Commission.

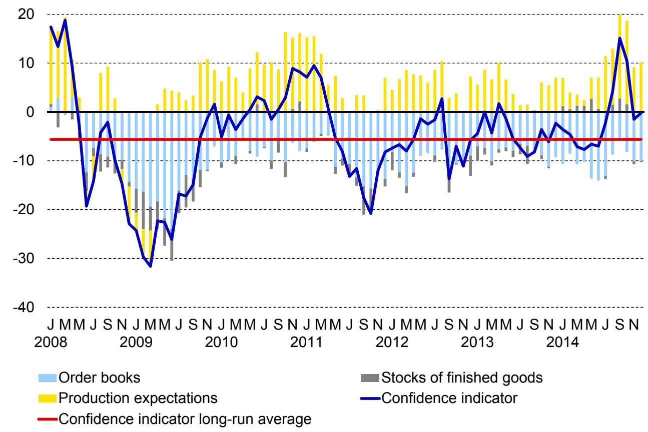
[1] The ESI summarises developments in confidence in the four surveyed sectors (industry, services, construction and consumers).

[2] Long-term averages are calculated over the entire period for which data are available. For the consumer and industrial confidence indicator, data became available in November 2002, while the service and construction confidence indicator data became available in May 2007 and May 2008, respectively. The long-term average of the ESI is computed from November 2002.

[3] The industrial confidence indicator is the arithmetic average of the seasonally adjusted balances (in percentage points) of replies to a subset of survey questions relating to expectations about production over the subsequent three months, to current levels of order books and to stocks of finished goods.

indicator weakened again in the last quarter of the year (see Chart 2). Reflecting these movements, sentiment for industry improved only moderately compared with 2013, with the score averaging -1 in 2014 from -4 in the previous year. Nonetheless, at 0, the end-of-year reading stood well above its long-term -5.1 average.

Chart 2
INDUSTRIAL CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

On average, during 2014 respondents reported below normal levels of stocks of finished goods. This contrasts with 2013 when stocks were assessed to be slightly above normal. However, by the end of the year, stock levels were assessed to have reverted back to a level above what respondents normally expect.[4]

Production expectations improved during 2014 and were the main factor behind the amelioration in the overall indicator during the summer. On the other hand, the majority of respondents reported weak order book levels and their assessment, on average, worsened from the previous year.

At the end of 2014 the production expectations sub-indicator stood above its long-term average, while readings for stock of finished goods and the order book were below their respective long-run average.

Supplementary data indicate that the share of respondents foreseeing a rise in employment was higher on average in 2014 compared with 2013 and well above its long-term average. Throughout the year, respondents anticipated a decrease in their selling prices and a large number indicated insufficient demand as the main factor inhibiting business activity.

A breakdown of the main industrial groupings shows that, on average compared with a year earlier, confidence improved in 2014 among those producing food products, fabricated metal products, wearing apparel, and reproduction of recorded media. On the other hand, confidence deteriorated among manufacturers of paper & paper products, rubber & plastic products, computer & electronic equipment. Confidence among producers of non-metallic mineral products remained constant.

Construction industry confidence surveys[5]

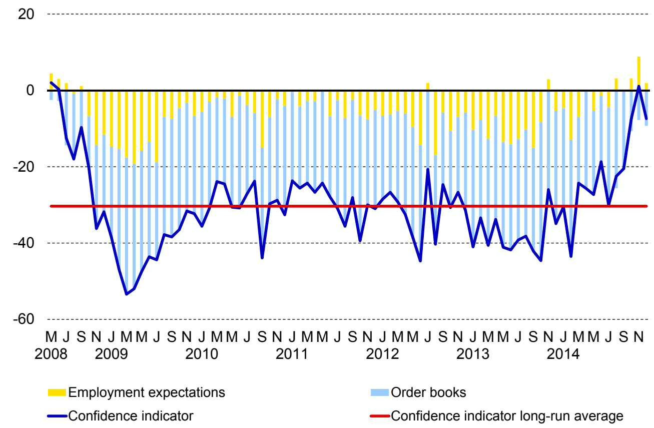
Sentiment in the construction sector was on average less negative than it was a year earlier. For 2014 as a whole, its average value stood at -21, as against -38 in 2013. A significant improvement was recorded during the last quarter of the year, possibly in response to policy measures aimed at supporting the sector. At the end of the year, at -7, the reading was significantly above its long-run average of -30 (see Chart 3).

[4] A decline in stock levels indicates higher turnover and affects the overall indicator in a positive way. Such decreases are thus represented by bars above the 0 mark in Chart 2.

[5] The construction confidence indicator is the arithmetic average of the seasonally adjusted balances (in percentage points) of replies to two survey questions, namely those relating to order books and employment expectations over the subsequent three months.

Compared with the previous year, operators in this sector were on balance more optimistic with regard to both employment prospects and demand for their services. Regarding their labour complement, until July respondents on balance expressed an intention to reduce their manpower levels. Thereafter, however, respondents began to report an increase in jobs in this sector.

Chart 3
CONSTRUCTION CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

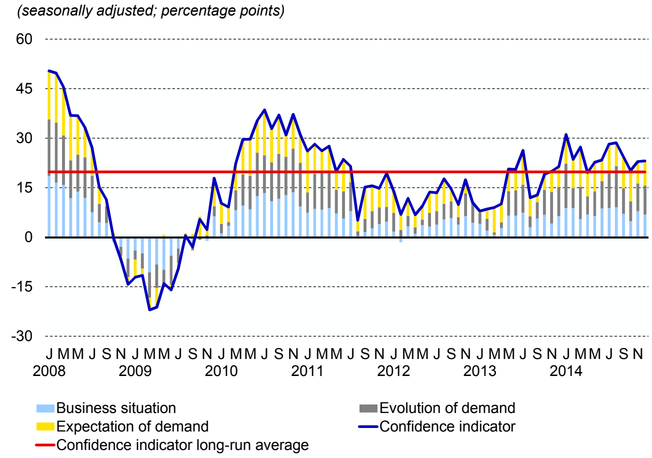
Although order book levels also improved significantly in the last quarter of the year, the majority of firms continued to consider their order books to be below normal. Additional survey data suggest insufficient demand as the primary factor inhibiting building activity. At the end of the year, both the order book and employment expectation indicators were above their long-term average.

Services confidence surveys[6]

Within the services sector, confidence levels did not exhibit a clear pattern in the course of 2014, but remained positive throughout the year (see Chart 4). The average confidence score increased to 25 in 2014, as against 16 in 2013. The reading ended the year at 23, above the long-run average of 20.

The improvement in confidence was evident in all components of the index. Throughout the year, the majority of respondents were more optimistic than in 2013 with regard to the evolution of demand and demand expectations. Moreover, the share of respondents anticipating a favourable business situation was higher. By the end of the year, the sub-indicators pertaining to the business situation, past demand and demand expectations stood above their respective long-term average.

Chart 4
SERVICES CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

[6] The services confidence indicator is the arithmetic average of the seasonally adjusted balances (in percentage points) of replies to survey questions relating to the business climate, the evolution of demand in the previous three months and demand expectations for the subsequent three months.

Supplementary data indicate employment expectations improved in 2014.

Firms providing services related to warehousing & support, real estate, food & beverage, accommodation and financial intermediation reported a rise in confidence compared with 2013. In contrast, confidence deteriorated in the audio visual sector, among firms engaged in advertising and market research, and, to a small extent, also in auxiliary financial services. Confidence was unchanged in the rental & leasing sector.

Consumer confidence surveys[7]

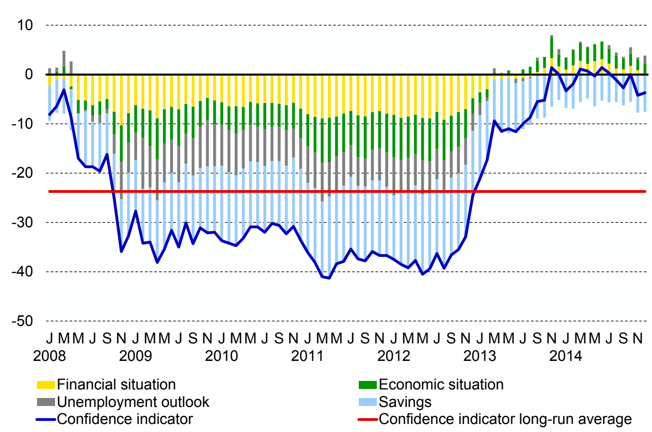
The consumer confidence indicator fluctuated between positive and negative readings during 2014, nevertheless remaining within a narrow range close to 0 (see Chart 5). In fact, over the year as a whole, the index averaged -1, better than the previous year's average of -9. Amid month-on-month fluctuations, the consumer confidence indicator began to show some signs of renewed pessimism in the second half of the year, with the overall reading closing at -4 in December. At this level, however, it was still well above its long-term average of -24.

The rise in confidence in 2014 was propelled by all components of the index. Consumers' assessments with regard to their own financial position and the general economic situation in the subsequent 12 months were positive throughout 2014. Savings expectations were also less negative than in 2013. Furthermore, consumers expected unemployment to decrease in the subsequent 12 months in contrast with 2013, when unemployment had been expected to rise.

The sub-indicators related to savings, the financial position and the economic situation ended 2014 higher compared with their respective long-term averages. Consumers' expectations with respect to labour market prospects were also significantly better compared with the long-term average.

Further survey information suggests that the number of consumers that considered the timing was right to make major purchases, given the existing economic situation, increased compared with 2013. However, compared with 2013 a larger share of respondents indicated that they would refrain from making major purchases in the subsequent 12 months. Overall, both inflation perceptions and expectations for the subsequent 12 months were lower compared with 2013, with the latter being negative during most of the year. However, by December the majority of respondents believed that prices would increase in the subsequent year.

Chart 5
CONSUMER CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

[7] The consumer confidence indicator is the arithmetic average of the seasonally adjusted balances (in percentage points) of replies to a subset of survey questions relating to households' financial situation, their ability to save, the general economic situation and unemployment expectations over the subsequent 12 months.

Consumer prices

HICP[22]

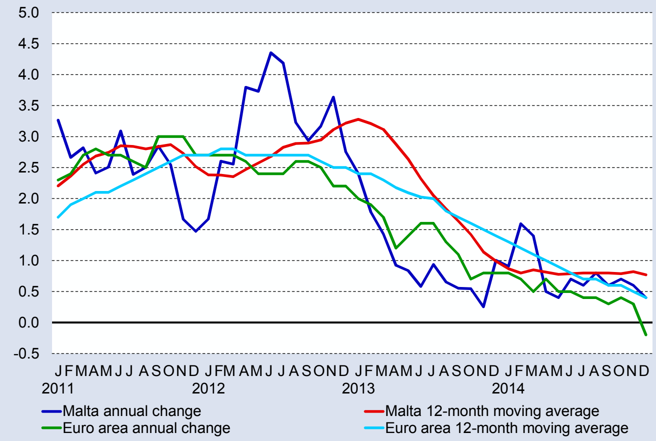
In 2014 the average annual rate of inflation based on the Harmonised Index of Consumer Prices (HICP) fell to 0.8% from 1.0% in 2013 (see Chart 3.11). The year-on-year inflation rate rose briefly in the first quarter of 2014, but then declined considerably in April as a result of a sharp drop in electricity tariffs.[23] Year-on-year inflation remained at low levels throughout the rest of the year, fluctuating between 0.4% and 0.8%. It ended the year at 0.4%, down from 1.0% in December 2013.

While inflation in Malta was low, it remained above that in the euro area during most of 2014, with the inflation differential averaging 0.3 percentage point during the year as a whole.

The deceleration in Malta's average inflation rate between 2013 and 2014 was mainly attributable to developments in food and energy prices (see Chart 3.12 and Table 3.9). Such downward pressure was partially offset by a pick-up in services and non-energy industrial good (NEIG) price inflation.

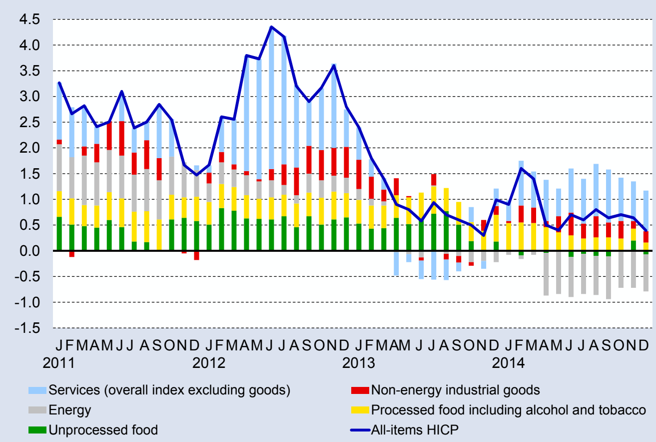
Due to a sharp reduction in electricity tariffs, the average inflation rate of

Chart 3.11
HICP INFLATION RATES IN MALTA AND IN THE EURO AREA
(annual percentage changes; annual average percentage changes)



Sources: NSO; Eurostat.

Chart 3.12
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION
(percentage points; annual percentage change)



Source: Eurostat.

Table 3.9
CONTRIBUTIONS TO HICP INFLATION
Percentage points

	2012	2013	2014
Unprocessed food	0.6	0.5	0.0
Processed food including alcohol and tobacco	0.5	0.5	0.3
Energy	0.3	-0.1	-0.6
Non-energy industrial goods	0.3	0.2	0.3
Services (overall index excluding goods)	1.5	0.0	0.8
HICP (annual average inflation rate)	**3.2**	**1.0**	**0.8**

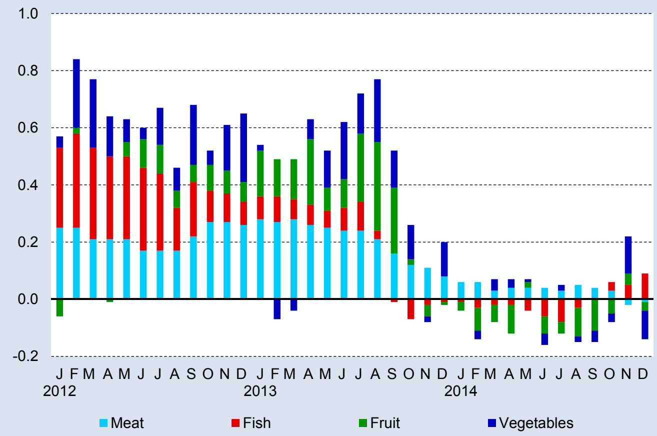
Source: Eurostat.

[22] In January 2014 the HICP weights were revised to reflect changes in household consumption patterns. As a result, the weight of non-energy industrial goods was reduced by 0.4 percentage point to 29.1%, while that allocated to services dropped 0.1 percentage point to 42.4%. In contrast, the weight related to energy increased by 0.4 percentage point to 8.0%, whilst that of food remained unchanged.

[23] As announced in the Budget 2014, Government lowered electricity and water tariffs for residential customers with effect from 31 March 2014.

the energy sub-component dropped to -7.6% in 2014 from -0.7% in the previous year. This pulled down the overall HICP inflation rate by 0.6 percentage point in 2014, as opposed to a modest 0.1 percentage point in 2013.

Chart 3.13
CONTRIBUTIONS TO HICP FROM UNPROCESSED FOOD
(percentage points; annual percentage change)



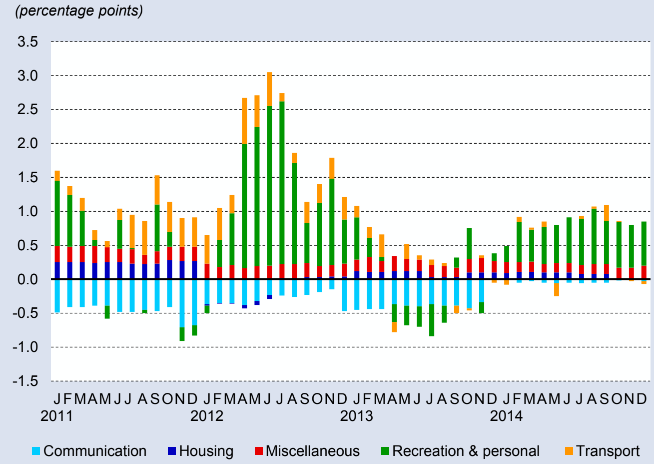
Source: Eurostat.

In addition, food price inflation slowed down considerably during the year under review, falling to 1.5% from 4.7% a year earlier. This was mainly the result of a significant swing in the inflation rate of unprocessed food, from 6.4% in 2013 to -0.4% a year later, largely on the back of decreases in the prices of vegetables, fruit and fish & seafood (see Chart 3.13). Furthermore, processed food prices rose at a slower pace, increasing by an average of 2.7% in 2014, down from 3.7% in 2013. This slowdown was broad-based, affecting in particular alcoholic beverages, sugar, jam & confectionary, and to a lesser extent, coffee, tea & cocoa.

On the other hand, the inflation rate of the services index – which has the highest weight in the overall HICP index – swung from an average of -0.2% in 2013 to 1.8% in the year under review. As a consequence, its contribution to overall inflation rose from nil to 0.8 percentage point (see Table 3.9). The main driver of this increase was the recreation & personal services category, largely reflecting an upswing in accommodation rates, as well as robust growth in restaurant prices (see Chart 3.14). Such developments were driven by a buoyant tourism industry, as evidenced by accommodation price inflation, which rose to 0.8% from -3.6%, and restaurant prices, which increased by 2.6% compared with 1.9% in 2013. In addition, the decline in communications prices moderated during 2014, as prices fell by an average of 1.0% compared with -8.8% in the preceding year.

Meanwhile, non-energy industrial goods prices registered a modest rise during the year under review. On average, prices of the sub-index went up by 0.9% in 2014, an additional 0.4 percentage point from the previous year. This was attributable to the durables component, which saw its inflation rate swing from a negative reading to a positive one owing to a base effect emanating from developments in the prices of motor vehicles. These recovered from the sharp drop they posted in 2013. As a consequence, NEIG's contribution to headline HICP inflation rose marginally, from 0.2 to 0.3 percentage point.

Chart 3.14
CONTRIBUTIONS FROM SERVICES TO HICP INFLATION
(percentage points)

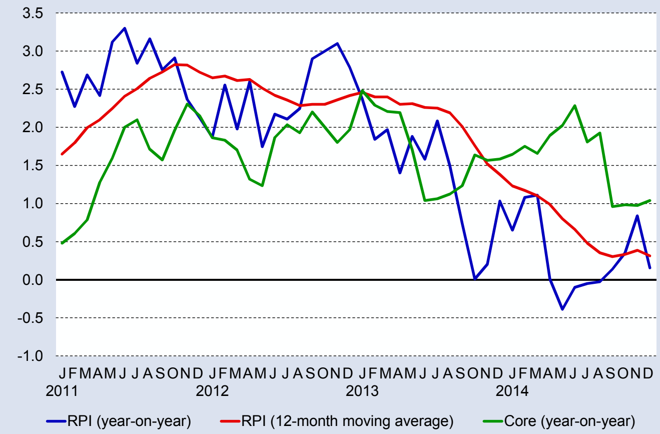


Source: Eurostat.

RPI and core inflation

The 12-month moving average inflation rate based on the Retail Price Index (RPI) fell from 1.4% in 2013 to 0.3% in the year under review (see Chart 3.15).

Chart 3.15
RPI AND CORE INFLATION
(annual percentage changes; annual average percentage change)



Sources: Central Bank of Malta estimates; NSO.

The slowdown in RPI inflation between 2013 and 2014 was mainly due to developments in the prices of energy and food, and, to a lesser extent, personal care & health.

On average, energy prices contracted by 13.9% compared with a 0.5% drop in 2013, largely reflecting the reduction in electricity tariffs. As a result, the contribution of the water, electricity, gas and fuels sub-index to the overall inflation rate fell from nil to -0.5 percentage point (see Table 3.10). In addition, average food price inflation slowed down significantly, going down to 0.5% in 2014 from 4.8% a year earlier. This component, which accounts for over one-fifth of the overall basket, thus contributed only 0.1 percentage point to overall inflation, compared with a whole percentage point in the preceding year. Developments in energy and food prices therefore broadly mirrored those in HICP data.

Furthermore, the average price inflation of services relating to housing and personal care & health fell somewhat during 2014, with the combined contribution to headline RPI declining from 0.3 to 0.1 percentage point.

On the other hand, there were some components which saw an acceleration in their respective inflation rates during 2014. Prices of services relating to recreation & culture rose by 2.9% compared with 2.2% in the previous year. Clothing & footwear prices also went up at a faster pace, increasing by 0.9% as opposed to 0.4% in 2013. As a result, the combined contribution of these two categories rose from 0.2 to 0.4 percentage point. In addition, prices of transport and communication declined at a slower rate during the year under review, pulling down RPI inflation only marginally by 0.1 percentage point, as opposed to a negative contribution of half a percentage point in 2013.

Table 3.10
CONTRIBUTIONS TO RPI INFLATION [(1)]
Percentage points

	Weights	2012	2013	2014
Food	21.23	1.0	1.0	0.1
Beverages & tobacco	6.09	0.3	0.3	0.3
Clothing & footwear	7.41	-0.1	0.0	0.1
Housing	7.61	0.0	0.1	0.0
Water, electricity, gas & fuels	3.36	0.0	0.0	-0.5
Household equipment & house maintenance costs	6.59	0.1	0.1	0.1
Transport & communications	22.76	0.5	-0.5	-0.1
Personal care & health	8.57	0.1	0.2	0.1
Recreation & culture	9.28	0.1	0.2	0.3
Other goods & services	7.10	0.3	0.0	0.0
RPI (annual average inflation rate)	**100.00**	**2.4**	**1.4**	**0.3**

[(1)] Totals may not add up due to rounding.
Source: NSO.

Meanwhile, prices of beverages & tobacco, household equipment & maintenance, and other goods and services continued to increase at broadly the same rate on average during 2014. Thus, their combined contribution to headline RPI remained stable at 0.4 percentage point.

Underlying price pressures gauged by the Bank's core RPI inflation measure, which excludes the more volatile components, show that the annual rate of underlying inflation averaged 1.6% in 2014, down marginally from 1.7% in the previous year. The core rate picked up gradually during the first half of the year, peaking at 2.3% in June. It then began to fall, reaching a low of 1.0% in September, mainly due to a drop in household equipment & maintenance prices, as well as a slowdown in the price growth of services relating to recreation and culture.

A comparison of developments in the annual rate of HICP and RPI inflation shows that the decline in RPI inflation in 2014 was slightly larger than reported in HICP data. In fact, during 2014 the annual rate of RPI inflation fluctuated in a wider band compared with the HICP, with a high of 1.1% in February and March, and a low of -0.4% in May. In contrast, as noted earlier, HICP inflation remained positive throughout 2014.

It is also relevant to note that following the dip in May, RPI inflation accelerated at a steadier pace than HICP inflation. This is largely due to the acceleration in food inflation during the course of 2014, which had a larger impact on the RPI, given the larger weight of this component in the latter.

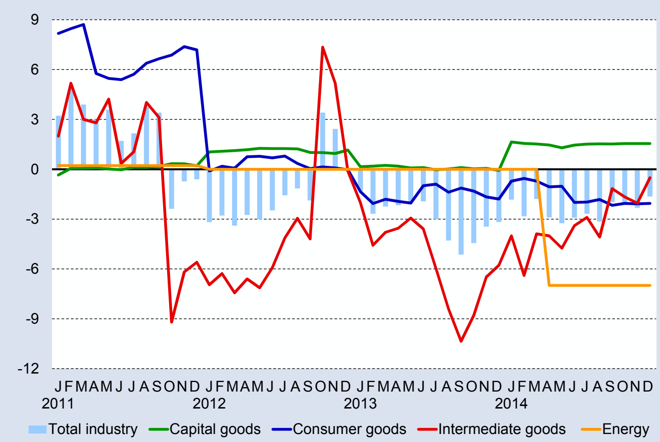
Costs and competitiveness

Producer prices[24]

The industrial producer price index (PPI) provides a measure of inflationary pressures at production stage. Throughout 2014, producer price inflation was negative, although prices contracted at a slower pace than in the previous year (see Chart 3.16). In fact, the 12-month moving average rate stood at -2.5% compared with -3.0% in 2013.

The weaker decline in producer prices during 2014 largely reflected movements in the prices of intermediate goods, which include semiconductors, pharmaceutical, paper and plastic products, and account for almost half of the overall index. Intermediate goods prices contracted by an average of 3.2% during 2014, after having declined by an average of 5.5% a year earlier. As a result, the contribution to overall producer price inflation became less negative, moving to -1.5 percentage points, from -2.6 percentage points in 2013. In addition, the average movement of capital goods prices accelerated to 1.5% from 0.1%, thus pushing up the overall PPI inflation rate by 0.2 percentage point.

Chart 3.16
INDUSTRIAL PRODUCER PRICE INFLATION
(annual percentage changes)



Source: NSO.

[24] The Industrial PPI measures the prices of goods at the factory gate and is commonly used to monitor inflationary pressures at the production stage. It monitors the ex-works sale prices of leading products as reported by a sample of 77 large enterprises accounting for over 80% of total industrial turnover. The index covers three areas of economic activity: mining & quarrying, manufacturing and the supply of electricity, gas & water. Products are divided into five main groupings: intermediate goods, capital goods, consumer durables, non-durable consumer goods and energy. In turn, producer prices are divided between export and domestic markets for each of the groupings, with the bulk of the weight given to the export index. Producer price inflation in Malta has been more volatile than consumer price inflation in recent years, reflecting relatively sharp fluctuations in producer prices in the energy and intermediate goods sectors.

Mainly reflecting the reduction in electricity tariffs, energy prices fell by 5.2% on average during the year under review, This decreased the overall PPI inflation rate by 0.7 percentage point, compared with a contribution of nil in 2013. Meanwhile, on average, consumer goods prices continued to fall at the same rate as in the previous year.

Labour costs

Central Bank of Malta estimates of wage inflation based on collective agreements show that negotiated wage growth on average accelerated slightly to 3.4% in 2014 from 3.3% in 2013, mainly driven by public sector wages.

Meanwhile, national accounts data for 2014 show that overall compensation per employee grew by 0.9% in nominal terms, following a drop of 0.4% in 2013.[25]

Further indicators on wage developments emerge from the LFS. According to the survey, over the first three quarters of 2014 the average annual salary per employee increased by 1.9%, compared with a rise of 1.7% over the same period of 2013.

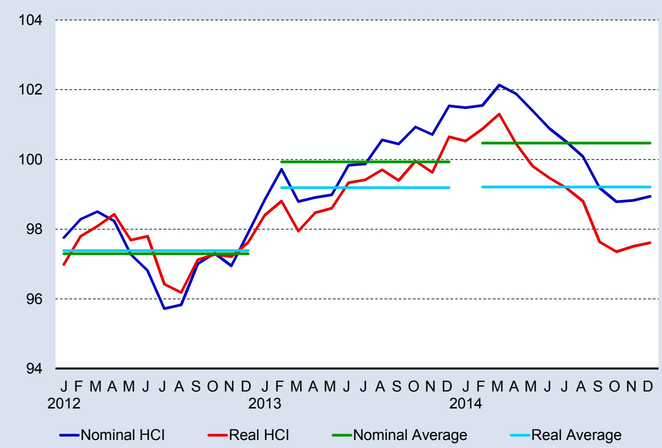
External competitiveness

Two measures of Malta's competitiveness in overseas markets are the harmonised competitiveness indicator (HCI) and unit labour costs (ULC).

The nominal and real HCI indices followed a downward path until October, before they started to increase again in the fourth quarter. With the two indices falling during most of 2014, the loss in competitiveness registered in 2013 was reversed during the year under review. In fact, by the end of the year the nominal HCI index was 2.6% lower than its end-2013 level, while the real HCI registered a decrease of 3.0% (see Chart 3.17).

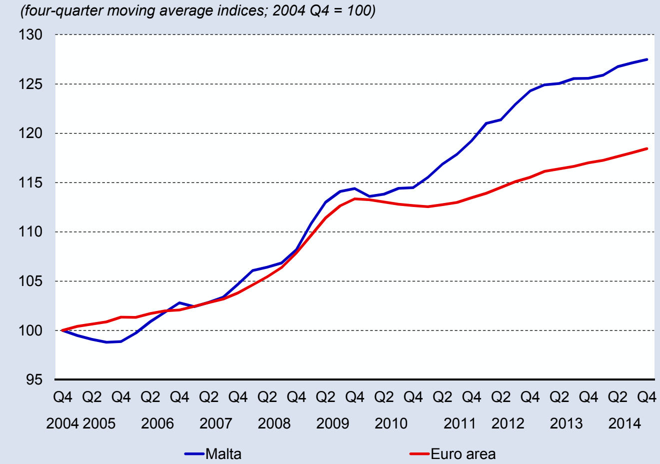
The decline in the nominal HCI between January and October mainly reflected the generally persistent weakening of the euro against the dollar and sterling. The more pronounced decline in the real index reflects as well the narrowing of the inflation differential between Malta and the euro area.

Chart 3.17
HARMONISED COMPETITIVENESS INDICATORS
(May 2004 = 100)



Source: ECB.

Chart 3.18
UNIT LABOUR COSTS IN MALTA AND IN THE EURO AREA
(four-quarter moving average indices; 2004 Q4 = 100)



Sources: ECB; Central Bank of Malta estimates.

[25] Compensation per employee is the total remuneration, in cash or in kind, that is payable by employers to employees, i.e. gross wages and salaries, as well as bonuses, overtime payments and employers' social security contributions, divided by the total number of employees.

In the final quarter of 2014, the decline in both the nominal and the real index was arrested. This is largely due to the fact that the euro ceased to depreciate against sterling during this period. Furthermore, the positive differential between inflation in Malta and the euro area started to widen again over the last three months of the year.

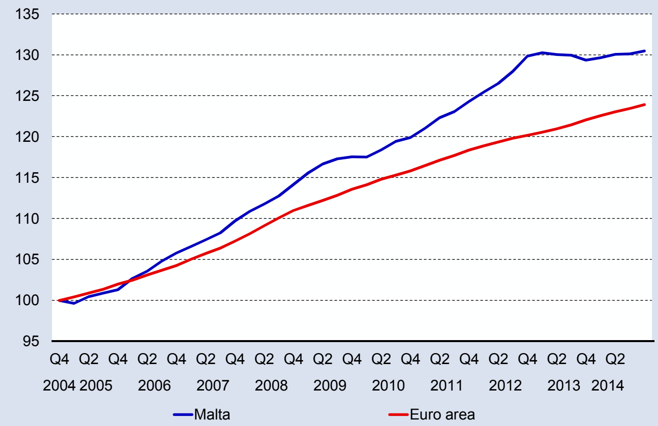
Unit labour costs[26]

Malta's ULC index rose by 1.5% in 2014, up from 1.0% a year earlier (see Chart 3.18). This acceleration in ULC was due to stronger growth in compensation per employee (see Chart 3.19).

In 2014 compensation per employee rose by 0.9%, after having declined by 0.4% in the previous year. With employment outpacing GDP, labour productivity continued to decrease, but did so at a slower rate of 0.6% during the year under review, compared with a drop of 1.4% in 2013 (see Chart 3.20).

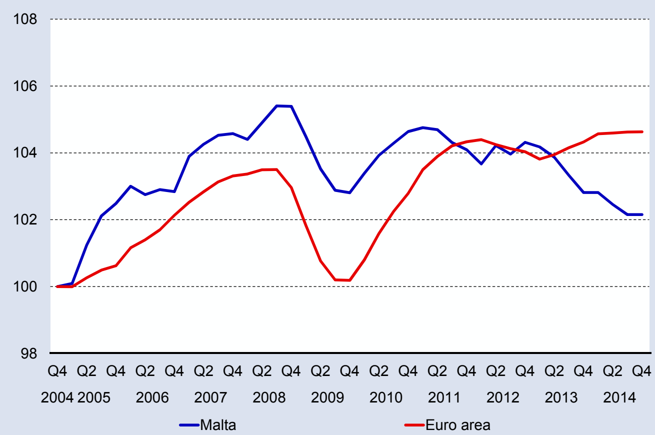
In the euro area ULC increased by 1.2% during 2014, 0.1 percentage point slower than a year earlier. This was the result of a marginal slowdown in compensation per employee to 1.4% from 1.5% in 2013. Meanwhile, labour productivity rose at an unchanged rate of 0.3%.

Chart 3.19
COMPENSATION PER EMPLOYEE IN MALTA AND THE EURO AREA
(four-quarter moving average indices; 2004 Q4 = 100)



Sources: ECB; Central Bank of Malta estimates.

Chart 3.20
PRODUCTIVITY IN MALTA AND THE EURO AREA
(four-quarter moving average indices; 2004 Q4 = 100)



Sources: ECB; Central Bank of Malta estimates.

[26] Unit labour costs capture the labour costs of producing a unit of output. They are measured as the ratio of nominal compensation per employee and labour productivity. The latter is defined as real GDP per person in employment. A drop in ULC indicates an improvement in competitiveness. Unless otherwise indicated, ULC and its components are measured on the basis of a four-quarter moving average to dampen volatility in the data.

BOX 4: STRUCTURAL CHANGES IN THE MALTESE ECONOMY[1]

Since the global recession that took hold around the first decade of this century, Malta registered a more favourable economic performance than most of the other euro area states. It is difficult to reconcile Malta's relatively high rate of economic growth with the openness of a small economy facing a hostile external environment. However, this could partly be explained by the pronounced structural changes that occurred in the Maltese economy in the years preceding the crisis, which, although a continuation of the trends observed in the decades since Independence in the mid-1960s, gave a new impetus to the economy. In fact, they appear to have led to significant divergences from past macroeconomic behaviour.

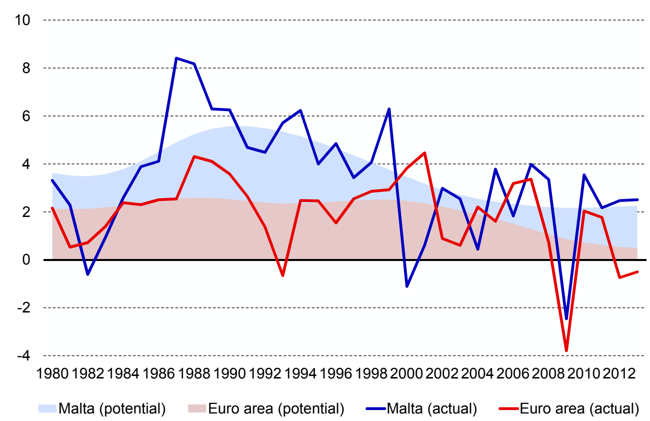
The impact of structural changes on the Maltese economy is harder to discern due to the lack of consistent macroeconomic time series extending to the years before 1995, when the European System of Accounts 1995 was adopted by the NSO.[2] Yet another major change in Malta's macroeconomic statistics was made in 2014, with the adoption of the European System of Accounts 2010.[3] While recognising the fundamental differences between pre- and post-European System of Accounts data, this box utilises both to create a longer time series.[4]

Economic growth and the economy's changing structure

In recent decades Malta's GDP has steadily risen and converged towards that of advanced economies of the European Union. Thus, while in 1980 Malta's GDP per capita stood at just 48.0% of Germany's, by 2013 it had risen to 70.0%.[5]

Chart 1 shows that in the 1980–2000 period the trend in the business cycle in Malta has been similar to that of the euro area.[6] However, growth in most years was higher in Malta than in the euro area. Real GDP grew at an average rate of 5.7%

Chart 1
REAL GDP GROWTH (ACTUAL AND POTENTIAL)
(annual percentage changes)



Sources: EA – New Area Wide Model Database; Malta – pre-1995 SNA spliced data, post-1995 Eurostat ESA 2010; potential – own estimates using HP filter.

---

[1] Prepared by Aaron G. Grech and Sandra Zerafa. Dr Grech is the Head of the Modelling and Research Department at the Central Bank of Malta. Ms Zerafa is a Senior Research Economist in the same department. Any errors, as well as the views expressed in this article, are the authors' sole responsibility. The data for the euro area used here are mostly from the Area Wide Model Database, http://www.eabcn.org/area-wide-model, the World Development Indicators Database, http://data.worldbank.org/data-catalog/world-development-indicators or the Eurostat website, http://ec.europa.eu/eurostat. Data for Malta pre-1995 can be found on the Central Bank of Malta's website, http://www.centralbankmalta.org/real-economy-indicators and in Grech A. G., "Assessing Employment in Malta", available at http://www.centralbankmalta.org/en/working-papers-pre2013. Post-1995 data are Eurostat data.

[2] For a description of these changes see Grech, A. G. and Pace, C., "The Adoption of the European System of Accounts 1995 Framework in the National Accounts of Malta", *Quarterly Review* 2004:2, pp. 55-67.

[3] For a description of these changes see Pace Ross M., Bonello J. and Dimech V., "A New National Accounts Framework", *Quarterly Review* 2014:3, pp. 82-90.

[4] Pre-1995 national accounts data are created by splicing series using previous growth rates. Unemployment data pre-2000 are from Grech, A. G. "Estimating the Output Gap for the Maltese Economy", *MPRA* Paper 33663, 2004.

[5] These estimates are from the latest Penn World Tables available at http://www.rug.nl/research/ggdc/data/pwt/pwt-8.0 and Eurostat.

[6] Use of the term "euro area" in the 1980s and 1990s refers to the 18 European Union countries that made up the euro area as at the end of 2014.

between 1988 and 1995 but slowed down in the second half of the 1990s, although at 4.7% was still higher than in the euro area. The first half of the 2000s marked a significant change of pace in Malta, as economic restructuring ahead of accession to the European Union in 2004 led to a marked slowdown in growth. While the liberalisation of markets and the removal of state aid and subsidies affected traditionally protected sectors, this period also saw the Maltese economy, in particular the electronics industry and the tourism sector, adversely hit by the substantial weakening of global demand, which had followed the bursting of the information technology stock bubble and the aftermath of the September 11 attacks on the United States.

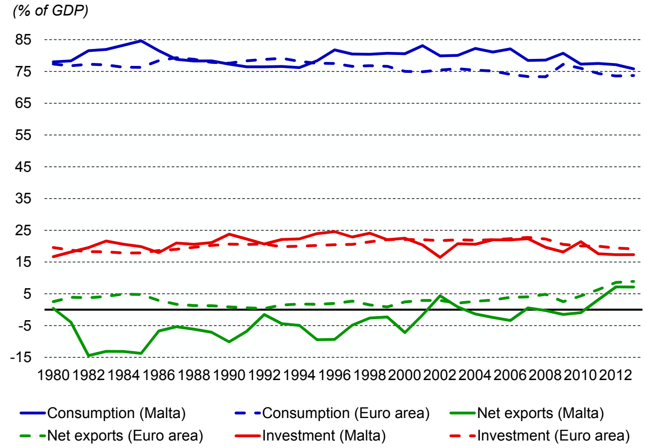
Despite the great recession, Malta's economic outturn remained relatively buoyant, and the gap between Maltese and euro area GDP growth rates started to diverge significantly. While in part this reflects the weak performance of the euro area as a whole, it provides evidence that Malta's potential output is picking up strongly and is no longer following the modest path observed since the early 1990s.

To understand the dynamics behind these developments, one can analyse the great ratios and net export shares of the Maltese economy and the euro area economy as a whole.[7] These confirm that, as expected, the Maltese economy is rather more volatile than the euro area average (see Chart 2). In more detail, with a few exceptions, the sum of private and government consumption has been higher in Malta. In particular, during the 1990s, private consumption was buoyed by rising house prices and the easing of liquidity constraints following the liberalisation of the financial sector.[8] However, in recent years the consumption-to-output ratio has declined and converged with the euro area average. On the other hand, while up to the 2000s the investment ratio in Malta had exceeded the euro area's, during the 2001–04 period it significantly declined.[9] This continued after the great recession.

The main medium-term difference between the Maltese and the euro area economies appears to be the development of the share of net exports of goods and services in GDP. While Malta had deficits of close to 15% of GDP in the early 1980s, the euro area has always been a net exporter. Malta's trade performance has steadily improved since the mid-1980s, but the pace accelerated only since 2006. Thus, Malta has been a net exporter for the last four years, with a net export surplus as a percentage of GDP close to the euro area average.

Chart 3 helps explain why this turnaround occurred. In the early 1990s, similar to the euro area, the share of agricultural output in the

Chart 2
GREAT RATIOS AND NET EXPORT SHARES
(% of GDP)



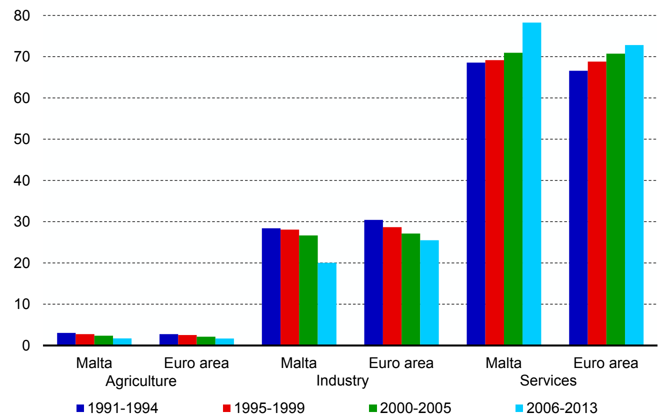
Sources: EA – New Area Wide Model Database; Malta – pre-1995 authors' calculations based on SNA spliced data, post-1995 Eurostat ESA 2010.

7 The great ratios referred to in this section are the consumption-to-output and investment-to-output ratios.

8 Cassar, J. & Cordina, G., "Consumption Expenditure in Malta: Behavioural Trends During the 1990s", *Review,* No 23 Bank of Valletta, Spring 2001.

9 Note, however, that the large decline reported for 2002 was a statistical effect of the national airline selling and leasing back its aircraft, rather than an actual decline in investment.

Chart 3
SECTORAL SHARES
(% of total gross value added)



Sources: EA – pre-2000 World Development Indicators, post-2000 Eurostat ESA 2010; Malta – pre-1995 SNA data, post-1995 Eurostat ESA 2010.

Maltese economy stood at less than 3% of total GVA. By the early 21st century it had halved. The industrial sector in Malta was smaller in the 1990s than in the euro area, accounting for 28.4% of GVA against 30.4% for the latter. However, by the start of the 2000s, robust growth in Malta's industry, away from labour-intensive industries to more skilled and technologically-based manufacturing, contributed to a substantial narrowing of the gap. Subsequently, however, the growth rate of value added in the manufacturing sector started to decelerate: in fact, the value added in the period 2006–13 was just 7.1% higher than in the 2000–05 period, as against a growth rate of 10.3% in the euro area in the same comparative periods. Reflecting this slower rate of growth, the share of industry in total value added declined to around 20% during the period from 2006 to 2013, while it largely held up in the euro area, at around 25%.

In contrast, growth in the services sector in Malta surged ahead. Liberalisation measures, the higher availability of better educated labour resources and a targeted strategy to attract foreign direct investment opened up new service sectors. Besides the traditional areas of tourism, education, health, retailing and banking activities, the services industry expanded to include higher value added activities generated by the financial services sector, specialised forms of tourism – like language schools and dive centres – maritime activity, professional services, back-office administration, information technology and gaming. Thus, over the 2006–13 period, the share of services in total output rose from 75.0% to 81.0% in 2013. In contrast, in 2013 the sector constituted less than 74% of total activity in the euro area, just 2 percentage points higher than in 2006. While the latter had an external services surplus of 1.3% of GDP in 2013, up from 0.5% in 2006, Malta had an 18.8% surplus, up from 13.8% of GDP seven years earlier.

The broader impact of these structural changes

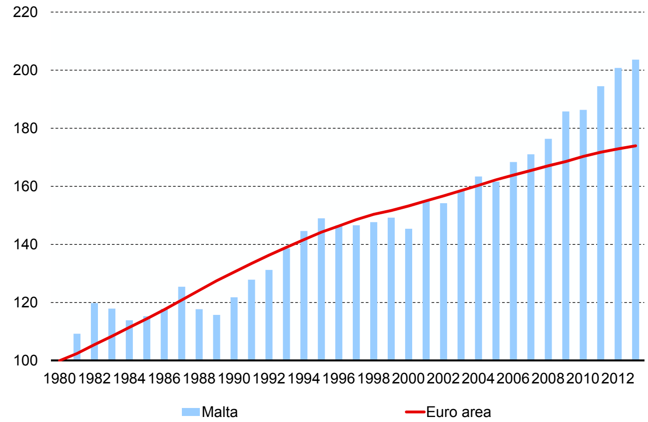
Using an index of ULCs to track Malta's competitiveness, Chart 4 shows that after largely following a similar path to the euro area over the 25 years to 2013, Malta's ULCs have been rising at a much faster rate since 2006.[10] Thus, in 2013 Malta's ULC index and the euro area's as a whole diverged by 17.0%. This development appears to be inconsistent since the relative loss in competition has occurred exactly at the same time that Malta's external position has considerably strengthened, as a result becoming a net exporter in recent years.

The significant shift towards services may be a key explanation for this. For instance, while value added in manufacturing increased by just 9.0% between 2006 and 2013, employment in the sector fell by 14.0%. In contrast, in two sub-sectors of services, namely, professional services and information & communication services, GVA grew much more rapidly, rising by 75.1% between 2006 and 2013, while employment increased by 47.0%. As a result, while GVA in these two sub-sectors

[10] ULCs measure the cost of labour compensation per unit of GVA produced. Typically, rising ULCs, particularly if increasing more than competitor countries, are seen as a worrying signal of a loss of competitiveness.

was equivalent to just 75.0% of the manufacturing sector's in 2006, by 2013, these had a GVA which was equivalent to 115% of manufacturing. The service sector, by its very nature, tends to be characterised by lower labour productivity levels than in manufacturing. This reflects the fact that while manufacturing became increasingly less labour intensive and moved towards automation in production, services, despite more automation and computerisation, remain dependent on a higher level of labour input. The rapid expansion of services in Malta and their higher contribution to GDP therefore have tended to raise ULCs for the Maltese economy as a whole.

Chart 4
UNIT LABOUR COSTS
(1980 = 100)

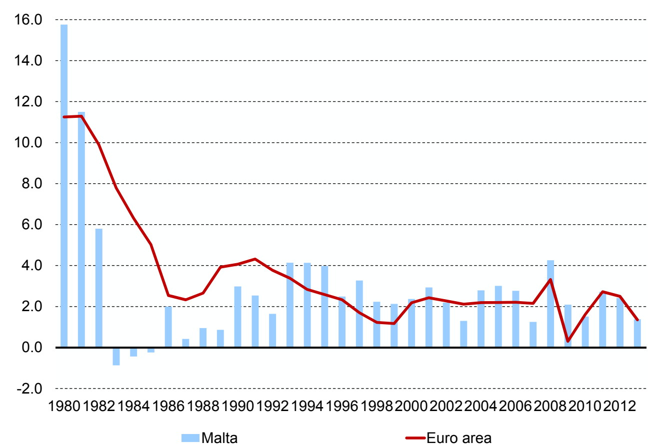


Sources: EA – New Area Wide Model Database; Malta – pre-1995 SNA, post-1995 Eurostat ESA 2010.

An increase in a country's ULCs relative to those of its trading partner countries is likely to be reflected in a higher rate of inflation. However, as can be seen from Chart 5, in the case of Malta there is no evidence of this. In fact, in contrast with developments in ULCs vis-à-vis its euro area trading partners, retail price movements in Malta have been contained, and in fact the local rate of inflation has tended to converge with the euro area's over the past couple of years.

In the early 1980s, Malta's rate of inflation was higher than in the euro area, but wage and price controls, coupled with a sharp recession, resulted in a short bout of deflation. In the 1990s inflation picked up in the wake of a 10.0% devaluation of the Maltese currency in 1992 that was triggered by the crisis in the European Exchange Rate Mechanism. The introduction of wage indexation at the same time may have resulted in the anchoring of inflation to a slightly higher rate than previously, though it is more likely that the higher inflation rate in the 1990s and early 2000s may have reflected the significant pace of economic growth and the associated pressures on wages. After a spike in the related price index, owing to a surge in international energy and food prices in 2008, inflation moderated in the subsequent years both in Malta and the euro area. Since 2010, there has been practically no divergence

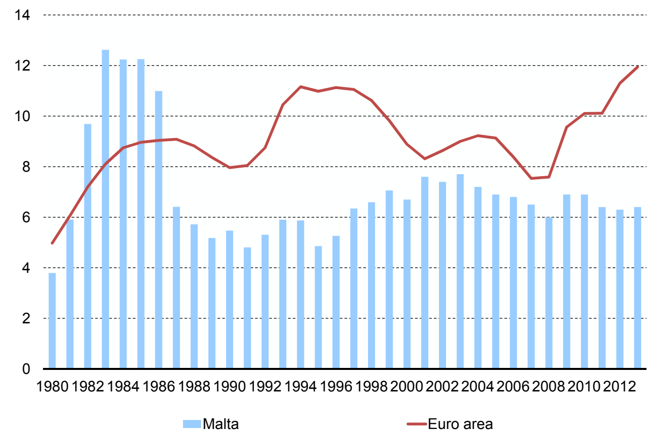
Chart 5
INFLATION RATE
(moving average % change)



Sources: EA – HICP – New Area Wide Model Database; Malta – RPI.

between Malta's retail price inflation and euro area inflation, as against a differential of 0.4 percentage point in the preceding decade.

Chart 6
UNEMPLOYMENT RATE
(% of labour force)



Sources: EA – New Area Wide Model Database; Malta – pre-2000 Grech (2004), post-2000 Eurostat.

Whereas inflation has converged to the euro area average, labour market developments in Malta have notably contrasted with those of the euro area (see Chart 6). Up to the mid-1980s, unemployment in Malta was particularly high and even exceeded the euro area's. The economic growth of the late 1980s, together with a sharp rise in public employment, helped reduce Malta's unemployment rate to well below the level in the euro area. The divergence continued to widen in the 1990s, but narrowed significantly in the early 2000s as the unemployment rate in Malta rose in response to the restructuring of the Maltese economy that was taking place ahead of EU accession. In the aftermath of the great recession, unemployment across most of the euro area increased sharply. In contrast, the Maltese labour market remained resilient, with the unemployment rate declining even though labour participation rates rose sharply.[11] While government assistance to manufacturing and tourism helped to cushion the labour market from the effects of the recession, the diversification to service activities helped to strengthen the economy, notwithstanding the adverse economic and financial conditions surrounding it. The sectors that raised the demand for labour were the new service sectors, which, due to their very nature, were able to offer flexible conditions that attracted new entrants into the labour market.[12] In fact, participation rates increased from 57.9% of the labour force in 2006 to 65.0% in 2013.

Conclusion

The structural changes in the Maltese economy are leading to a higher utilisation of labour resources and to a much improved position on the external account. Despite the investment ratio remaining well below its historical average, potential output growth appears to be rising again and the inflation differential with the euro area has virtually disappeared, while the rate of economic growth has persistently exceeded the euro area's as a whole. For this benign scenario to continue, policymakers need to buttress their policies to improve labour skills and encourage more participation in the labour market, while supporting growth and competition across all sectors of the economy.

[11] See Micallef, B. "Labour Market Resilience in Malta", *Quarterly Review* 2013:1, pp. 41-46.

[12] For example, administrative records suggest that the number of persons employed in "gambling and betting activities" has been growing by an annual average rate of 14.7% since 2009.

BOX 5: ECONOMIC PROJECTIONS FOR 2015 AND 2016

Outlook for the Maltese economy[1]

The Bank's latest macroeconomic projections indicate that after the strong expansion of 2014, the Maltese economy will continue to grow at a fast pace in 2015 and slow down slightly in 2016. Thus, in 2015, real GDP growth is expected to remain almost unchanged from the 3.5% recorded in 2014, at 3.4%, before easing to 2.8% in 2016 (see Table 1).

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA(1)

	2013	2014	2015(2)	2016(2)
Real economic activity (% change)				
GDP	2.7	3.5	3.4	2.8
Private consumption expenditure	1.6	3.4	3.2	3.0
Government consumption expenditure	-0.2	7.3	0.9	3.6
Gross fixed capital formation	2.7	14.0	8.5	3.9
Exports of goods & services	-1.0	-0.2	2.9	3.3
Imports of goods & services	-1.1	0.1	3.2	3.7
Contribution to real GDP growth (in percentage pts)(3)				
Final domestic demand	1.3	5.7	3.5	3.1
Net exports	0.1	-0.5	-0.2	-0.4
Changes in inventories	1.3	-1.7	0.0	0.0
Real disposable household income(3)	2.6	4.2	2.7	2.6
Household saving ratio(3)	9.3	10.1	9.6	9.2
Balance of payments (% of GDP)				
Goods and services balance	5.5	6.0	6.0	5.8
Current account balance	3.1	2.7	2.7	2.5
Labour market (% change)				
Total employment	4.2	4.2	2.1	1.8
Unemployment rate (% of labour force)(4)	6.3	5.8	5.8	5.9
Prices and costs (% change)				
RPI	1.4	0.3	0.6	1.4
Overall HICP	1.0	0.8	1.2	1.9
HICP excluding energy	1.1	1.5	1.7	1.9
Compensation per employee	-0.4	0.9	1.5	2.4
ULC	1.0	1.5	0.3	1.4
Public finances (% of GDP)(4)				
General government balance	-2.7	-2.2	-1.8	-1.6
General government debt	69.2	68.4	67.3	65.9
Technical assumptions				
EUR/USD exchange rate	1.33	1.33	1.14	1.13
Oil price (USD per barrel)	108.8	99.3	58.5	66.8

(1) Data on GDP were sourced from NSO *News Release* 046/2015 published on 9 March 2015. Data on the current account balance were sourced from NSO *News Release* 054/2015.
(2) Central Bank of Malta projections.
(3) Data for 2013 and 2014 are Central Bank of Malta estimates.
(4) Data for 2014 are Central Bank of Malta estimates.

[1] The Bank's outlook for the Maltese economy is based on information available up to 18 March 2015 and is conditional on the technical assumptions shown in Table 1.

The outcome for real GDP growth in 2014 was higher than the Bank's previous projections. Consequently, the Bank has revised upwards its earlier forecast of 2.8% for 2015, by 0.6 percentage point.[2]

This upward revision in 2015 is largely driven by the carry-over impact of higher than expected growth in private consumption and investment in 2014. Additionally, the Bank has revised upwards its assumptions regarding investment related to the energy projects. Previously, it only took into account part of the allocated expenditure for the projects involved. Moreover, the Bank anticipates slightly higher government consumption, whereas previously it had expected it to decline. Thus, the contribution of domestic demand to GDP growth is now expected to be greater compared with the previous exercise. Meanwhile, the contribution of net exports to real GDP growth is expected to remain negative and of a similar magnitude to that foreseen in December, as imports are expected to continue outpacing exports.

Domestic demand

The Bank expects economic growth in 2015 and 2016 to be driven by domestic demand, particularly private consumption and private investment. Government consumption is also expected to support activity over the forecast horizon, though its contribution is expected to be smaller than that of private activity. However, government investment is set to decline in 2015 following the substantial increase recorded in 2014, and to contract further in 2016. Net exports, which lowered GDP growth in 2014, are seen to retain their negative contribution in both 2015 and 2016. Although exports are set to recover, these are projected to be outpaced by imports, which are expected to be boosted by investment goods. Changes in inventories, which include the statistical discrepancy, are assumed to have a neutral impact on growth.

While private consumption is projected to continue expanding, its rate of growth is expected to decelerate slightly from 3.4% in 2014 to 3.2% in 2015, and to 3.0% in 2016. This slower rate of growth is consistent with developments in disposable income, which is projected to register more modest growth compared with 2014.[3] However, private consumption is expected to be supported by a reduction in the household savings ratio, after the latter is estimated to have reached a relatively high level in 2014, on the back of a strong increase in income.

A similar trend is expected to be followed by government consumption. Its rate of expansion is set to moderate substantially in 2015 and 2016, largely on presumed controls on recruitment into the public service following two years of strong expansion in government employment. In consequence, outlays on compensation of employees and on intermediate consumption are expected to grow at a progressively weaker pace in 2015 and 2016. Growth in these two items of expenditure, moreover, should be partly offset by revenue derived from the Individual Investor Programme, which is netted from government consumption.[4] As a result, real government consumption is forecast to grow by a modest 0.9% in 2015 before accelerating to 3.6% in 2016.

Compared with 2014, gross fixed capital formation is set to expand at a much lower rate in 2015 and 2016. This downward trend in the growth rate partly reflects developments in government investment, as the latter is expected to decline from the exceptionally high level recorded in 2014. In 2016, moreover, private investment growth is expected to moderate, as most of the expenditure on energy-related projects is projected to be incurred in 2015.

After the surge in government investment that took place in 2014, mostly in connection with EU-funded infrastructural projects, a drop is expected in 2015 since most of these projects are now nearing

[2] See *Quarterly Review* 2014:3, Central Bank of Malta, pp. 77-81.
[3] Disposable income is estimated by the Central Bank of Malta.
[4] This Programme allows non-Maltese high net worth individuals to obtain Maltese citizenship against a number of conditions. These include the payment of a registration fee and the purchase (or rental) of residential property in Malta.

completion. Government investment is set to decline again in 2016, as past experience suggests that the take-up of EU Funds under the 2014−20 Programme will initially be low.

In contrast, private investment growth is set to accelerate from 8.8% in 2014 to 12.8% in 2015, before moderating to 7.1% in 2016. A major project underpinning private capital expenditure over the forecast horizon is the new gas-fired power plant, which will have a considerable impact on investment in both equipment and non-residential construction. However, as the gas-fired power plant comes on stream in 2016, the overall annual growth rate of private investment is expected to slow down that year. Private investment is also expected to be supported by government measures, such as the easing of restrictions on hotel heights. Meanwhile, the Eurosystem's recently-announced expanded asset-purchase programme should have a positive impact on investment in construction.

With regard to private dwelling investment, this is expected to recover in 2015 and keep growing in 2016, supported by a streamlining of MEPA procedures relating to the issue of development permits and by a surge in the number of permits that were granted in the last few months of 2014. Investment in dwellings should also benefit from an accommodative monetary policy stance and demand for high-end property from participants in the Individual Investor Programme. Other investment, which mainly relates to IT development, is set to support private investment growth over the forecast horizon, spurred by the launch of a number of government strategies in e-commerce, the digital economy and e-gaming.

Net exports

After having contracted by 0.2% in 2014, exports are set to grow by 2.9% in 2015, partly on account of an expected recovery in the semiconductor industry. Export growth is set to reach 3.3% in 2016, as exports of other goods also respond to improving foreign demand conditions. In addition, during the forecast horizon, export growth is also expected to be supported by developments in services. Service exports are expected to grow strongly in response to higher flows of inward tourist traffic, partly through the addition of new airline routes and an expansion in bed capacity. Other service exports, including financial and professional services, as well as personal services, are set to grow moderately. Service exports should also be boosted by inflows related to the Individual Investor Programme.

Largely mirroring developments in exports, imports are also set to recover strongly in 2015, and grow at an even faster pace in the following year. However, imports of capital goods, predominantly related to the purchase of machinery for the gas-fired energy plants, are also set to drive the expansion.

As a result, the contribution of net exports to GDP growth is set to remain negative in both 2015 and 2016.

The balance of payments

In 2015 the surplus on external trade in goods and services is expected to remain broadly stable at 6.0% of GDP, as a widening in the merchandise trade balance is broadly offset by an increasing surplus on services. The low oil price, that is assumed to prevail over the projection horizon, is expected to have a positive effect on the balance of trade in goods. However, this is expected to be offset by the substantial increase in import volumes mainly related to investment and production of exports.

The trade surplus-to-GDP ratio is set to narrow to 5.8% in 2016, as a further deterioration in the goods balance outweighs additional improvement in the services balance.[5]

[5] Data on the trade balance used in this Box are consistent with NSO *News Release* 046/2015 and with projections for real exports and imports reported in Table 1. The current account projections are based on balance of payments data published in NSO *News Release* 054/2015.

Consequently, the current account balance is projected to remain in surplus over the forecast period, though it is also expected to decline slightly as a share of GDP, in line with developments in the trade balance, ending 2016 at 2.5%.

The labour market

Following strong increases in both 2013 and 2014, employment growth is set to moderate in both the private and government sector in 2015 and 2016. Slower growth in private sector employment should enable the sector to reverse the downward trend in productivity. In the government sector, a decline in employment growth is consistent with the Government's policy of restricting employment in the sector.

The unemployment rate is set to remain at 5.8% in 2015. In 2016, however, it is expected to rise marginally, as GDP growth slows down. Nonetheless, at 5.9%, it is set to remain low from a historical perspective.[6]

In 2014 compensation per employee rose by 0.9%, as a drop in the private sector component partly offset an increase in average compensation levels in the government sector. Growth in compensation per employee is set to accelerate to 1.5% in 2015 and further to 2.4% in 2016. This reflects expected productivity gains in the private sector in 2015 and 2016. In fact, after having declined in 2013 and 2014, productivity is set to recover in 2015, when it is expected to grow by 1.2%. In 2016 it is expected to decelerate to 1.0%, as GDP growth moderates.

Reflecting these developments, and also given the gradual pick-up of consumer price inflation over the forecast horizon, private sector employees are expected to demand higher wage increases, particularly in the services sector, which is set to remain the major driver of economic activity.

ULCs increased by 1.5% in 2014, as compensation per employee rose, while productivity declined. In 2015 ULCs are set to rise further, as compensation per employee continues to outpace the recovery in productivity. The accelerating pace is expected to become more pronounced in 2016 as compensation per employee rises more strongly and offsets the increase in productivity in that year. Thus, ULC growth is forecast to stand at 1.4% in 2016.

Fiscal developments

The Bank estimates the general government deficit-to-GDP ratio at 2.2% in 2014, as increased outlays on compensation of employees and on intermediate consumption were offset by substantially lower capital transfers to the national airline and a significant rise in revenue, partly as a result of intakes under the Investment Registration Scheme.

The deficit ratio is set to narrow further in 2015 and 2016 to 1.8% and 1.6%, respectively.

The decline in 2015 mainly reflects expectations that expenditure on wages and intermediate consumption will moderate following the very strong rise in 2014. At the same time, further revenue intakes from the Individual Investor Programme should compensate for the increases in these categories of expenditure. The drop in the deficit ratio in 2015 is also supported by increased tax revenue, reflecting strong growth in private consumption, as well as higher excise duties announced in the Budget 2015.[7] The deficit ratio is set to decrease further in 2016, reflecting continued restraint in expenditure.

---

[6] In the Bank's projection exercise, the unemployment rate is computed as the ratio of the number of unemployed reported in the LFS to a measure of the labour force based on the LFS and national accounts data. For this reason, references to the unemployment rate in this Box may differ from those mentioned elsewhere in this *Report*.

[7] The Bank's fiscal projections may differ from those of Government due to variances in the underlying macroeconomic projections and different assessments about the impact of fiscal measures.

General government debt is estimated to have fallen to 69.2% of GDP in 2014. It is set to decline further over the projection horizon, reaching 65.9% by 2016.

Prices

The inflation projections are influenced by the technical assumptions shown in Table 1, more specifically a notable decline in the price of oil in 2015 and a simultaneous weakening of the exchange rate of the euro against the dollar. With the latter expected to remain broadly unchanged in 2016, and oil prices in USD increasing, the oil price in euro terms is expected to register an increase in that year.

Overall, the effect of the drop in oil prices in 2015 is offset by the impact of a weaker euro and other domestic factors that are expected to push up a number of price indices. Thus, the annual average rate of inflation, measured by the HICP is expected to accelerate from 0.8% in 2014 to 1.2% in 2015 and 1.9% in 2016.

The acceleration in HICP inflation in 2015 reflects the Bank's expectation that unprocessed food prices, which had fallen in 2014, continue the recovery evident since the last quarter of that year. Services are also expected to have an upward impact on the overall price index, largely reflecting projected developments in the prices charged by restaurants and hotels in the context of a buoyant tourist sector. At the same time, the negative trend in energy price inflation is set to be less pronounced compared with 2014, as the effect of the cut in household electricity tariffs of April 2014 drops out of the annual inflation rate.

A further pick-up in inflation is expected in 2016 as prices of food, services and energy show more buoyancy. Energy inflation is projected to turn positive as electricity tariffs remain unchanged and oil prices start to increase after reaching a trough in 2015. Services inflation is set to accelerate, partly in response to an expected strong performance in the tourist sector.

Compared with the Bank's earlier projections, the latest inflation outlook entails a slight downward revision for 2015, as the lower path for oil prices is partly counterbalanced by a faster than expected acceleration in food and service prices.

Risks to the projections

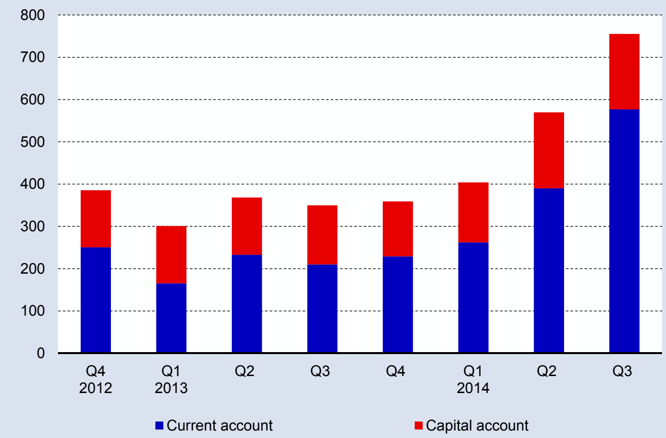
Risks to the GDP growth projections are balanced. Downside risks relate to the fragility of the global economic recovery and its implications for external demand. Exports could also be lower than expected if the envisaged recovery in the semiconductor industry does not materialise. On the other hand, a further weakening of the euro compared with baseline assumptions would have a positive impact on exports. The rapid implementation of the EU Investment Plan represents another upside risk. GDP growth could also surprise on the upside if the assumed restraint in government expenditure does not materialise.

Risks to the inflation projections are also balanced. On the one hand, a prolongation of the currently weak inflation environment in Malta's main trading partners could translate into lower import prices that, in turn, will have a dampening effect on consumer prices domestically. Inflation would also be lower than expected, if domestic fuel prices were to fall further in response to earlier declines in international oil prices. On the other hand, a further weakening of the euro, or a sharper than expected rebound in international commodity prices, could result in higher inflation in Malta.

4. BALANCE OF PAYMENTS[1]

In the four quarters to September 2014, the current account of the balance of payments recorded a surplus equivalent to 7.3% of gross domestic product (GDP), 4.5 percentage points higher than in the 12-month period to September 2013 (see Chart 4.1). The increased surplus was attributable to favourable developments in all the main components of the current account. Higher net inflows were also recorded on the capital account.

Chart 4.1
CURRENT AND CAPITAL ACCOUNT BALANCES
(four-quarter moving sums in EUR millions)



Source: NSO.

Meanwhile, the financial account balance moved from a net borrowing position to a net lending one, equivalent to 5.4% of GDP.[2] At the same time, net errors and omissions remained negative, but lower than in the four quarters to September 2013.[3]

The current account

In the year to September 2014, the current account surplus expanded by €366.7 million, to stand at €576.8 million (see Table 4.1). This improvement was mainly attributable to lower net outflows on the income

Table 4.1
BALANCE OF PAYMENTS
EUR millions

	2011	2012	2013	Four-quarter moving sums 2013 Q3	Four-quarter moving sums 2014 Q3
Current account	**22.7**	**250.5**	**229.1**	**210.0**	**576.8**
Goods	-1,207.8	-1,108.4	-1,098.1	-1,082.8	-994.3
Services	1,411.1	1,631.2	1,640.2	1,619.0	1,669.7
Primary income	-267.2	-378.3	-447.0	-459.4	-277.5
Secondary income	86.6	105.9	134.0	133.2	178.9
Capital account	**81.6**	**134.9**	**129.9**	**139.8**	**178.6**
Financial account	**398.2**	**881.7**	**-608.6**	**-285.0**	**423.0**
Direct investment	-11,553.7	-8,843.7	-7,213.6	-9,120.3	-4,373.3
Portfolio investment	11,484.2	9,317.9	8,903.0	11,474.8	9,762.5
Financial derivatives	-246.7	-438.5	-99.8	-342.3	-484.2
Other investment	767.2	724.6	-2,159.3	-2,236.8	-4,686.5
Reserve assets	-52.9	121.4	-38.8	-60.3	204.4
Errors and omissions	293.9	496.3	-967.6	-634.8	-332.3

Source: NSO.

[1] This analysis is based on balance of payments data issued by the National Statistics Office (NSO) in accordance with the guidelines contained in the Sixth Edition of the International Monetary Fund's Balance of Payments (BOP) and International Investment Position (IIP) Manual (BPM6). The most notable difference resulting from these guidelines compared with those of the Fifth Edition relates to the inclusion of data pertaining to Special Purpose Entities (SPE) and to a new treatment of international banks. From a local perspective, the inclusion of SPEs in external data raises the value of both service exports and imports, and also has an impact on the primary income account. For further information on the new methodology see NSO *Release* 176/2014.

[2] Following the adoption of BPM6, increases in assets are not recorded with a negative sign and increases in liabilities are not recorded with a positive sign. Both increases are recorded with a positive sign. Decreases in assets and liabilities are both recorded with a negative sign.

[3] Negative net errors and omissions imply an overestimation of the current and capital account surplus and/or the value of net increases of assets on the financial account is too low.

components. Nonetheless, a narrowing of the merchandise trade gap and an increase in net receipts on services also contributed (see Chart 4.2).

Goods

Balance of payments data on the goods account show that in the four quarters to September 2014, both exports and imports contracted over the corresponding months of the previous year.[4] However, as imports fell by €298.8 million, whilst exports dropped by €210.4 million, the merchandise trade gap narrowed by €88.5 million, or 8.2%, to €994.3 million (see Chart 4.3).

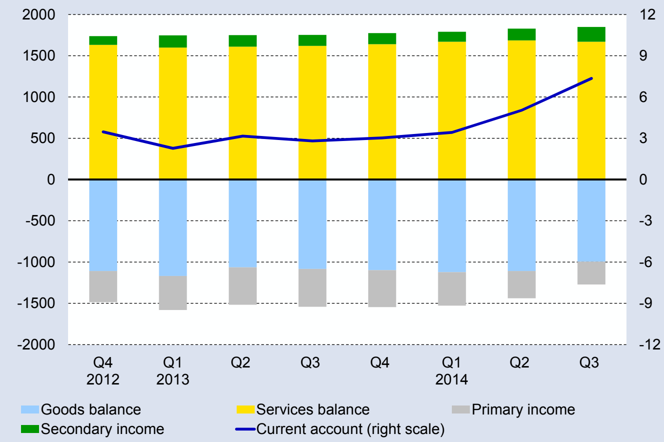
Merchandise trade developments based on customs data for 2014 are explained in detail in Box 6 below.

Services

Over the 12-month period under review, the surplus position on the services account reached €1,669.7 million, an increase of €50.6 million, or 3.1%, on a year earlier. The higher surplus reflected a surge of €100.0 million in receipts, which was offset by a €49.4 million increase in payments.

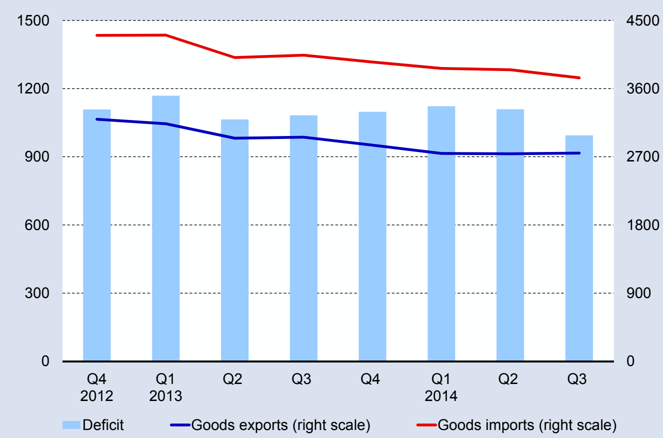
Higher net receipts on services continued to be strongly influenced by the buoyancy in the tourism sector, as the net surplus on travel rose by €68.0 million to €827.1 million (see Chart 4.4). This arose as tourism receipts continued to outpace spending by Maltese residents travelling abroad. At the same time, increased net exports were also registered on the "other services" component. Net receipts on such services amounted to €947.4 million in the year to September 2014, up by €44.1 million on the corresponding period of 2013. This amelioration was driven by higher net receipts

Chart 4.2
COMPOSITION OF CURRENT ACCOUNT
(four-quarter moving sums in EUR millions; as a percentage of GDP)



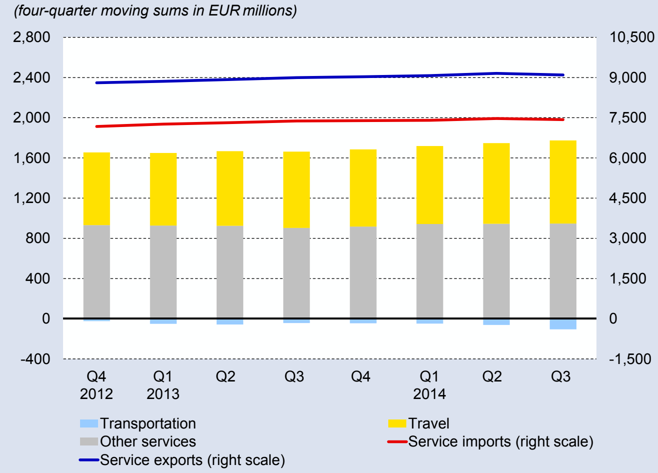
Source: NSO.

Chart 4.3
GOODS DEFICIT
(four-quarter moving sums in EUR millions)



Source: NSO.

Chart 4.4
SERVICES BALANCE
(four-quarter moving sums in EUR millions)



Source: NSO.

[4] In the compilation of balance of payments statistics, customs data on merchandise trade are adjusted for coverage, valuation and timing. During the period reviewed, these methodological differences were especially pronounced with regard to trade in fuel, as well as imports of capital goods, mainly related to the registration of boats and aircraft.

from remote gaming, telecommunications and insurance services. Conversely, net inflows from financial services contracted when compared with a year earlier.

The favourable developments in travel and "other services" were partly dampened by a rise in net transport payments. Net outflows on the latter climbed to €104.8 million, €61.5 million more than in the previous 12 months. This was mainly driven by a rise in payments, albeit a drop in transport receipts also contributed.

BOX 6: MERCHANDISE TRADE DEVELOPMENTS IN 2014

Customs data show that in 2014 the visible trade gap widened markedly, expanding by 47.4% to stand at €2,595.6 million, as imports increased whilst exports fell (see Table 1). Purchases and sales of fuels continued to heavily influence merchandise trade developments, particularly imports (see Table 2).[1]

Between January and December 2014, the value of imported goods climbed to €6,314.3 million, up by 11.1% on a year earlier. The increase was primarily driven by a surge in foreign purchases of capital goods and fuels. The rise of €422.5 million in the former category was mostly attributable to new registrations of aircraft and ships. Fuel imports climbed by €325.3 million. Meanwhile, consumer goods imports also advanced, although the increase was much more moderate, amounting to €42.6 million. Higher purchases of durable goods accounted for around half of the increase, with the rest broadly split between food and beverages, and other consumer goods categories. On the other hand, industrial supplies contracted by over a tenth from their 2013 level, mainly driven by a fall in semi-finished imports, predominantly electronic components.

In the year under review the value of exports fell by €206.7 million, or 5.3% over 2013. All major export categories, except chemicals, recorded declines when compared with 2013. The largest drop was recorded in the machinery & transport category, which includes semiconductors. Exports in this category fell by €124.1 million on 2013, thereby being responsible for 60.0% of the drop in

Table 1
MERCHANDISE TRADE BY BROAD ECONOMIC CATEGORY
EUR millions; annual percentage changes

	2012(1)	2013(1)	2014(1)	2013	2014
		Amount		%	
Imports	**6,187.5**	**5,685.8**	**6,314.3**	**-8.1**	**11.1**
Industrial supplies	1,565.0	1,549.6	1,387.6	-1.0	-10.5
Capital goods & others	811.0	868.6	1,291.2	7.1	48.6
Consumer goods	1,023.3	1,037.9	1,080.6	1.4	4.1
Fuel & lubricants	2,788.3	2,229.7	2,555.0	-20.0	14.6
Exports	**4,438.8**	**3,925.4**	**3,718.7**	**-11.6**	**-5.3**
Trade deficit	**-1,748.7**	**-1,760.4**	**-2,595.6**	**0.7**	**47.4**

(1) Provisional.
Source: NSO.

[1] Customs data tend to show higher values for imports and exports than BOP data for comparable commodity groups. In particular, the former record the physical entry into, and the corresponding exit from Maltese territory of all goods, whereas BOP data only capture transactions that entail a change of ownership between residents and non-residents. These differences are especially pronounced in the case of trade in fuel, aircraft and ships.

Table 2
MERCHANDISE TRADE BY MAJOR COMMODITY GROUP
EUR millions; annual percentage changes

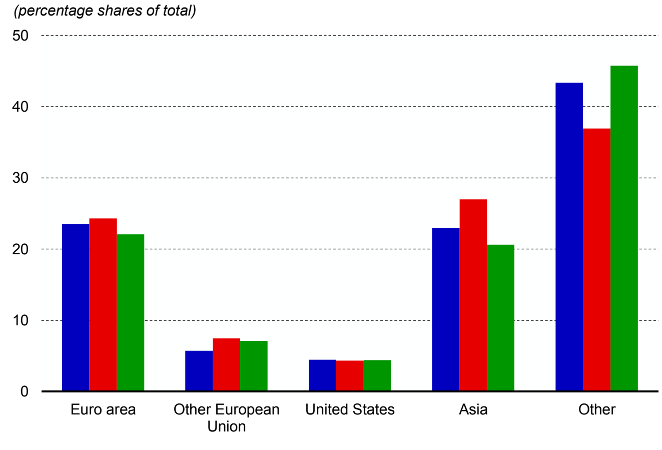
	2012[1]	2013[1]	2014[1]	2013	2014
Imports	**6,187.5**	**5,685.8**	**6,314.3**	**-8.1**	**11.1**
Food, beverages and tobacco	585.8	577.0	583.1	-1.5	1.1
Mineral fuels, lubricants & related materials	2,791.3	2,235.8	2,556.0	-19.9	14.3
Chemicals	447.5	439.9	496.9	-1.7	13.0
Semi-manufactured goods	318.5	310.9	331.1	-2.4	6.5
Machinery & transport equipment	1,567.8	1,668.0	1,897.9	6.4	13.8
Miscellaneous manufactured articles	408.9	398.5	404.9	-2.5	1.6
Others	67.7	55.8	44.5	-17.6	-20.3
Exports	**4,438.8**	**3,925.4**	**3,718.7**	**-11.6**	**-5.3**
Food, beverages and tobacco	227.2	248.0	243.0	9.1	-2.0
Mineral fuels, lubricants & related materials	2,010.8	1,665.7	1,608.2	-17.2	-3.4
Chemicals	321.4	358.1	376.3	11.4	5.1
Semi-manufactured goods	126.5	117.8	113.4	-6.9	-3.7
Machinery & transport equipment	1,322.2	1,112.4	988.3	-15.9	-11.2
Miscellaneous manufactured articles	400.9	404.5	372.1	0.9	-8.0
Others	29.8	19.1	17.5	-36.0	-8.3

[1] Provisional.
Source: NSO.

merchandise exports. A less significant drop was recorded in fuel re-exports, which contracted by €57.5 million on a year earlier (see Table 2). A number of other export categories, including pharmaceuticals, also declined, although to a lesser extent. Conversely, exports of organic chemicals rose substantially when compared with 2013.

Exports to the European Union declined by €160.2 million in 2014, whereas imports contracted by €150.7 million. Nonetheless, the European Union remained Malta's major trading partner during the year under review, accounting for 29.2% of merchandise exports and 49.7% of total goods imported (see Charts 1 and 2). When compared with 2013, the European Union's share in exports dropped by 2.5 percentage points whereas its share in imports contracted by 8.1 percentage points. Meanwhile exports to the euro area accounted for 22.1% of total exports, down from 24.3% in the previous year. The share of imports was also lower, standing at 38.9% compared with 47.2% in 2013. This was largely driven by lower purchases from Italy and France, although a marginal drop in imports from Germany also contributed. Consequently, whilst Italy remained Malta's main source of imports, its share

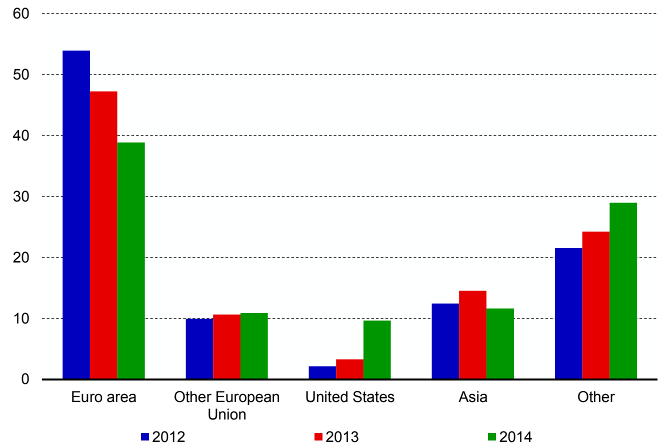
Chart 1
DIRECTION OF EXPORTS
(percentage shares of total)



Source: NSO.

declined from 24.8% in 2013 to 18.1% in 2014. At the same time, although Germany and France remained Malta's prime export markets, exports to these countries dropped when compared with a year earlier. As a result, the share of these two countries in total exports contracted by 1.8 percentage points to 13.5%. Outside the euro area, the United Kingdom was Malta's largest EU trading partner, with imports increasing by more than a fifth during 2014, but exports decreasing by 10%.

Chart 2
DIRECTION OF IMPORTS
(percentage shares of total)



Source: NSO.

Trade with Asian markets also fell when compared with 2013. Their share in aggregate imports and exports dwindled to 11.6% and 20.6%, respectively, as both imports and exports registered a fall in 2014. The drop in merchandise exports to Asian markets was predominantly driven by lower sales of electronic components to Singapore and Japan.

Exports to the United States remained broadly unchanged during the year, while the value of imports more than trebled when compared with 2013. The latter was largely driven by a surge in the registration of ships and aircraft. Merchandise exports to "other" markets were primarily dominated by the African market, mainly reflecting a surge in re-exports of fuel to North African countries. On the import side, a rise in imports from "other" markets mainly reflected new registrations of yachts from Australia and Oceania.

Primary income account

In the primary income account inflows and outflows were heavily influenced by activities of SPEs and internationally-oriented firms, including banks, which predominantly engage in financial operations with non-residents. During the 12 months to September 2014, net outflows on this account contracted by €181.9 million compared with the same period a year earlier, to stand at €277.5 million. This was largely driven by a decline in income payments related to direct investment of foreign firms operating in Malta. At the same time, higher net earnings on portfolio investment abroad also contributed. These movements were partly offset by a drop in net interest earnings on outstanding loans to non-residents.

Secondary income account

Over the period under review, net inward flows on the secondary income account increased to €178.9 million as opposed to €133.1 million in the 12 months to September 2013. This rise was predominantly due to higher net government receipts, which continued to be heavily influenced by timing differences between tax receipts and refunds related to companies engaged in international business.

The capital account

In the year to September 2014, the capital account recorded net inward flows of €178.6 million, an increase of €38.8 million on a year earlier (see Table 4.1). The expansion in net inflows was mostly attributable to bigger transfers related to EU funds.

The financial account

Meanwhile, the financial account turned from a net borrowing position of €285.0 million in the 12 months to September 2013 to a net lending position of €423.0 million. Movements on this account were heavily influenced by transactions of internationally-oriented banks and SPEs.

Developments on the financial account during the period surveyed were primarily driven by a substantial fall in net direct investment liabilities, which were down by around €4.7 billion on a year earlier. This largely followed a sharp contraction in the equity position of an international bank. The switch to a net lending position was also influenced by an expansion of €204.4 million in reserve assets as opposed to a contraction of €60.4 million in the same period ending September 2013. Movements on the direct investment account and reserve assets were in part offset by marked declines in "other" investment and, to a lesser extent, in portfolio investment assets in the form of debt securities held by the banking sector. At the same time, net liabilities relating to financial derivatives increased on a year earlier.

International investment position

Malta's net creditor position vis-à-vis the rest of the world as at end-June 2014 expanded notably on a year earlier.[5] Data on the IIP show that Maltese residents' holdings of external financial assets climbed to €212.9 billion, up by €4.5 billion. At the same time their liabilities rose by €3.8 billion on the June 2013 level to €210.5 billion; thus, at end-June 2014, Malta's net external asset position stood at €2.4 billion, an increase of €0.7 billion from a year earlier (see Table 4.2).

The improvement in the net external balance partly reflected developments on the financial account. However, favourable market valuation changes and exchange rate movements also contributed.

In the year to June 2014, net portfolio investment assets increased substantially, reflecting higher holdings of foreign equity and long-term debt securities. In addition, albeit to a lesser extent, a rise in financial derivatives and reserve assets also contributed. These positive developments were partly offset by a decline in net "other investment" assets, predominantly in the form of loans, as well as an increase in net direct investment liabilities.

Table 4.2
INTERNATIONAL INVESTMENT POSITION
End-of-month position; EUR millions

	2012 June	2012 Dec.	2013 June	2013 Dec.	2014 June
Net international investment position	**1,797.9**	**1,753.5**	**1,739.9**	**1,964.0**	**2,438.7**
Total assets	**201,632.2**	**204,162.6**	**208,395.7**	**208,259.9**	**212,895.0**
Direct investment abroad	53796.0	53323.2	52730.1	52040.7	51335.9
Portfolio investment	74,848.1	79,284.7	82,968.5	84,682.3	92,928.2
Financial derivatives	2,466.2	1,996.1	1,729.6	1,777.2	2,539.7
Other investment	69,972.0	69,024.9	70,518.3	69,324.3	65,233.4
Reserve assets	549.8	533.8	449.3	435.4	857.8
Total liabilities	**199,834.3**	**202,409.1**	**206,655.8**	**206,295.8**	**210,456.4**
Direct investment in Malta	143,169.3	146,892.4	150,116.4	150,860.1	152,490.7
Portfolio investment	5,941.7	5,423.3	4,623.3	4,471.5	5,108.6
Financial derivatives	691.3	587.1	508.2	468.1	510.2
Other investment	50,032.0	49,506.3	51,407.9	50,496.1	52,346.8

Source: NSO.

[5] The IIP statement issued by the NSO shows the stock of external assets and liabilities of residents vis-à-vis the rest of the world as at the end of a particular period. Developments in the IIP reflect financial transactions but also exchange rate movements and valuation changes.

5. GOVERNMENT FINANCE

According to the latest Central Bank of Malta estimates, the general government deficit for 2014 was estimated to have declined to 2.2% of GDP from 2.7% in 2013, as revenue increased more strongly than expenditure.[1] Meanwhile, general government debt was estimated to have reached 68.4% of gross domestic product (GDP) at the end of 2014, from 69.2% a year earlier.[2]

General government outcome

In the first nine months of 2014, the general government deficit narrowed by €9.5 million on the corresponding period of 2013, to €229.2 million (see Table 5.1). The primary deficit, which excludes interest payments from total expenditure, declined to €58.6 million from €70.1 million in the first three quarters of 2013.

Between January and September revenue grew by €189.6 million, or 9.0% on the same period a year earlier, with around three-fourths of the increase driven by higher tax revenue, in line with favourable developments in the Maltese economy. Inflows from taxes on production and imports rose by 7.9% as growth in domestic consumption pushed up revenue from VAT and excise duties. The latter were also affected by an increase in duties on cement, cigarettes, beer and spirits as announced in the Budget 2014. At the same time, strong

Table 5.1
GENERAL GOVERNMENT BALANCE[(1)]
EUR millions

	2013 Q1-Q3	2014 Q1-Q3	Change Q1 - Q3 Amount	%
Revenue	**2,101.2**	**2,290.8**	**189.6**	**9.0**
Taxes on production and imports	700.3	783.6	83.3	11.9
Current taxes on income and wealth	728.3	753.3	25.0	3.4
Social contributions	369.2	400.7	31.5	8.5
Capital and current transfers	114.3	155.9	41.6	36.4
Other[(2)]	189.1	197.3	8.2	4.3
Expenditure	**2,339.9**	**2,520.0**	**180.1**	**7.7**
Compensation of employees	731.5	789.6	58.1	7.9
Intermediate consumption	327.1	360.8	33.6	10.3
Social benefits	727.3	752.0	24.8	3.4
Subsidies	56.8	74.7	18.0	31.6
Interest	168.6	170.5	2.0	1.2
Current transfers payable	112.0	137.9	25.8	23.0
Gross fixed capital formation	146.1	173.7	27.7	18.9
Capital transfers payable	69.8	57.1	-12.7	-18.2
Other[(3)]	0.7	3.6	2.9	-
Primary balance	**-70.1**	**-58.6**	**11.4**	**-**
General government balance	**-238.6**	**-229.2**	**9.5**	**-**

[(1)] The general government balance is computed in line with the ESA2010 methodology. For further details, see http://nso.gov.mt/en/nso/Sources_and_Methods/Unit_A2/Public_Finance/Documents/ESA10_Glossary.pdf

[(2)] "Other" revenue includes market output, composed mainly of sales of goods and services by entities classified within general government, as well as income derived from property and investments.

[(3)] "Other" expenditure reflects changes in the value of inventories and in the net acquisition of valuables and other assets.

Source: NSO.

[1] The general government balance captures all transactions of the central government, which is defined to include extra-budgetary units, as well as local councils, on an accrual basis. In contrast, the Consolidated Fund only captures transactions of the central government on a cash basis. On the revenue side, discrepancies between the two sets of accounts mainly stem from timing differences in the recording of the receipt of income tax and VAT revenue. On the expenditure side, significant differences often arise in the treatment of capital expenditure.

[2] Further information about the Bank's latest fiscal projections is available in Box 5 in this *Annual Report*.

growth in employment and wages resulted in a higher intake from social contributions and current taxes on income and wealth, which increased by 8.5% and 3.4%, respectively.

Inflows from capital and current transfers surged by 36.4% on the back of higher grants from the European Union. Meanwhile, "other" revenue increased by 4.3%, owing to higher inflows from sales by extra-budgetary units.

In the first three quarters of 2014, general government expenditure rose by €180.1 million, or 7.7% compared with the same period of 2013. Most of the increase stemmed from higher recurrent spending. Compensation of employees grew by 7.9%, mainly driven by growth in employment in the education and health sectors. At the same time, spending on intermediate consumption rose by 10.3%, mainly owing to additional expenditure on health, while social benefits increased by 3.4%, principally driven by retirement pensions.

Outlays on current transfers rose by 23.0%, following higher expenditure on various items, such as transfers to the EU budget. Subsides grew by 31.6% owing to additional spending on public transport, while interest payment went up by 1.2%.

In the period under review, spending on gross fixed capital formation increased by 18.9% as a result of additional outlays on infrastructural projects that are mainly financed from EU funds. On the other hand, capital transfers declined by 18.2%, as the equity injection by Government to the national airline was smaller than it had been in the same period of 2013.

Consolidated Fund

Between January and November 2014, the Consolidated Fund deficit narrowed by €118.4 million on a year earlier, as revenue grew by 13.1% while expenditure rose by 7.2% (see Table 5.2). In the same period, the primary balance swung from a deficit of €99.9 million to a surplus of €21.7 million.

Table 5.2
CONSOLIDATED FUND BALANCE
EUR millions

	2013 Jan.-Nov.	2014 Jan.-Nov.	Change Amount	Change %
Revenue	**2,395.6**	**2,709.6**	**314.0**	**13.1**
Direct tax	**1,177.6**	**1,268.9**	**91.4**	**7.8**
Income tax	803.7	861.0	57.3	7.1
Social security contributions(1)	373.9	408.0	34.1	9.1
Indirect tax	**921.1**	**1,090.8**	**169.7**	**18.4**
Value added tax	551.1	593.2	42.1	7.6
Customs and excise duties	167.2	278.8	111.6	66.7
Licences, taxes and fines	202.9	218.9	16.0	7.9
Non-tax(2)	**296.9**	**349.8**	**52.9**	**17.8**
Expenditure	**2,702.8**	**2,898.4**	**195.6**	**7.2**
Recurrent(1)	**2,363.6**	**2,528.0**	**164.4**	**7.0**
Personal emoluments	543.1	591.2	48.1	8.9
Programmes and other operational expenditure(3)	1,409.9	1,486.5	76.6	5.4
Contributions to entities	203.2	239.6	36.4	17.9
Interest payments	207.4	210.6	3.2	1.6
Capital	**339.2**	**370.5**	**31.2**	**9.2**
Primary balance(4)	**-99.9**	**21.7**	**121.6**	**-**
Consolidated Fund balance	**-307.2**	**-188.9**	**118.4**	**-**

(1) Government contributions to the social security account in terms of the Social Security Act 1987 are excluded from both revenue and expenditure.

(2) Includes grants but excludes proceeds from sale of assets, sinking funds of converted loans and borrowings.

(3) Includes programmes & initiatives and operational & maintenance expenditure.

(4) Revenue less expenditure excluding interest payments.

Source: NSO.

The main reason for such a large turnaround in the Consolidated Fund outcome was the receipt, in November, of excise duty on fuel owed by Enemalta, which had accrued in previous years. As a result, inflows from customs and excise duties rose by 66.7% during the period under review.

Other forms of tax revenue also registered strong increases, supported by robust economic growth. Inflows from income tax and VAT rose by 7.1% and 7.6%, respectively, while intakes from social contributions went up by 9.1%. Meanwhile, non-tax revenue grew by 17.8%, in part due to higher grants from the European Union, but also owing to the receipt of a portion of fees generated from the Investment Registration Scheme. The scheme allowed Maltese residents to regularise their position with regard to undeclared assets.

The increase in expenditure primarily reflected higher recurrent spending, which went up by 7.0%. Programme and other operational outlays rose by 5.4%, largely owing to higher spending on health, social benefits and subsidies on public transport. Additional spending on health and education services contributed to an 8.9% growth in personal emoluments and to a 17.9% increase in contributions to government entities.

Capital expenditure grew by 9.2%, as spending on infrastructural projects co-financed by the European Union increased.

Government debt

Between the end of 2013 and November 2014 central government debt, excluding debt issued by extra-budgetary units and local councils, as well as debt held by sinking funds, increased by €281.7 million. At the end of November the outstanding amount stood at €5,261.7 million (see Table 5.3).

The increase in borrowing was substantially more than the amount needed to finance the shortfall recorded in the Consolidated Fund in the same period, as Government also built up its stock of financial assets, notably its bank deposits.

During the first 11 months of 2014 the maturity composition of debt changed slightly in favour of Malta Government Stocks (MGS). By November, the outstanding amount of such bonds increased by €291.8 million from their level at end-2013, so that the share of MGS in total central government debt edged up to 92.4% from 91.8%. Conversely, outstanding amounts of Treasury bills ended November at 4.6% of total debt, down from 5.0% at the end of 2013.

Over the same period, foreign loans decreased by €7.9 million to €43.0 million, as Government continued the repayment of external debt, while the stock of loans issued by residents was unchanged. Meanwhile, the value of euro coins in issue, which represent a liability to Government, increased by €5.0 million.

Table 5.3
GOVERNMENT DEBT[1]
EUR millions

	2013 end-Dec.	2014 end-Nov.	Change Dec. 13 - Nov. 14
Government debt[1]	**4,980.0**	**5,261.7**	**281.7**
Euro coins issued in name of the Treasury	55.3	60.3	5.0
Treasury bills	248.1	241.0	-7.1
Malta Government Stocks	4,569.2	4,861.0	291.8
Local loans	56.4	56.4	0.0
Foreign loans	51.0	43.0	-7.9

[1] Excluding government debt issued by extra-budgetary units and local councils and debt held by sinking funds.
Source: Central Bank of Malta.

PART II

BANK POLICIES,

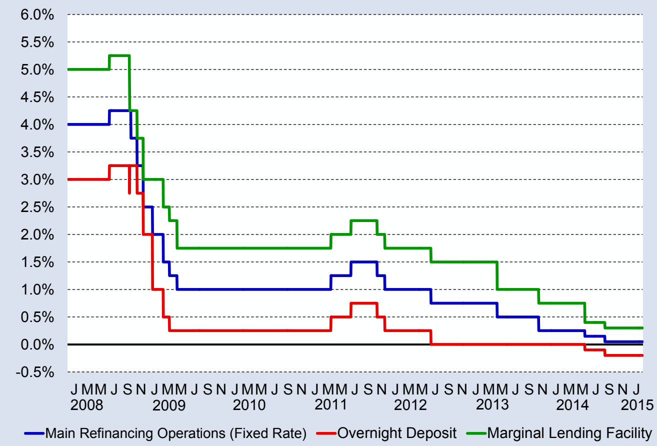
OPERATIONS AND ACTIVITIES

1. THE CONDUCT OF MONETARY POLICY

Monetary policy operations

The Central Bank of Malta implements the single monetary policy decisions of the Eurosystem in Malta. For that purpose, the Bank regularly conducted open market operations with domestic credit institutions. It also offered standing facilities and administered the minimum reserve system.

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



Source: ECB.

In 2014 the key euro area policy rates were cut on two occasions, leading to the introduction of a negative deposit facility rate (see Chart 1.1). On 11 June the main refinancing operation (MRO) rate was lowered by 10 basis points to 0.15%, while the rate on the marginal lending facility was reduced by 35 basis points to 0.40%. The overnight deposit facility rate was lowered by 10 basis points to -0.10%. Subsequently, on 10 September the MRO was cut by a further 10 basis points to 0.05%, with the lending facility and the deposit facility both lowered by 10 basis points to 0.30% and -0.20%, respectively. As a result, symmetry was retained around the MRO rate.

Open market operations

Open market operations are used to manage the level of liquidity in the money market and to steer short-term market interest rates close to the European Central Bank's (ECB) official rates. The Eurosystem has various types of open market operations at its disposal.

MROs are short-term liquidity-providing reverse transactions, which are executed according to a pre-specified calendar. They take place on a weekly basis, with a maturity of one week.

The Eurosystem also conducts long-term refinancing operations (LTRO), which consist of reverse transactions at a monthly frequency and with a normal maturity of three months. In addition, the Eurosystem uses fine-tuning operations with no fixed maturity to deal with unexpected liquidity fluctuations in the market. These operations can be either liquidity-providing or liquidity-absorbing.

Throughout 2014 the Eurosystem continued to provide the financial system with a sufficient amount of liquidity by means of fixed rate tender procedures with full allotment through MROs and LTROs. A total of 52 MROs were conducted by the ECB during the year, all at a fixed rate and with full allotment. Eligible domestic credit institutions participated in almost all these weekly operations, bidding a total of €0.5 billion, compared with €3.6 billion in the previous year (see Table 1.1). Moreover, the ECB conducted 12 regular three-month LTROs, with full allotment and at a fixed rate equal to the average of the MRO rate during the lifetime of the operations.

Furthermore, maintenance period operations (special-term refinancing operations) were conducted until June 2014. Then, on 5 June 2014, the Governing Council decided to discontinue these operations following the operation allotted on 10 June 2014. The fixed rate tender procedure with full allotment was applied in these operations, which had a tenor equivalent to the length of the relevant maintenance period.

Table 1.1
PARTICIPATION OF ELIGIBLE DOMESTIC CREDIT INSTITUTIONS IN EUROSYSTEM OPEN MARKET OPERATIONS

EUR billions

Type of operation	Amount bid	Amount allotted
Main refinancing operations	0.51	0.51(1)
Longer-term refinancing operations		
Maintenance period	0.04	0.04(1)
3-month	0.23	0.23(1)
Liquidity-absorbing operations (SMP-related)	17.97	17.61
US dollar Collateralised operations		
7-day	-	-
84-day	-	-

(1) In these Eurosystem open market operations, the amount allotted is equal to the amount bid due to the ECB's full allotment policy.

Local credit institutions obtained longer-term liquidity at various tenors totalling €0.3 billion, with 84.6% of this funding obtained through the three-month LTROs.

On 5 June 2014, the Governing Council also decided to continue conducting its MROs on a fixed rate and full allotment basis for as long as necessary, and at least until the end of the Eurosystem's reserve maintenance period ending in December 2016. Furthermore, the Governing Council decided to conduct the three-month LTROs to be allotted before the end of the Eurosystem's reserve maintenance period ending in December 2016 as fixed rate tender procedures with full allotment. The rates in these three-month operations will be fixed at the average rate of the MROs over the life of the respective LTRO.

Although the Securities Markets Programme (SMP) was terminated with the announcement of the Outright Monetary Transactions (OMT) on 6 September 2012, the ECB continued to conduct the weekly, seven-day liquidity absorbing operation until mid-2014. This operation was intended to neutralise the liquidity impact of the SMP. It was conducted with an intended volume covering the amount of securities settled by the end of the previous week. However, on 5 June 2014, the Governing Council decided to suspend this weekly fine-tuning sterilising operation following that allotted on 10 June 2014. During 2014 eligible domestic credit institutions participated in liquidity-absorbing operations to the amount of €17.6 billion (see Table 1.1).

Over the course of 2014, the ECB altered the modalities of its regular US dollar liquidity-providing operations. On 24 January 2014, the Governing Council decided to discontinue the three-month US dollar liquidity-providing operations as of April 2014. On the other hand, on 17 June 2014, the ECB announced that it would continue conducting the one-week US dollar liquidity-providing operations until further notice. During the year under review, local credit institutions did not utilise US dollar liquidity-providing operations.

On 5 June 2014, the Governing Council of the ECB decided to conduct a series of targeted longer-term refinancing operations (TLTRO) aimed at improving bank lending to the euro area non-financial private sector, but excluding loans to households for house purchases, over a window of two years. To this effect, the ECB conducted the first two TLTROs in September and December 2014. Between March 2015 and June 2016, all counterparties will be able to borrow additional amounts in a series of TLTROs conducted quarterly. The interest rate on the TLTROs will be fixed over the life of each operation at the MRO rate prevailing at the time of take-up, plus a fixed spread of 10 basis points. Interest will be paid in arrears when the borrowing is repaid. All TLTROs will mature in September 2018.

Additionally, on 5 June 2014, the ECB decided to intensify preparatory work related to outright purchases of asset-backed securities.

On 2 October 2014, in order to enhance the transmission of monetary policy, the ECB announced the operational details of asset-backed securities and covered bond purchase programmes.

Standing facilities

Eligible counterparties may utilise two standing facilities on their own initiative to obtain overnight liquidity against eligible collateral or to place overnight deposits with the Eurosystem. During 2014 counterparties continued to place excess liquidity with the Eurosystem through the overnight deposit facility, even though the rate on the overnight deposit facility was at 0.0% and subsequently fell into negative territory during the year under review. In fact, during 2014 recourse to the overnight deposit facility by local credit institutions amounted to €57.9 billion, down from €114.7 billion in 2013. Recourse to the marginal lending facility increased from €0.02 billion in 2013 to €0.05 billion in 2014.

Collateral management

The Central Bank of Malta is responsible for assessing the eligibility of domestically issued assets and reporting them to the ECB for inclusion in the Eligible Assets Database. As at end-December 2014, the nominal outstanding volume of eligible domestic marketable assets amounted to €5.1 billion.

At end-year the market value, after haircuts, of securities pledged by eligible domestic counterparties in the pool of collateral with the Central Bank of Malta stood at €1.0 billion. This amount consisted of both domestic and cross-border securities.

To enable the Eurosystem to determine liquidity needs despite the full allotment currently adopted, the Bank continued to provide the ECB with daily forecasts of items on its balance sheet that are unrelated to monetary policy instruments, such as banknotes in circulation, government deposits, net foreign assets and net assets denominated in euro.

Reserve requirements

The ECB requires credit institutions established in the euro area to hold reserve deposits with national central banks. The objective of the Eurosystem's minimum reserve system is to contribute to the stabilisation of money market interest rates and to help ensure the efficient operation of the Eurosystem as a liquidity supplier. Each credit institution is accordingly obliged to hold minimum reserve deposits with the Central Bank of Malta. In 2014 the reserve requirement ratio remained unchanged at 1.0%.

There was, however, a change in the reserve maintenance period. On 3 July 2014, the ECB announced that the Governing Council meetings dedicated to monetary policy would change to a new six-week cycle from January 2015. In order to match the new frequency of the monetary policy meetings, the reserve maintenance periods would also be extended to six weeks.

Reserve management

The Central Bank of Malta manages an investment portfolio with a value of €2.7 billion as at the end of 2014, comprising both euro and foreign-currency denominated assets. The former amount to €2.3 billion. These investments include money market instruments, government bonds and other fixed income securities. Following the Bank's membership in the Eurosystem, the main investment objective of the Bank is to maximise the return on portfolio within the safety and liquidity parameters approved by the Board of Directors and the Investments Policy Committee (IPC).

The IPC, which shapes the Bank's investment strategies, is chaired by the Governor and includes the Deputy Governors and senior officials representing other sections of the Bank. The IPC monitors the performance of the Bank's financial assets, evaluates the implementation of investment strategies, reviews the operational and risk framework of asset management practices, and assesses the overall investment policy. The risk parameters for asset management continue to be gauged in terms of credit quality and duration, with foreign exchange risk remaining largely hedged, except for minimal exposure in US dollars and pounds sterling. The IPC met on a monthly basis during 2014.

During 2014 the Bank's financial asset holdings increased by €0.4 billion. The financial assets of the Bank, as in previous years, were also influenced by retail and wholesale transactions conducted by the Payment and Banking Operations Office.

The Bank continued to co-manage its portion of US dollar reserves on behalf of the ECB by way of a pooling mechanism that is administered jointly with the Central Bank of Ireland. During the year the Investments Office worked closely with its Irish counterparts to review the investment strategy, discuss trades and analyse the portfolio's performance.

To further diversify the reserve assets of the Bank, an investment was made in the Bank for International Settlements Investment Pool Sovereign China Fund, while the investment management mandates to two external asset managers that started in 2013 were continued during 2014.

In terms of the European Exchange Rate Mechanism II (ERMII) agreement, and as a national central bank acting on behalf of the ECB, the Bank may conduct interventions in those currencies participating in the ERMII regime. No such interventions were necessary during 2014.

Outright spot foreign currency purchases, including customer transactions, amounted to €591 million in 2014, compared with €669 million in 2013. Outright spot foreign currency sales, including customer transactions, amounted to €615 million in 2014 compared with €664 million in 2013.

Foreign currency (FX) swap purchases decreased to €8,531 million in 2014 from €15,717 million in 2013. For the same period, there were swap sales of €2,482 million compared with €1,429 million in the previous year.

The Bank also monitors developments in foreign exchange transactions in Malta. Foreign exchange transactions between credit institutions in Malta were reported at €11.6 million, compared with €23.8 million in 2013. This decline was due to a lower volume of spot transactions.

At €15.7 billion in 2014, the total foreign exchange turnover between credit institutions and unrelated third parties was lower than the €17.3 billion reported in 2013. Business was mainly driven by euro transactions which, at €13.5 billion, were largely distributed between corporates and households, followed by credit institutions outside the euro area.

The foreign exchange turnover in euro in 2014 was mainly split between spot transactions at €7.2 billion and FX swaps at €4.8 billion. The remaining €1.5 million related to new forwards and, to a lesser extent, other derivatives. As in 2013, the largest share of turnover in non-euro currencies in 2014, at €2.2 billion, was primarily the result of growth in other financial derivatives. This consisted mainly of exercised options in non-euro currencies by a few large credit institutions outside the euro area with unrelated third parties. Around half of all spot deals transacted − €3.9 billion out of €7.2 billion − involved the non-bank private sector and reflected in large part sales relating to current account payments in respect of trade, tourism and personal transfers, along with financial portfolio flows.

Looking forward, the Bank's membership in EUREX, which provides an online marketplace in the major foreign exchange asset classes, will further enhance repo activity. Moreover, changes to risk parameters of externally managed funds will likely result in further compliance.

Market-making operations

During 2014 the Central Bank of Malta continued to act as a market-maker in the secondary market for Malta Government Stocks (MGS) and Treasury bills. In line with the Bank's statutory preclusion from participation in the primary market in all types of public sector debt instruments, the Bank did not participate in the primary market for MGS and did not provide any other form of financing to Government.

The Bank continued to publish the daily bid and offer prices, and the respective yields on all listed MGS, as well as the daily buying and selling rates for Treasury bills. The Bank also quoted on a daily basis the International Securities Market Association redemption yields of all MGS.

During the year the Bank continued to offer advisory services on external funding and debt management techniques to Government.

Relations with financial institutions

The Financial Markets Committee, which provides a forum for the Bank and all credit institutions operating in Malta to exchange views and information on various market-related issues, met twice during 2014.

Discussions revolved mainly on domestic government bond issuance. The committee also discussed the Eurosystem monetary policy framework, particularly collateral management and market expectations.

2. FINANCIAL STABILITY

In line with its mandate to ensure the resilience of the financial system and to formulate and implement macro-prudential policy, the Central Bank of Malta undertakes macro-prudential research to identify and evaluate potential systemic risks and vulnerabilities in the financial system, and to implement the appropriate policy measures.

The Bank published its *Financial Stability Report* in August, followed by an *Update* of this *Report* in December.[1] The analysis in the *Reports* is based on the three-way classification of banks: core-domestic, non-core domestic and international banks, with each category being distinguished by the extent of its linkages with the domestic economy. Both reports analysed potential vulnerabilities within and outside the financial sector, and provided an outlook on the identified risks.

Moreover, the Bank continued to participate in a quarterly survey of bank lending conditions, which is carried out across Member States of the euro area.

The Bank continued to provide input for the European Central Bank's (ECB) comprehensive assessment, which included a stress-testing exercise, through its participation in the National Steering Committee. The latter was established by the Malta Financial Services Authority (MFSA) specifically for this purpose. In the local context, Bank of Valletta plc, HSBC Bank Malta plc and Deutsche Bank (Malta) Ltd were the three banks included in the sample of the comprehensive assessment. The stress test revealed the resilience of these banks to the simulated shocks, whereby the CET1 ratios for each of them remained above the baseline and above the adverse thresholds, which were set at 8.0% and 5.5%, respectively.

With the advent of the Single Supervisory Mechanism (SSM) in November 2014, the three banks that took part in the comprehensive assessment were placed under the direct supervision of the ECB. The interaction between the Governing Council and the Supervisory Board became fully operative and a number of decisions were taken by the Governing Council in this regard.

By virtue of Article 17A of the Central Bank of Malta Act, the Bank was allocated the legal power to issue, amend or revoke directives to implement macro-prudential policies. In terms of Legal Notice 29 of 2014, the Minister for Finance appointed the Bank as the designated authority to implement various macro-prudential instruments as stipulated in CRR and CRD IV. The Bank is responsible for the implementation of the counter-cyclical capital buffer, the systemic risk buffer, CRR Art 458 and, in conjunction with the MFSA, the Other Systemically Important Institutions (O-SII) in Malta buffer. The CRD IV/CRR Framework introduces stronger rules for capital and liquidity, together with a new set of macro-prudential tools.

In this respect, during the year the Bank amended its Directive No 11 on Macro-Prudential Policy. The objective of the Directive is to contribute to the safeguarding of the financial system as a whole by strengthening the resilience of the financial system and limiting the build-up of systemic risks, thereby ensuring the sustainable contribution of the financial sector to economic growth. The amended Directive identifies the intermediate and ultimate objectives of macro-prudential policy and defines the macro-prudential responsibilities of the Bank aimed at mitigating systemic risk through the activation of appropriate macro-prudential instruments. The Directive also transposes into domestic legislation the macro-prudential instruments embedded in CRD IV.

The Bank's Financial Stability Committee met twice during 2014.[2] The Committee discussed the findings of specific analyses of the financial system, policy issues and the Bank's financial stability publications.

The Joint Financial Stability Board (JFSB), which is chaired by the Governor and includes representatives of the Bank and the MFSA, met five times during 2014. The Minister for Finance attended all the meetings as

[1] Both *Reports* are posted on the website of the Central Bank of Malta.
[2] The Financial Stability Committee is chaired by the Governor and includes a number of senior officials of the Bank.

an observer. The JFSB facilitates cooperation between the authorities on matters related to financial stability, particularly the formulation of macro-prudential policy and the assessment of macro-prudential instruments. Over the course of 2014, the Board focused primarily on matters related to the ECB's asset quality review and stress test, the European Insurance and Occupational Pensions Authority Insurance Stress Test for Solvency II, the counter-cyclical capital buffer and the identification of O-SIIs.

The Bank continued to monitor the resilience of domestic banks to a number of key risks through its univariate stress tests, while further enhancing the methodology of these exercises. These tests simulate credit quality deterioration in the securities portfolio, an increase in non-performing loans due to adverse macroeconomic conditions, a drop in property prices and persistent deposit withdrawals. Through its credit risk model, the Bank also assessed potential credit risk in the loan portfolio of individual banks. In addition, the model captures the impact of extreme, but plausible, macroeconomic shocks on banks' balance sheets.

During 2014 the Bank's Forum for Financial Stability, which is composed of representatives of the relevant authorities and major stakeholders in the financial services sector, met once. The objective of the Forum is to foster a structured dialogue on issues of common interest, with particular emphasis on the identification and management of risks within the financial system. During the meeting, members were updated on recommendations issued by the European Systematic Risk Board (ESRB) on the counter-cyclical capital buffer and on the SSM.

In collaboration with the MFSA, the Central Bank of Malta conducted further rounds of the Quantitative Impact Study (QIS), with guidance from the Bank for International Settlements. As new regulatory capital requirements came into force in January 2014, the objective of the QIS shifted towards the analysis and identification of unintended consequences of the new liquidity regulation. The new regulatory requirements will be implemented in stages over the coming years, with full implementation envisaged by 2018.

The Domestic Standing Committee, composed of senior officials of the Bank, the MFSA and the Ministry of Finance, met regularly during 2014. The Committee mainly focuses on issues related to the management of a potential crisis. Its work programme also included discussions on the transposition of the EU Directive for Bank Recovery and Resolution, which will become effective in 2015, and of the Single Resolution Mechanism, which will become operational in 2016. The Committee also reviewed Directive 94/19/EC on Deposit Guarantee Schemes.[3]

Furthermore, the Bank and the MFSA held quarterly meetings with the Malta Bankers' Association to discuss issues that are of significance to the banking sector.

During the year senior Bank officials involved in financial stability issues participated in the activity of the ESRB and of the ECB, as well as in activities of the related sub-structures. The Bank was also represented at meetings of the Board of Supervisors of the European Banking Authority and the Supervisory Board of the ECB.

[3] The new Directive was published in the Official Journal of the European Union on 12 June 2014.

3. ECONOMICS, RESEARCH AND STATISTICS

Economics and research

The Bank analyses on an ongoing basis economic and financial developments in Malta and abroad. As in previous years, Bank staff provided inputs into the monetary policy process by regularly briefing the Governor on economic and financial developments in the euro area ahead of his participation in meetings of the Governing Council and the General Council of the European Central Bank (ECB). Bank staff also prepared briefs for the Bank's senior management ahead of discussions within the Eurosystem, as well as with external bodies, such as the European Commission, the International Monetary Fund (IMF) Article IV Consultation Mission and the credit rating agencies. They also provided input and advice to Government on economic and financial issues as requested.

As customary, the Bank published its analysis of economic developments in its *Quarterly Reviews* and *Annual Report*. It also released a monthly commentary on monetary developments in Malta and in the euro area.

The Bank continued to participate in the preparation of euro area wide macroeconomic projections undertaken by the Eurosystem. A comprehensive projection exercise was carried out twice during 2014 as part of the Eurosystem's Broad Macroeconomic Projection Exercise, while a detailed short-term projection of inflation developments was prepared every quarter as part of the Eurosystem's Narrow Inflation Projections Exercise. The findings of a separate projection exercise are published in the Bank's *Annual Report*. The Bank also prepared detailed fiscal forecasts as part of the European System of Central Banks' (ESCB) forecast exercises. Further work was carried out during the year to strengthen the Bank's short-term forecasting capability with the help of experts from the Banca d'Italia.

Empirical research spanned a broad range of topics that were mainly related to the Maltese economy. In 2014 these included the pass-through of monetary policy measures to lending and deposit rates, the estimation of potential output and structural unemployment, the determinants of household saving, the demand for currency, fiscal multipliers and the cyclical adjustment of fiscal balances. Papers on these topics were uploaded on the Bank's website or featured in its regular publications. During 2014 research findings on topics, such as demand in the Maltese tourism sector and pension reform, were presented at the ECB, at local and international conferences or were published in international journals.

At the same time, staff continued to develop the Bank's macro-econometric model. The revised version includes four key improvements: a detailed fiscal block, a richer financial block, enhanced macro-financial linkages and a price block that is more responsive to domestic economic activity. In addition, the model's equations were re-estimated with more recent data. The updated version was then used in ECB simulations to assess the impact of a set of stylised economic shocks. It was also used to estimate the impact of the reduction of utility tariffs on the Maltese economy.

In addition, an econometric modelling technical cooperation programme, which focusses on the construction of new advanced models, was set up with the Banca d'Italia.

Staff members participated actively in the work of two ESCB research networks. The first one, the Competitiveness Network, aims at developing a set of new competitiveness indicators focusing on micro-data from each participating country. The second one, the Wage Dynamics Network, assesses, by means of harmonised country surveys, how firms price their products while also investigating the process of wage formation.

Statistics

The Bank is primarily responsible for the compilation of monetary, financial, payment and financial stability statistics in Malta. It also contributes to the compilation of the balance of payments in cooperation with the National Statistics Office (NSO). As from 2014, the Bank started publishing Malta's non-consolidated financial accounts statistics with an annual time series spanning back to 2004.

The Bank also fulfils its international statistical reporting obligations mainly to the ECB, the European Systematic Risk Board and the IMF. It also participates in the IMF'S Special Data Dissemination Standard, the General Data Dissemination System, and in various surveys conducted by the IMF.

During 2014 the Bank revised the statutory statistical bank returns, bringing them in line with the amended or recast ECB regulations and guidelines. This also included the implementation of requirements stemming from the new European System of Accounts 2010 (ESA 2010) and the sixth edition of the IMF's Balance of Payments Manual, which came into effect in 2014. In line with ESA 2010, special purpose entities are now treated as resident corporations.

Central Bank of Malta Directive No 5 was amended to allow the Bank to receive COREP and FINREP statistics directly from the Malta Financial Services Authority (MFSA).[1]

Moreover, during the year under review, the Bank collected statistical information related to targeted longer-term refinancing operations from those credit institutions participating in these operations.

In view of the envisaged enactment of ECB regulations on the money market, insurance companies and on the ESCB credit dataset (Anacredit), the Bank carried out the necessary fact finding exercises. The Bank will implement amendments to its statutory returns in line with regulatory requirements.

During 2014 the Bank updated its governance structure in the area of statistics. An internal Statistics Policy Committee was established primarily to define and implement the policy on statistical information. Meanwhile, the Technical Committee on Financial Statistics was renamed as the Forum for Central Bank of Malta Statistics. This Forum, which is chaired by the Bank and includes representatives from credit institutions, MFSA, NSO and the Malta Bankers' Association, coordinates the smooth transition to new statistical reporting requirements while seeking to enhance existing ones. In its new format, the Forum will include other financial institutions or their associations as necessary.

The Bank took on various surveys in areas which require analysis and research. In this respect, it undertook the third wave of the Eurosystem's collaborative Wage Dynamics Network project, which aims to identify key features of wage and price-setting behaviour in Malta. The fieldwork was carried out between May and July when a sample of 178 private companies employing ten or more persons participated in the survey. The latter also consisted of a panel component. The summary results are presented in this *Annual Report*, while further analysis will be presented in the Bank's publications and on its website during the course of 2015.

Another survey was the ESCB's Household Finance and Consumption Survey. The related fieldwork was conducted between January and May, when 1,000 households were surveyed. The data were vetted, edited and validated by the ECB, while data imputations are being carried out in liaison with the Central Bank of Slovakia. The final results are envisaged to be released by end-2015.

The Bank also participated in the ESCB's COMPNET initiative by contributing specialised statistical information. The COMPNET project engages in research on the competitiveness of euro area countries.

Following the survey completed in 2014 on Maltese payment habits, the Bank continued with the analysis of results. These findings establish a base for recommendations to be put forward as part of the national payments strategy.

During the year the Bank enhanced its online database of economic statistics. The Bank's website also provides a link to an ECB website that enables comparison with other countries in the euro area. Additional historical data were added to the Bank's database, in some cases spanning back to the 1950s.

---

[1] COREP is the standardised reporting framework for the purposes of the Capital Requirements Directive, while FINREP is the standardised framework for financial accounting data.

The processing of statistics requires a robust, efficient and adaptable IT solution. In 2014 the Bank reached an agreement with the Banca d'Italia, procuring its statistical information solution. The related service level agreements will be signed by both Banks in early 2015, while the actual migration of the statistical process is expected to commence in the second half of 2015.

At a national level, the Bank continued to be represented on the Government Finance Statistics Committee (GFSC), which also includes officials from the NSO and the Ministry for Finance. The GFSC is responsible for the reporting of government finance statistics related to the EU Commission's Excessive Deficit Procedure notification.

4. CURRENCY, PAYMENT SYSTEMS AND BANKING SERVICES

The Central Bank of Malta is responsible for the issue and circulation of euro banknotes and coins in accordance with the legal framework of the European System of Central Banks and the European Central Bank (ECB), and of the Central Bank of Malta Act. The Bank issues coins on behalf of Government. Moreover, the Bank is responsible for the regulation and oversight of the payment and securities settlement systems in Malta.

Currency operations

The Bank issues euro banknotes and coins in line with the demand of the banking system. All banknotes and coins returned to the Central Bank of Malta are examined for their authenticity. The quality of currency in circulation is ensured through the withdrawal of counterfeits and the destruction of unfit banknotes and coins.

Circulation of notes and coins

During 2014 the Bank inspected a total of 86.8 million notes, as compared with 100.1 million in 2013. The inspected notes had a value of €2.0 billion, which was €52.8 million higher than in 2013 (see Table 4.1). The proportion of inspected banknotes that were destroyed decreased to 15% in 2014 from 22% in 2013.

In September 2014 the ES2 €10 banknote, which has enhanced security features, was issued as part of the Europa Series. Prior to the launch, the Bank was intensively involved in the testing of banknote handling machines and authentication devices primarily in the banking sector. Banknotes from the first and second series are being issued concurrently, and this is expected to continue until the stock of the first series is exhausted in January 2015.

Acting as an agent for Government, the Bank is responsible for procurement, storage and circulation of euro coins, while the ensuing seigniorage is passed on to Government. As shown in Table 4.2, the outstanding volume of euro coins rose by 9.2% during 2014, reaching €60.7 million at the end of the year. A total of 63.3 million euro coins, with a value of €36.1 million, were examined by the Bank. Both volume and value were higher than in 2013.

The Central Bank of Malta monitors cash handling at credit institutions and other locations. Results of tests performed on nine different types of banknote handling machines were all satisfactory. Credit institutions

Table 4.1
BANKNOTES ISSUED BY AND PAID INTO THE CENTRAL BANK OF MALTA IN 2014
EUR millions

2014	Issued by Central Bank of Malta	Paid into Central Bank of Malta	Net issue	Issued and outstanding
January	147.1	167.4	-20.3	820.2
February	154.6	145.5	9.2	829.4
March	155.3	145.6	9.7	839.1
April	178.7	175.9	2.8	842.0
May	171.7	175.3	-3.6	838.4
June	184.1	179.0	5.2	843.5
July	191.8	192.8	-1.1	842.4
August	176.2	182.0	-5.9	836.6
September	187.8	185.5	2.4	839.0
October	180.4	183.9	-3.5	835.4
November	155.0	155.6	-0.6	834.8
December	217.3	185.5	31.8	866.6
Total 2014	**2,100.0**	**2,074.0**	**26.1**	**866.6**
Total 2013	**1,977.9**	**1,985.5**	**-7.6**	**840.6**

Source: Central Bank of Malta.

Table 4.2
COINS ISSUED BY AND PAID INTO THE CENTRAL BANK OF MALTA IN 2014
EUR millions

2014	Issued by Central Bank of Malta	Paid into Central Bank of Malta	Net issue	Issued and Outstanding
January	2.7	3.1	-0.4	55.2
February	2.4	2.5	-0.1	55.1
March	2.7	2.5	0.2	55.3
April	3.4	3.0	0.4	55.7
May	3.6	2.9	0.7	56.4
June	3.8	2.7	1.0	57.4
July	4.8	3.5	1.3	58.7
August	3.8	3.2	0.6	59.4
September	3.7	3.3	0.4	59.8
October	4.1	3.5	0.5	60.3
November	2.9	2.7	0.3	60.5
December	3.4	3.3	0.1	60.7
Total 2014	41.3	36.2	5.1	60.7
Total 2013	39.2	34.4	4.8	55.6

Source: Central Bank of Malta.

reported operational data in a timely manner for the first six months of 2014. This information was passed on to the ECB through the Currency Information System and the Eurosystem Currency Register. Assistance was also provided to institutions and retailers on the upgrading of their banknote authentication devices.

The ongoing smooth launching of the new ES2 banknotes has benefitted from the cooperation of credit institutions and other cash handling entities. Regular meetings with credit institutions were held during 2014 to keep them updated on currency matters.

During 2014 the Currency Operations Office launched the Certification of the Professional Cash Handlers programme: this involves cashiers going through an e-learning tool and subsequently sitting for an online certification test before being allowed to handle euro banknotes. Also, through the support of the Financial Intelligence Analysis Unit, the e-learning tool has been upgraded to include an anti-money laundering module.

Throughout the year, the Currency Operations Office remained committed to its educational responsibilities. In fact, in conjunction with the Ministry of Education, the educational programme "Currency Notes and the Euro" was completed in May 2014. The programme involved the set-up of a mobile currency exhibition and presentations in public and private schools. This was complemented by a publication that focused on security features embedded in euro banknotes.

Collection and disposal of Maltese lira banknotes

A total of 90,466 Maltese lira banknotes with a value of €1.8 million were exchanged at the Bank during 2014. A total of 3.2 million lira banknotes remained in circulation at end-2014, equivalent to €41.1 million.

Numismatic and commemorative coins

Once again, the Bank took part in the Europa Coin Programme. This year's theme was "Musicians" and the Bank commemorated Maestro Charles Camilleri with the issue of a silver coin and a gold coin in February. In March 2014 the *zecchino* was issued under the Smallest Gold Coin Programme, whilst in April the Bank commemorated Malta's role as the "Nurse of the Mediterranean" during the First World War by issuing two coins, one in silver and one in cupro-nickel. This sought after coin set was issued in May 2014 and sold out within a few weeks.

The issue of a series of coins depicting Auberges of the Knights of St John continued in June 2014, with two coins, one in gold and one in silver, showing an image of Auberge d'Aragon.

The Bank issued two silver coins on the occasion of two national celebrations, namely the 50th Anniversary of Malta's Independence in September and the 40th Anniversary of Malta becoming a Republic in December.

The Bank issued two €2 commemorative coins in 2014. The first issue was in July, commemorating the 200th Anniversary of the Malta Police Force, and the other was in October, featuring the Independence monument. The latter was the fourth in a series of five coins featuring milestones in Malta's constitutional history.

All coin products were very well received by coin collectors and dealers, and a number of products were sold out shortly after their issue, including the joint product issued with MaltaPost. The coin themes adopted by the Bank are based on proposals made by the Currency Advisory Board, set up for this purpose and composed of experts in this field.

Anti-counterfeit measures

The Currency Surveillance Unit (CSU) within Currency Operations is responsible for the coordination of anti-counterfeit measures in Malta. During 2014 more than 1,500 counterfeit notes and 620 counterfeit coins were analysed and findings were uploaded onto the ECB's Counterfeit Monitoring System. CSU personnel were also asked to provide expert evidence in ten court cases.

With the introduction of the new €10 banknote in the Europa Series, CSU personnel delivered several training and information sessions on the security features of the new series to various credit institutions and to other stakeholders.

During 2014 Currency Operations issued two press releases to inform the public on the status of counterfeit notes in the Eurosystem in general, and more specifically on the local situation.

In 2014 the number of counterfeit notes identified by the Bank declined by 14.5% compared with 2013.

Counterfeit awareness was also raised through participation in a programme on a TV station, and also by the setting up of a dedicated section during the *Notte Bianca* event.

Payment and securities settlement systems

As provided for in 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 2014 the Bank issued Directive No 13 on the Approval of Payment Systems. This Directive sets out the terms and conditions for the approval of payment systems prior to the start of operations. The Bank also followed up on a number of regulations being developed at EU level. These included the Payment Account Directive, the Regulation on Interchange Fees for Card-Based Payment Transactions and the Payment Services Directive 2.

In addition, the Bank finalised its assessment of MaltaClear, the local securities settlement system, on the basis of the Committee on Payments and Market Infrastructure – International Organisation of Securities Commissions Principles for Market Infrastructures.

At operational level, the Central Bank of Malta continued to manage facilities at the Malta Clearing House (MCH), which provides banks with a cheque clearing system. In 2014 the number of cheques cleared at the MCH fell marginally while their value increased by 11.8% (see Table 4.3).

Table 4.3 **NUMBER AND VALUE OF CHEQUES PROCESSED BY THE MALTA CLEARING HOUSE, 2013 AND 2014**		
	Number of cheques	Value (EUR millions)
2013	5,208,480	7,810.8
2014	5,197,364	8,732.9
Change	-11,116	922.1
Percentage change	-0.2%	11.8%
Source: Central Bank of Malta.		

The total volume of SEPA payments processed by the Bank in 2014 was 2.4 million, with a corresponding value of €2.5 billion. This figure represents a growth of 1.9 million transactions in volume and €1.1billion in value on the previous year. This increase mainly resulted from migration to SEPA in 2014. After the EU Commission extended the SEPA migration date from 1 February 2014 to 1 August 2014, local credit institutions, including the Central Bank of Malta, switched their direct credits to SEPA Credit Transfers on 1 May 2014 and their direct debits to SEPA Direct Debits on 1 August 2014. As the Bank is the appointed Competent Authority under SEPA Regulation, it was also involved in the collection of statistics and in meetings with stakeholders to monitor the migration to SEPA by local credit and financial institutions.

While the total number of institutions participating directly in Target2 (T2) operations remained unchanged at five institutions, the payments processed through T2 registered an increase in 2014. These numbered 79,343 with a total value of €139.2 billion, out of which 17,143 were interbank payments, with a value of €134.8 billion. The remainder were customer payments, amounting to 62,200 with a value of €4.4 billion.

Banker to the public sector

The Central Bank of Malta provides a range of banking services to Government and to public sector entities. These consist mainly of the provision of various types of accounts in euros, as well as foreign currencies; the encashment of cheques drawn on the Bank and issued by government departments; deposits of cash and cheques; processing of SEPA credit transfers; a night-safe facility; safe-custody services; and the processing of payments through T2. During the year the Bank took steps to enhance processes concerning retail banking services to Government.

In 2014 the number and value of cheques drawn on the Bank by the public sector recorded a decrease as a result of the ongoing efforts by government departments to effect payments through SEPA rather than through the use of cheques (see Table 4.4). It should be noted that the decrease would have been larger but for the issuance of cheques for various one-off initiatives on the part of several government departments.

As in previous years, foreign exchange services provided to Government and to public sector entities during 2014 included facilities related to the sale and purchase of foreign currencies; outward and inward payments

Table 4.4 **NUMBER AND VALUE OF CHEQUES DRAWN ON THE CENTRAL BANK OF MALTA BY THE PUBLIC SECTOR**		
	Number of cheques	Value (EUR millions)
2013	872,259	786.7
2014	846,799	777.5
Change	-25,460	9.2
Percentage change	-2.9%	-1.2%
Source: Central Bank of Malta.		

by SWIFT; the encashment of bills negotiated; the maintenance of foreign currency accounts; and the processing of documentary letters of credit, collections and guarantees.

Throughout 2014, the Bank continued to effect payments in connection with the servicing of the Government's external debt. Payments in connection with the repayment of capital amounted to €10.6million, slightly less than in the previous year, while interest-related payments totalled €2.3million. The total value of funds transferred to external debt sinking funds by debit of the government account during 2014 was €10.1million.

Banker to the banking system

The Bank also acts as banker to the rest of the banking system, providing deposit facilities to credit institutions. These hold balances at the Bank mainly to meet their reserve deposit requirements, to carry out transactions or as a store of liquidity. Credit institutions hold reserve accounts, current accounts, margin call accounts, as well as accounts pledged in favour of the Depositor Compensation Scheme.

Other financial services

During 2014 the Bank continued to provide portfolio management services to the Investor Compensation Scheme and to the Depositor Compensation Scheme on the basis of guidelines set by the Schemes' Management Committees, whose members are appointed by the Malta Financial Services Authority. The Bank also provided financial accounting and other support services in connection with activities of the Schemes. During the year the Bank continued to hold margin call accounts, as well as accounts pledged in favour of the Depositor Compensation Scheme. It also regularly reported on the asset positions of the two Schemes.

The year 2014 marked the start of the testing phase for the T2 Securities project. As Malta is included in the first migration wave, the Bank successfully completed its bilateral certification testing in December 2014. Multilateral testing activities also progressed according to plan, ahead of the go-live date of 22 June 2015.

5. INTERNAL MANAGEMENT

Governance

Board of Directors

During 2014 the Board was composed of Professor Josef Bonnici as Governor and Chairman, Mr Alfred DeMarco and Mr Alexander Demarco as Deputy Governors, and Mr Peter J. Baldacchino, Mr Victor Busuttil, Dr Romina Cuschieri and Ms Philomena Meli as non-executive Directors. All members of the Board are appointed for a statutory term of five years. Dr Bernadette Muscat acts as Secretary to the Board. During the year the Board met 12 times.

The Board of Directors is responsible for the policy and general administration of the Bank, except for functions relating to the Treaty on the functioning of the European Central Bank (ECB), or the statute of the European System of Central Banks (ESCB) and the ECB, or functions which are conferred exclusively on the Governor in terms of the Central Bank of Malta Act (Cap. 204).

Management and internal organisation

In line with amendments to the Central Bank of Malta Act, the President of Malta, acting on the advice of the Prime Minister, appointed Mr Alexander Demarco as Deputy Governor focusing on financial stability for a period of five years with effect from 1 January 2014.

With increased responsibilities vested in the Legal Office, the Board approved the upgrade of this office into a department. The Legal Department now assumes the role of assuring compliance at the Bank. Consequently, the functions related to the Freedom of Information Act (Cap. 496) and the Data Protection Act (Cap. 440) were transferred from the Strategy, Planning and Risk Department to the Legal Department.

Similarly, in line with the necessity of strengthening the Bank's research and forecasting capacity, along with the upgrade of the Bank's publications, the Board of Directors approved the division of the former Economics & Research Department into two departments: an Economics & Monetary Analysis Department and a Modelling & Research Department. The Economics & Monetary Analysis Department retains the responsibility for macroeconomic forecasts and for the Bank's economics publications, as well as for research on monetary policy issues. The Modelling and Research Department concentrates on economic and financial research, and on the maintenance of the Bank's econometric models. The resulting specialisation contributes towards the improvement of both the quantity and quality of publishable research carried out at the Bank.

Governor's activities in Malta

The Governor served as a member of the Board of Governors of the Malta Financial Services Authority (MFSA) during the year. He also participated regularly in the proceedings of the Malta Council for Economic and Social Development.

In January 2014 the Governor delivered a presentation to the Parliamentary Committee on Economic and Financial Affairs on access to bank funding for businesses. In March the Governor participated in the Economist Business Roundtable organised with the Government, during which he made a presentation on investing in Malta.

The Governor presented the Bank's *Annual Report 2013* at its press launch in April. He also delivered a presentation on recent economic developments and structural considerations to the Parliamentary Committee on Economic and Financial Affairs in May, during which he outlined the main issues arising from the *Annual Report 2013*. In December the Governor was the keynote speaker at the annual dinner of the Institute of Financial Services. On this occasion he presented his views on the enhancement of economic competitiveness.

In addition, the Governor also appeared on public broadcasting programmes and was interviewed on various news media.

Governor's international engagements

During 2014 the Governor participated in a number of high level events. He attended the first ECB Forum on Central Banking held in Portugal on "Monetary policy in a changing financial landscape". In June he delivered a presentation at an event hosted by MNI Connect in London. At the 7th policy dialogue between Eurosystem Governors and the Executives' Meeting of East Asia-Pacific Central Banks hosted in July by the Bank of Thailand, the Governor chaired a session on "Lessons from the crisis in the euro area for monetary and financial integration". In August he attended the annual Economic Symposium in Jackson Hole, Wyoming. The Governor was on the panel of the IMF-Bank of Slovenia High-Level Seminar held in September on re-invigorating credit growth in Central, Eastern and Southern European Economies. In October he was a discussant in a session entitled: "Towards the banking union: opportunities and challenges for statistics" at the 7th ECB Statistics Conference. He was a discussant at a conference organised in October by the *Fondazione Centesimus Annus – Pro Pontifice*, Dublin Group, on finance and the common good. In addition, he attended the Banque de France symposium on the way forward for central banking in November. In December he delivered a speech at the ceremony of the handover from Bulgaria to Malta of the ECB's Cultural Days. Over the course of the year, the Governor gave a number of interviews to local and international media services.

Strategy and planning

The Bank continued to implement the departmental and cross-organisational initiatives that underpin the Bank's strategic plan for 2013−15, with progress of the plan being monitored by the Board of Directors. The strategic plan for 2016−18 will be developed during 2015.

The Bank is also reviewing the planning and prioritisation of projects and resource intensive processes to ensure an effective, efficient and economic use of resources. To this end, a Corporate Calendar was launched in December to capture the relevant information regarding resources required for cross-organisational initiatives to assist in their planning and implementation.

Another initiative in the final stages is the development of a Project Portfolio Prioritisation Methodology, a tool which supports management in selecting the optimal project portfolio mix that best meets the Bank's priorities.

Governor's Office

The Governor's Office continued to provide expert support to the Governor in connection with his internal and external engagements. The Office focuses on research and on the development of policy position of the Governor, and also contributes to speeches, presentations and interviews.

Audit Committee

The composition of the Bank's Audit Committee was unchanged during 2014. The Committee was chaired by Mr Victor Busuttil, with Mr Alfred DeMarco and Mr Peter Baldacchino as members. It held six meetings during the year. The Head of the Internal Audit Department attended all meetings and reported on governance and policy matters, including internal audit methodologies and exposures to risk.

External auditors

Following the expiry of KPMG's five-year term, PwC were appointed as the Bank's statutory auditors on the basis of a competitive tender, with effect from the financial year 2014.

Internal Audit Department

In fulfilling its assurance obligations, the Internal Audit Department conducted local risk-based audits during 2014. These focused on the evaluation of the adequacy and effectiveness of governance, risk management and control processes in various critical parts of the Bank. In addition, methodologies were enhanced to provide targeted assurance on areas that are more susceptible to fraud.

In discharging its consultative role, the Internal Audit Department provides support to other offices within the Bank, primarily on cost effectiveness of controls, project management, issues related to policy implementation, and the enhancement of the Bank's risk assessment and information security framework. The Internal Audit Department also made presentations to officials and staff at all levels as part of the Bank's ongoing Fraud Awareness Programme. The Department also contributed to the re-assessment of risk under the Operational Risk Management Framework, as well as under the Risk Tolerance Framework.

To meet its ESCB-related responsibilities, the Internal Audit Department also performed six audits on behalf of the ESCB.

Operational risk assessment

The Risk Committee met regularly in 2014, reviewing the Bank's overall risks, including financial, operational and legal risks.

In 2014 a Risk Policy Statement was approved by the Board of Directors. The Bank is currently reviewing the Operational Risk Management (ORM) Framework, which should be finalised in early 2015. An incident reporting policy was also approved and implemented.

To enhance risk management, risk coordinators were appointed across the Bank during 2014 to help office managers and heads in the identification and mitigation of risks, and also to report on any operational incidents. Training was provided to risk coordinators on the ORM framework, incident reporting and business continuity, whilst all staff members attended awareness sessions on these topics.

The findings and risk mitigation proposals that emerged in the first ORM cycle were discussed in various committees during 2014, with the Board of Directors being periodically informed of the status of risk mitigation in respect of any high risk findings. A second cycle of the ORM process will be completed in 2015.

The Bank undertook a Business Impact Analysis exercise to review the maximum tolerable outage of the Bank's processes, enabling the prioritisation of resources in an emergency. As a result, the Bank identified those critical processes requiring a business continuity plan or a review of an existing one. These plans, which will be drawn up and tested in due course, will enable the Bank to recover its operations in the shortest time possible in case of a major disruption. In conjunction, an assessment was made of the resources required for the Bank to operate from an alternative disaster recovery location.

The Bank continued to benefit from expertise of other central banks in risk management through cooperation in the review of policies, frameworks and best practice.

An exercise to update all the Bank's Policies and Procedures was commenced during the year and is expected to be completed during 2015.

Legal issues

During 2014 the Legal Department was directly involved in the drafting of a new Central Bank of Malta Directive, other subsidiary legislation and amendments to a number of Bank Directives, as follows:

- the drafting of the Central Bank of Malta Act (Appointment of Designate Authority to implement Macro-Prudential Instruments) Regulations, 2014, through which the Minister of Finance appointed the Bank as the designated authority for the implementation of a number of macro-prudential instruments as stipulated in Directive 2013/36/EU and Regulation (EU) No 575/2013 (commonly referred to as the CRD IV package);
- amendments to the Central Bank of Malta Directive No 5 on Statistical Reporting Requirements empowering the Bank to collect statistical information on an individual and consolidated basis, as required under the Common Reporting Framework (COREP);

- amendments to the Central Bank of Malta Directive No 6 on the Harmonised Conditions for participation in TARGET-2 Malta, aimed at introducing changes to the TARGET-2 legal harmonisation framework;
- several amendments to the Central Bank of Malta Directive No 8 on Monetary Policy Instruments and Procedures, in order to implement amendments introduced by Guidelines ECB/2014/10 and ECB/2014/12;
- amendments to Directive No 11 on macro-prudential policy to implement the provisions of Directive 2013/36/EU and Regulation (EU) No 575/2013, in relation to a number of macro-prudential instruments including the systemic risk buffer, the counter-cyclical capital buffer, the buffer for global systemically important institutions, and for other systemically important institutions;
- the drafting of Central Bank of Malta Directive No 13 on the approval of payment systems, which sets out the applicable terms and conditions for the approval of payment systems prior to commencement of operations, and the procedure for the suspension of operations and closure of payment systems.

The Bank's legal staff also advised senior management on issues related to the Bank's governance structure and to various ESCB activities and other projects, including:

- the continued implementation of the Bank's Legal Risk Management Framework intended to eliminate or mitigate legal risks in the Bank's processes;
- the analysis of documentation related to the setting up of the Banking Union, including bank recovery and resolution, and backstop measures;
- legal support in relation to the implementation of the ECB's TARGET2 Securities project within the Bank;
- legal analysis of documents related to the Bank's participation in the EUREX platform;
- the update of the master agreements Schedules to the International Swaps and Derivatives Association Master Agreement and the Global Master Repurchase Agreement;
- the legal review of the documentation related to the adoption and implementation of the second Payment Services Directive and the Multilateral Interchange Fee Regulation.

The Legal Department also took on responsibility for regulatory compliance at the Bank and for the implementation of the Bank's policies in relation to the Freedom of Information Act and the Data Protection Act. The Department also contributed to the drafting and reviewing of the Bank's policies on whistleblowing and insider trading. In addition, the Legal Department continued monitoring against money laundering and counteracting terrorist financing.

During the year the Legal Department participated in the ECB's Ethical Framework Task Force, which was mandated by the Governing Council to prepare the main principles and implementation practices to increase harmonisation of national ethics rules. The Legal Department also participated in the Technical Cooperation Programme with other ESCB central banks to compile a Needs Analysis Report for the Bank of Albania.

Human resources

The Bank had 329 full-time equivalent employees at the end of 2014, two more than in 2013. The number of full-time positions increased by eight and stood at 340 at the end of 2014, while the number of part-timers was unchanged at 27.

During 2014 the Bank recruited 21 employees (12 Officers II, four Officers I, two Part-Time Officers I and three security guards). At the same time, nine employees resigned from the Bank, one of whom had worked on a part-time-basis.

In 2014 three employees continued their secondment to offices within the public sector and with a charitable organisation.

In addition, seven staff members were seconded to the ECB, three of whom took up a three-year appointment with the Single Supervisory Mechanism (SSM). The Bank also engaged one intern who worked on a specific research project.

The Bank provided temporary summer work placement to seven students from the University of Malta and to six others from the Institute of Business and Commerce at MCAST.

Training and development

As in previous years, the Bank allocated resources to staff training, both within the Bank and through courses organised by local and foreign providers.

The internal training programme consisted of 46 different courses, mainly in IT, economics, statistics, health & safety, and general staff and management development. In addition, the Bank held a number of seminars on its strategic objectives in the medium term. Induction programmes were also organised for all new employees. In addition, staff in the Economics & Research Department organised a number of lectures in econometrics for Bank employees.

As shown in Table 5.1, 215 staff members participated in external training programmes during 2014. These courses were provided by the ECB, other central banks and professional institutions.

During the year a number of employees benefited from the Bank's study programmes (see Table 5.2). Eight staff members completed their postgraduate education, while 28 continued their enrolment in degree programmes.

The Heading for Leadership Programme, which is one of the ECB's open training events, was again hosted by the Bank in April 2014. As currently set up, this programme gives participants the opportunity to identify their personal leadership style and to adapt it to the needs and expectations of the staff members being managed. It also tackles issues such as how to deal with conflict, managing performance and developing teamwork skills. A total of 14 participants from 12 national central banks (NCB) took part in this event.

In June 2014 the Bank participated in "Jobs in Financial Services Exposure". This programme was organised in collaboration with the MFSA and the Education Consultative Council. This initiative is an annual event, which provides Form IV students with a job shadowing experience in a financial organisation. Two students were welcomed at the Bank for a one-week placement.

Table 5.1
STAFF TRAINING DURING 2014

Type of training	Number of courses/seminars	Number of participants
Internal	46[1]	1,167[1]
External		
Local	68	117
Foreign	94	98

[1] These figures include 285 employees that participated in the Bank's Strategic Direction Seminar and 267 employees that participated in seminars on the Policy on the Prevention of Abuse of Insider Information and on the Policy on Whistleblowing.

Source: Central Bank of Malta.

Table 5.2
ACADEMIC AND PROFESSIONAL COURSES DURING 2014

Type of degrees	Number of employees	
	Completed degrees	Ongoing studies
Postgraduate	8	25
Undergraduate (Honours)		2
Diploma		1

Source: Central Bank of Malta.

In view of the importance of identifying and addressing training needs of the organisation, the Human Resource Assessment Task Force continued to identify skill gaps in various departments at the Bank through the analysis of job descriptions, skills and competency levels. The task force developed a standard list of general and technical competencies to facilitate the detection of skill gaps across the Bank.

Information Systems and Knowledge Management

Information Systems

In 2014 the Bank continued to provide IT solutions through a two-pronged approach: by delivering tailored software solutions developed in house and maintaining IT services and infrastructure.

In the longer term, IT solutions have to be aligned with the Bank's evolving business strategy and processes. In this regard, the commitment to the Business Applications Architecture project moved ahead in the identification of IT solutions that would address the Bank's changing needs. Moreover, the Information Systems Department was actively involved in the planning of the new Data Centre, currently under construction.

The introduction of the SSM in November 2014 was a major driver for various IT initiatives at Eurosystem level. The Bank and the MFSA addressed the challenge of exchanging a larger volume of information using a secure telecommunications link.

The Bank also completed the upgrade of its SharePoint and SQL Server platforms to the latest releases and widened the SEPA application to cater for more than 140,000 monthly government transactions. In addition, changes to the financial institution reporting regime were reflected in the update of the relevant statistical information systems. Further enhancements were made to cater for other statistical data services. In collaboration with the Eurosystem, the Bank also upgraded its CoreNet infrastructure and implemented a new Teleconferencing System.

Target 2 Securities (T2S) was another major project embarked upon in 2014. This resulted in a series of SWIFT infrastructure upgrades and in-house developments to ensure that the Bank meets the expected messaging standards. The testing of the application-to-application component on T2S was successfully conducted and the process is expected to continue in 2015. As a follow-up to the rollout of Reuters EIKON in 2013, the backend systems were upgraded to Thomson Reuters Enterprise Platform for Real-Time, facilitating an efficient and reliable distribution of information.

Throughout the year, the Bank reviewed and upgraded several security components, enhancing IT security and resilience. This task also included a gap analysis and compliance exercise on various information security policies. The ESCB Public Key Infrastructure was rolled out in 2014. This initiative is a component for the upcoming Secure ESCB Email Project and involved the rollout of smartcards with digital certificates to all Bank staff involved in Eurosystem-related duties.

The Bank continued its participation on the Eurosystem IT Steering Committee, as well as on IT committees and sub-structures, including various working groups.

Knowledge Management

During 2014 the Knowledge Management Department continued to deploy Microsoft SharePoint within the Bank as a content management platform and a collaborative tool. Within its remit of document management and in preparation for a new document and information management system, the Bank's records, previously stored electronically on other systems, were converted to SharePoint. Work on the Bank's metadata continued to enable the implementation of the new knowledge management strategy.

The Bank's library made further strides through its electronic portal by offering various eLibrary services to its staff and external users. It continued to enhance its print and electronic collections on economics and finance. The library added a scholarly database, providing a collection of bibliographic and full text content on economics, finance and other disciplines. This includes a wide collection of e-journals. The library will enhance these electronic services by subscribing to Business Book Summaries. The Bank also introduced eBooks to further improve its collection on economic and financial literature. The Bank's objective is to expand its eLibrary services to external users through its website.

Premises and procurement

During 2014 the Bank continued with its refurbishment plans as part of a ten-year energy plan, through which old electrical equipment, switchgear and power factor units are being replaced to provide energy efficiency and cost savings. In addition, the construction of a water cistern at the lower garden area next to the St James Counterguard premises has been completed and will now provide second-class water to the Bank and for irrigation purposes. The Bank also embellished the surrounding areas through soft lighting and landscaping.

Construction work on the new building at St James Counterguard proceeded with the installation of the steel structure. Materials handling has presented a particular challenge because of site logistics.

The Bank continued to participate in the Eurosystem Procurement Coordination Office (EPCO), mostly in areas related to software and market data. EPCO enables NCBs in the euro area to benefit from efficiencies in the joint procurement of supplies and services.

Corporate Social Responsibility

As part of its commitment to the environment, the Bank conducted regular paper recycling exercises during the year, through which it collected 6.8 tons of paper for recycling. In addition, material collected from offices generated a further 3.3 tons of waste paper over the course of 2014. All such paper was eventually baled by the Bank's contractor, combined with other paper waste, and sent abroad for recycling.

Meanwhile, in cooperation with the Park Afforestation and Rural Conservation within the Ministry for Sustainable Development, the Environment and Climate Change, the Bank repeated the previous year's initiative of planting trees in various parts of the island.

In the philanthropic sphere, the Bank assisted various cultural organisations, including *Fondazzjoni Patrimonju Malti* and *Din L-Art Ħelwa*. Philanthropic assistance was provided to various charities, including the Malta Community Chest Fund, Little Sisters of the Poor, *Dar l-Emigrant* and *Dar tal-Providenza*. In addition, the Bank sponsored the participation of staff members in the sixth edition of the President's Charity Fun Run held in December.

The Bank continued to provide financial support to institutions in areas connected to its functions, as well as to non-governmental organisations through donations and sponsorships. For the third consecutive year, the Bank sponsored the "Central Bank of Malta Chair in Economics" at the University of Malta through the latter's Research, Innovation and Development Trust.

Information and public relations

The Bank offers the general public information on its policies, operations and activities in printed form and electronically on its website. The latter was upgraded in November 2014, and now provides users with enhanced content and accessibility, and improved navigation features. The website also includes an eLibrary containing all Bank publications and press releases.

The Communications Department responds to local and foreign media requests, and organises various corporate events. In addition, the Bank hosted seven ESCB meetings during the course of the year. The Department prepares the Bank's publications for printing and issue.

The Department handled 16 school visits in 2014. These visits focussed on the role and function of the Bank and the Eurosystem, using audio-visual material, and include tours of the Bank's currency museum.

The Bank organised two numismatic events in 2014. One consisted of the fifth annual coins symposium and was held in January to introduce the Coin Issuance Programme for 2014, and to promote public awareness of the historical significance of new commemorative coins. The other event, held in May, launched the issue of a numismatic coin jointly with Maltapost.

In 2014 the Department organised two national information campaigns. One was on the occasion of the launch by the Ministry for Finance of the Investment Registration Scheme. The other involved the issue of the new €10 banknote, which forms part of the Eurosystem's Europa series. For the fifth consecutive year, the Bank opened its doors to the public on the occasion of the *Notte Bianca* in October.

6. INTERNATIONAL RELATIONS

As a member of the Eurosystem, the European System of Central Banks (ESCB) and of the European Systemic Risk Board (ESRB), the Central Bank of Malta continued to participate in these institutions' decision-making processes in 2014 and to collaborate closely with the European Central Bank (ECB). The Bank also maintained strong relations with other international institutions, notably the European Commission, the International Monetary Fund (IMF), the World Bank Group, and the European Bank for Reconstruction and Development (EBRD).

Eurosystem and European System of Central Banks

The Governor continued to participate in meetings of the Governing Council of the ECB, which is made up of the ECB's Executive Board members and the national central bank (NCB) governors of the euro area Member States. The Council is responsible for monetary policy within the euro area and decides on the implementation of tasks entrusted to the Eurosystem (which comprises the ECB and the euro area NCBs).[1] In 2014 the Governing Council also held a number of separate meetings dedicated to the operation of the Single Supervisory Mechanism (SSM). The Governor is also a member of the General Council of the ECB, which mainly performs an advisory role and is composed of the President and Vice-President of the ECB, and of the NCB governors of all Member States of the European Union.

The Governing Council and the General Council are supported by a number of committees and working groups. Throughout the year senior Bank officials participated in the 18 Eurosystem and ESCB committees while other staff members took part in more than 120 sub-structures of these committees (see Table 6.1). During 2014 the Bank, in collaboration with the Malta Financial Services Authority (MFSA), continued to be actively involved in the preparations for the setting up of the SSM. In November 2014 the ECB assumed responsibility for banking supervision in Member States participating in the SSM. The Governor attended the SSM inauguration event and the first Macro-Prudential Forum in Frankfurt. The Central Bank of Malta is represented on the Supervisory Board of the ECB by the Deputy Governor for Financial Stability.

During 2014 the Governor was a signatory to a number of multilateral agreements related to operations of the Eurosystem and the ESCB. These included the fourth Central Bank Gold Agreement signed in May.

In January, following an update undertaken every five years, the Bank's share in the key for the ECB's capital subscription rose marginally to 0.0648%. This led to a slight increase in the Bank's share in the ECB's total subscribed and paid-up capital to EUR7.0 million.

In 2014 the Central Bank of Malta, together with the ECB and ten other ESCB NCBs, took part in an EU-funded technical cooperation programme with the Bank of Albania. This programme consisted of a needs analysis with recommendations on how to reinforce the institutional capacity of the Bank of Albania and bring its practices more in line with EU standards, in view of Albania's official

Table 6.1
EUROSYSTEM/ESCB COMMITTEES

Accounting and Monetary Income Committee (AMICO)
Banknote Committee (BANCO)
Budget Committee (BUCOM)
Committee on Cost Methodology (COMCO)
Eurosystem/ESCB Communications Committee (ECCO)
Eurosystem IT Steering Committee (EISC)
Financial Stability Committee (FSC)
Human Resources Conference (HRC)
Information Technology Committee (ITC)
Internal Auditors Committee (IAC)
International Relations Committee (IRC)
Legal Committee (LEGCO)
Market Operations Committee (MOC)
Monetary Policy Committee (MPC)
Organisational Development Committee (ODC)
Payment and Settlement Systems Committee (PSSC)
Risk Management Committee (RMC)
Statistics Committee (STC)

[1] Latvia joined the euro area and Latvijas Banka became part of the Eurosystem in 2014.

candidature for accession to the European Union. The Central Bank of Malta contributed specifically in matters relating to the legal framework.

European Systemic Risk Board

The Governor, as a member, participated in four General Board meetings of the ESRB held during 2014, while senior Bank officials participated in the ESRB's Advisory Technical Committee and its sub-structures.

During the year the General Board agreed on documentation designed to help authorities put into operation the new macro-prudential policy framework that came into force on 1 January 2014. The Board also discussed systemic risks that may emerge from large banking systems and approved a Recommendation on guidance to EU Member States on counter-cyclical buffer rates. The guidance, which is required under EU legislation, seeks to establish a common approach to setting the counter-cyclical capital buffer across Europe.

When discussing the extent of progress achieved in the implementation of its Recommendation on the macro-prudential mandate of national authorities, the General Board noted that legislative initiatives were proceeding in all Member States. In April the ESRB published the adverse scenarios for the EU-wide stress tests for banks and insurance firms to be carried out by the European Banking Authority and the European Insurance and Occupational Pensions Authority in 2014.

Throughout the year the ESRB continued to publish its risk dashboard. This is a set of quantitative and qualitative indicators of systemic risk in the EU financial system, occasional papers and macro-prudential commentaries.

Other EU institutions

The Governor and the Deputy Governor for financial stability participated in informal sessions of the Economic and Financial Affairs Council that were held in September and April, respectively. The Deputy Governor for monetary policy or other senior Bank officials regularly took part in meetings of the Economic and Financial Committee (EFC). During 2014 EFC discussions continued to focus mostly on topics related to economic governance, fiscal and macroeconomic surveillance, international economic coordination and financial sector stability.

In particular, the Bank participated in EFC discussions on issues related to the monitoring of financial stability in the European Union and to the completion of the Banking Union. Discussions focused on the design and implementation of the SSM and of a Single Resolution Mechanism and possible backstop arrangements. Furthermore, the EFC was involved in the review of the European System of Financial Supervisors and also discussed recommendations and warnings issued by the ESRB. The EFC also discussed other matters in the financial sphere, such as changes to banking structures, market fragmentation, the internal market, shadow banking and long-term finance.

During the year the EFC continued to play a crucial role, through substantive discussions and agreements on terms of reference, in the preparation of common European positions at the G-20 meetings and in other international fora, such as the IMF and the Financial Stability Board (FSB). Particular attention was paid to the framework for economic growth, the reform of the international financial architecture and financial regulation.

Bank officials formed part of various EFC sub-structures, in which matters of relevance to central banks, such as sovereign debt and IMF-related issues, were discussed.

The Bank also participated directly in various other committee structures of the European Union, and contributed extensively through consultations with Malta's representatives within the respective EU structures on matters of an economic and financial nature.

European Bank for Reconstruction and Development

The Bank monitored developments at the EBRD and collaborated with the Ministry for Finance on various issues related to Malta's membership in this institution. In particular, the Bank provided advice to the Ministry on resolutions that required decisions by the EBRD's Board of Governors, such as those related to Libya's membership of the EBRD and the New Safe Confinement Project in Chernobyl.

In May the Deputy Governor for monetary policy accompanied the Minister for Finance at the annual meeting of the EBRD held in Warsaw, Poland, where the EBRD announced a positive and profitable financial performance despite the persistence of a difficult operating environment.

International Monetary Fund

The Governor, in his position as Governor for Malta on the Board of Governors of the IMF, attended the IMF/World Bank Spring Meetings in April and Annual Meetings in October. Furthermore, he voted on a number of Resolutions proposed by the Fund's Executive Board.

In December IMF staff members visited Malta in connection with the 2014 Article IV consultation with Malta. The IMF mission held a number of meetings with senior officials of the Central Bank of Malta, the Government, the MFSA and other entities. Later that month, the IMF released a concluding statement about its mission to Malta and published a detailed report on its findings.

Malta's quota in the IMF remained unchanged in 2014 at SDR102.0 million, pending the increase in quotas expected to come into effect following the ratification of proposed amendments to the IMF's Articles of Agreement concerning the reform of its Executive Board. Under the quota review Resolution, Malta's quota would increase by SDR66.3 million to SDR168.3 million.

During 2014 Malta's net cumulative allocation of SDRs, which is computed in proportion to its quota share, remained unchanged at SDR95.4 million, though the Bank's holdings decreased from SDR89.5 million at the end of December 2013 to SDR84.5 million a year later. This reflected sales under the Bank's two-way voluntary arrangement with the Fund. Transactions under this arrangement are subject to limits such that Malta's SDR holdings are not less than 65%, but not more than 117%, of its net cumulative allocations.

The Bank also continued to carry out transactions related to the IMF's operational budget. The amount of new loans extended by the Bank continued to exceed repayments. As a result, Malta's reserve tranche rose from SDR37.3 million to SDR38.3 million, while the Fund's holdings of the national currency with the Bank decreased from the equivalent of SDR64.8 million to SDR63.7 million by the end of the year.

During 2014 no drawings were effected under the 2012 bilateral loan agreement between the Bank and the IMF. The non-ratification of the 14th General Review of Quotas prompted the IMF to initiate a general exercise to mitigate its impact on Fund resources and in July, following consultation with the IMF, the Maltese authorities concurred to the first one-year extension of the 2012 loan agreement, which was due to expire in February 2015.

World Bank Group

The Bank continued to assist the Ministry for Finance in monitoring developments within the World Bank Group and by providing advice on relevant proposals from the Group. The Bank also continued to provide administrative support to the Small States Network for Economic Development and to act as fiduciary agent for the Network's Board of Trustees.

Other matters

The Bank continued to monitor developments related to initiatives endorsed by the FSB and the Bank for International Settlements (BIS). Staff members also participated in seminars organised by the Financial Stability Institute, which was jointly created by the BIS and the Basel Committee on Banking Supervision in 1999 to assist in improving and strengthening financial systems.

ENHANCING COMPETITIVENESS[1]

Professor Josef Bonnici
Governor of the Central Bank of Malta

I would like to thank the President and Committee of IFS-Malta for once again organising this Annual Dinner and giving me the opportunity to share my thoughts with such a distinguished audience.

I would like to take this opportunity to welcome Ms Pelin Berkmen, Head of an IMF delegation, and members of her team, who are with us tonight and who have just concluded the annual Article IV Mission. A warm welcome also goes to Mr Antonio Bassanetti, from the IMF's Executive Director's office. I trust you will find this evening of relevance.

Mr President, I was pleased to hear about the achievements of the Institute over the past year. Education and training are fundamental components of a successful and sustainable financial services sector. The endeavours of the Institute deserve due recognition. Well done to all of you and I wish you every success in the future.

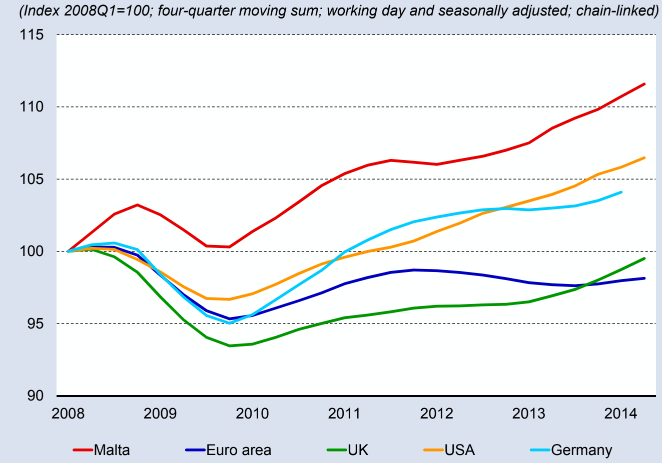
Introduction

The aftermath of the crisis provides an important starting point for the discussion of competitiveness, which will be the main theme of my remarks tonight.

I will commence by focussing on Chart 1, which compares the performance of various economies since the onset of the crisis. All the curves start from a common point of 100 in 2008. Setting the Maltese economy aside for a moment, several considerations stand out. The real GDP of the euro area has yet to return fully to its 2008 level, and the same can be said for the United Kingdom. In fact, the euro area economy is currently 1.9% smaller than in 2008, while the British economy is 0.5% smaller.

The euro area average is composed of countries recovering at different speeds. For example, Germany is a top performer in the euro area, though its economy has lagged somewhat behind the United States. In fact, German output is currently 4.8% higher than in 2008, while in the US it is 6.5% higher.

Chart 1
REAL GDP
(Index 2008Q1=100; four-quarter moving sum; working day and seasonally adjusted; chain-linked)



Source: Eurostat.

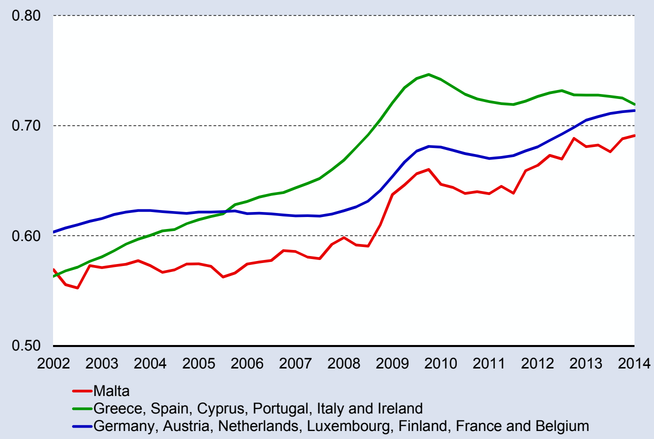
Where does Malta fit in all this? As the Chart shows, Malta compared favourably throughout the crisis and in the aftermath. The contraction at the trough in 2009 was relatively moderate. The path taken in the recovery has been stronger – in fact, consistently stronger – than in the other economies shown in the Chart. Output is at present 12% higher than in 2008.

I believe that a number of factors have shaped the course of the Maltese economy.

[1] Speech given at the Annual Dinner of the *ifs* Malta on 15 December 2014.

Malta passed through a liberalisation and restructuring experience that saw the exit of inefficient entities and businesses mostly prior to EU accession in 2004. This process of rationalisation, which occurred only a few years before the start of the crisis in 2008, made the overall economy resilient and in a better position to weather adverse events in external markets.

Chart 2
NOMINAL UNIT LABOUR COSTS
(four-quarter moving average; EUR per unit of output)



Source: Eurostat.

Post-2008 growth was enabled by the smooth entry into the euro area, which coincided with the start of the crisis in 2008. The transition was facilitated by the fact that, in the preceding decades, there had been no recourse to monetary financing of government debt, generally no recourse to currency depreciation to offset internal competitiveness issues, while fiscal policies had been in large part prudent.

Another consideration relates to the growth of new sectors, which improved the capacity of the economy to offset downturns in external demand. Diversification is often more difficult to achieve in relatively small economies. However, the degree of diversification in the private sector in Malta is remarkable, and has resulted primarily from the growth of financial services, internet-related services and aviation servicing, along with the reorientation of both the tourist and manufacturing sectors.

Although we have experienced higher GDP growth, we must be aware that some of our competitors are starting to benefit from the structural reforms and internal devaluation that they went through in response to the impact of the financial crisis on their economies. Chart 2 displays unit labour costs in the euro area since 2002, distinguishing between the stressed economies and the relatively unstressed ones. The path of Malta's ULC is displayed separately. The Chart shows that Malta trends lower than either of the two groups. However, one also notes that costs in the stressed countries have been levelling off, so that Malta's competitive advantage has somewhat narrowed.

This suggests that Malta must remain extra attentive to the factors that influence competitiveness. Over the course of the crisis, Malta's economy was never in need of austerity measures, which in itself is a manifestation of economic and financial sector resilience and good governance. But, at this stage, we need to ensure that our competitive edge is not eroded.

Structural and fiscal policies in the euro area

Turning to current policy issues at euro area level, one of the major challenges is the choice of the right instruments, or finding the proper balance between demand-oriented and supply-oriented policies.

In view of the serious damage caused by the financial crisis, there is widespread realisation that a durable solution to the current economic stagnation needs to be built around a structural reform programme. Over time, these reforms would result in a greater degree of competitiveness, improving the growth potential of the economy. In the short run, however, such supply-side reforms often involve transitional costs, hence, the importance of demand-side measures to alleviate the impact on those that are negatively hit by structural reforms. This would prevent deflation and high levels of unemployment.

Unfortunately, the choice of policy instruments has been severely constrained by the absence of space to manoeuvre on the budgetary side. Indeed, the financial crisis that hit the European economies at a time when a number of Member States had unsustainably high public debt levels left less room for demand management. Major structural reforms and internal devaluations, which included outright cuts in nominal wages, were inevitable, and these had to be effected without the possibility of complementing them with appropriate compensation on the demand side. The result is a prolonged and painful recovery with permanent effects on potential economic growth, in some countries driving a disinflationary process.

A further challenge arises from the fact that in the Eurosystem the centralised monetary stance is accompanied by a fragmented fiscal effort on the part of various national governments. This contrasts with, for example, the United States where both monetary and fiscal policies are more centralised, and hence can be harmonised towards a common goal.

While these limits on national fiscal policies have influenced the slow momentum of recovery, there are still various options that can address this weakness. On the fiscal side, the recent proposal by the Commission to create a European Fund for Strategic Investments is one way of funding large scale investment projects that would promote competitiveness and boost activity in stressed areas. The Fund would be backed by guarantees from the EU budget and the European Investment Bank. A complementary policy is the switching of government expenditure to more investment and growth friendly areas, while reducing bureaucracy and other inefficient expenditure.

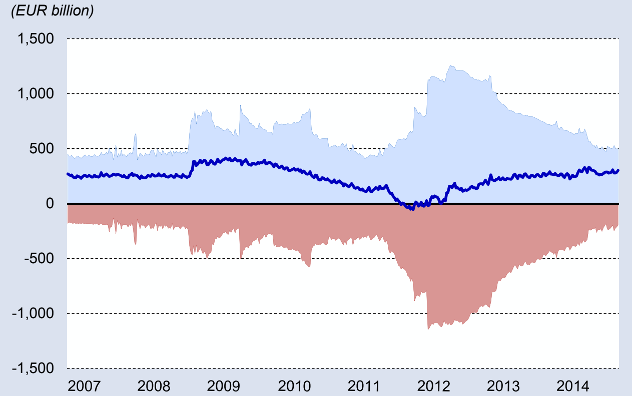
Monetary policy in the euro area

Against this background, the role of monetary policy has become, and is likely to remain, more accommodative in the euro area. The ECB has played a major role in supporting economic growth, using its interest rate policy – now at near zero level – and policies designed to influence credit provisioning and risk reduction. The ECB has also reaffirmed that, if necessary, further measures will be taken to counter the risk of a prolonged period of low or negative inflation and to bring inflation to its medium-term target of under, but close to 2%.

The possibility of a deflationary situation materialising in the euro area is of concern as its dynamics would raise real interest rates. It would penalise investors and increase the burden of holding business inventories. It would also discourage consumption, as buyers await lower prices by delaying spending. A de-anchoring of inflation expectations carries a risk of the euro area becoming stuck in a stagnant environment for a prolonged period of time. Basically, a deflationary scenario would be inconsistent with what is needed to support an economic recovery in Europe.

The effectiveness of monetary policy in the euro area depends on a properly functioning banking sector, since the transmission of monetary stimulus operates at least partly through the bank lending channel. In the euro area, the debt overhang in the private sector and the balance sheet position of the banks have been hampering the transmission and effectiveness of the ECB's accommodative policy measures.

Chart 3
ECB MONETARY OPERATIONS
(EUR billion)



Source: Statisitical Data Warehouse.

Turning to Chart 3, the solid line shows that, in spite of various measures adopted by the ECB, whether those operating through the interest rate channel or through credit volumes, the *net* injection of liquidity remains relatively low. The upper part of the Chart, in blue, shows the liquidity injected by the ECB into the euro area economies. The lower part, in red, shows the balances deposited with the Eurosystem by euro area banks. The Chart also shows how a large part of new liquidity was deposited back at the ECB by banks. The objective of the current targeted longer-term refinancing operations (TLTRO) is to inject more liquidity at a low rate that is fixed for four years, while the negative deposit rate is to discourage funds going back to the ECB.

There are indications that the contraction in credit supply is bottoming out. This signals a potential turnaround in credit dynamics in the euro area. Also, the latest ECB's Bank Lending Survey saw banks report a further easing of overall credit standards. The various announced measures are expected to inject liquidity into the system in two different ways, namely through direct asset purchases and through bank borrowing from the Eurosystem. Both routes essentially transfer risks from the financial system to the Eurosystem, and hopefully should lead to a greater ability to fund investment in the economy. In the process, the Eurosystem's balance sheet will expand.

Prudential reform in the euro area

I will now turn to financial stability issues. As you are aware, the Comprehensive Assessment of major banks undertaken by the ECB marked the start of a trilateral relationship between banks, National Competent Authorities and the ECB, in its role of supervisor of banks in the euro area. The Single Supervisory Mechanism's micro-prudential responsibilities will complement the existing ECB's macro-prudential role in shaping the future of banking in the euro area. Banking supervision, viewed as one of the tools at the disposal of the ECB, will help ensure financial stability, which is needed to sustain macroeconomic growth. The demanding Asset Quality Review and stress tests, coupled with an overall result that exceeded expectations, set a positive mood in the market and should lead to easier access to bank funding for investment growth.

Financial sector dimension of Malta's competitiveness

Turning to the Maltese context, it would be a pity if the low-cost credit conditions that are being offered by the ECB are not fully exploited in Malta. Broadly speaking, the overall participation in the TLTRO programme by core Maltese banks has been somewhat disappointing, with the participation of very few banks and with the actual take-up being way short of the limits available.

On the positive side, we have noted the introduction of a lending scheme that a domestic bank is funding from the ECB's TLTROs. These TLTROs provide funds at very favourable terms – at a very low interest rate that is fixed for four years. Although the size of this particular scheme is limited, one hopes that it can be expanded and emulated by other banks. Such programmes are a prime example of the banking sector fulfilling its role of promoting economic growth by providing the necessary low-cost funding, while at the same time contributing to the profits of the bank.

It is worth noting also that competitiveness does not depend only on costs; as the crisis has reminded us, financial stability is equally essential. In Ireland, for example, it was the poor governance and risky credit practices of commercial banks that drove the country into the crisis, even though the competitiveness indicators were very positive.

Generally speaking, Maltese banking is run on a prudential and cautious business model and this is particularly true of the systematically-relevant banks, which manifest, for example, a low loan-to-deposit ratio. Nevertheless, we have stepped up our efforts, jointly with the MFSA, to ensure that the soundness of the banking system is not only preserved but also enhanced.

The Joint Financial Stability Board between the Central Bank of Malta and the MFSA has contributed to major initiatives, notably amendments to Banking Rules 09 and 12. These amendments will improve the overall coverage ratio and strengthen provisioning practices. They also boost bank capital and reserves to mitigate potential risks from lending portfolios. The amendments also address the risks arising from banks' concentration in the real estate sector.

I want to take this opportunity to commend our banks, particularly those participating in the Comprehensive Assessment, as this was a very challenging year. The changes I just mentioned coincided with the new requirements and rules under the Comprehensive Assessment. I recognise that these changes may impact profitability in the short term, but sound governance sets the stage for sustainably higher returns in the longer term.

Banks are now subject to the single rule book and this calls for increased awareness and focus to meet these new challenges. This will reduce the overall risk in the financial system both in Malta and elsewhere.

Going forward, there are other challenges that will need to be addressed by our financial system in order to further mitigate certain risks.

In the aftermath of the sovereign debt crisis there is a heightened recognition that a more diversified investment portfolio would reduce the risk exposure related to the bank-sovereign nexus. Looking into the future, further diversification of our sovereign debt market may be warranted. It would be advisable if, going forward, stable alternative options are identified to complement current practice. Long-term placements with certain international wealth funds, for example, would ensure that government securities can have a more diversified investor base and possibly reduce the Government's borrowing costs at the same time.

There is a further consideration that I have raised on previous occasions – one that would enhance the effectiveness of the intermediation role in our financial system and address some of the funding gaps, resulting possibly in instances of market failures. Malta lacks a consistent supply of long-term finance that would efficiently fund a project addressed to SME funding needs or to finance structural, economic, social and environmental policies in connection with the long-term financing of priority projects. If we look at other countries, such as Germany and France, they managed to cater for SMEs, as well as for other environmental and infrastructure investment through promotion or development banks. A development bank would contribute to economic growth by funding sectors and projects that are not catered for by commercial banks on their own. The Central Bank of Malta looks at such an initiative as a necessary diversification of our financial base. I understand that progress is being made on this initiative and I find this to be a very positive development.

The road ahead

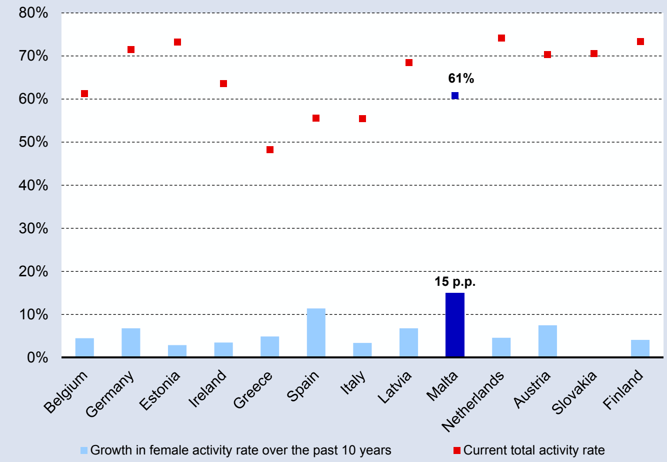
Against a rapidly changing economic landscape, Malta needs to be attentive to take advantage of its flexibility and adaptability. In the past years, the Maltese economy went through significant structural change, not only by diversifying into a number of new growth sectors, such as aviation services, pharmaceuticals and internet related activity, but also by upgrading its investments in the traditional sectors. For example, the tapping of new source markets for tourists in European cities that were newly serviced by low-cost airlines allowed the hospitality sector to overcome the recession-driven weak demand in already serviced markets. Similarly, the financial and other service sectors continued to expand, thanks to the right conditions for growth, including the appropriate legislative environment.

There are a number of reasons for being positive and optimistic about Malta's potential growth in future. In contrast to various developed countries, Malta has some structural issues that, if addressed, can provide opportunities for an ongoing momentum to growth.

Take, for example, the labour participation rate in Malta. Although it is among the lowest in the euro area (as shown in Chart 4), Malta has gone a long way in achieving progress on this issue. Over the past ten years, Malta registered the largest increase among Member States in the female activity rate, which rose from 36% in 2004 to over 50% this year. The recently introduced incentives for female participation will continue to steer our labour market in the right direction, also boosting Malta's potential economic growth.

At the same time, we also observe a higher number of foreigners who are contributing to economic activity in a variety of sectors. First, it has to be remarked that an expanding labour force through this route is in itself a sign of Malta's strong rate of economic growth relative to other areas of the European Union. Second, it reduces the likelihood of skill gaps in the labour market. Though this added flexibility needs to be recognised for the positive effect it has on potential output, the role of retraining programmes by the ETC remains of utmost importance in better matching skills with vacancies and further reducing the rate of unemployment.

Chart 4
LABOUR MARKET PARTICIPATION RATE



Source: Eurostat.

Turning to the fiscal dimension, Government forecasts the deficit to decline to 2.1% of GDP this year and to 1.6% in 2015. This is a financially responsible objective which needs to be truly maintained. The government debt-to-GDP ratio has reached around the 70% level. This ratio needs to plateau and eventually to drop, and this requires sustainable management of both budgetary inflows and outflows.

Clearly, budgetary performance depends on economic performance as higher growth ensures higher tax revenues. In turn, faster growth is only possible by producing and delivering more goods and services. This can only be attained by being competitive.

Moreover, other significant challenges remain. Inefficiencies in public administration processes hamper the development of the Maltese business environment and need to be improved, so as to better support competitiveness and encourage foreign direct investment.

As I already mentioned, there is also room for further improvement in the business environment in terms of access to credit. The cost of credit in Malta remains on the high side and further easing would help our businesses to invest at a lower cost. Going forward, various initiatives are envisaged to improve the current situation, including the introduction of a credit register that will be administered by the Central Bank of Malta. A credit register will narrow the information gap that exists in the Maltese banking system by reducing asymmetric information between borrowers and lenders. It also improves risk management, thereby contributing to a better performing loan portfolio and, as a result, a lower cost of capital.

Ladies and gentlemen, let me close with a few concluding remarks.

As you are well aware, the banking sector across the euro area is passing through regulatory and supervisory changes that are sometimes viewed as expensive, and of imposing unnecessary burdens on the sector. This is a short-sighted assessment. Though dividend pay-outs may be lower in the short run, their sustainability will be strengthened in the longer term. Similarly, higher bank capital does not necessarily lead to lower volumes of loans over the long run. Instead, a higher capital base mitigates balance sheet risk, lowers bank funding costs, hence allowing banks to charge a lower risk premium on their loans, to the advantage of both lenders and borrowers.

The crisis has uncovered various shortcomings in corporate governance in the banking sector, mainly in areas like risk management and internal controls, compensation, corporate structures and transparency. Some Maltese banks have yet to adopt a number of necessary risk oversight practices that would ultimately benefit the banks and their stakeholders.

What needs to be stressed is that reputation is a key asset of Malta's financial system which cannot be taken for granted. Efforts to safeguard financial sector reputation need to be ongoing and undertaken by all concerned in the financial sector.

Reforms in the banking system need to be accompanied by structural reforms in other parts of the economy. However, this can only be possible if the economy is growing sustainably. Within the context of limited fiscal space, there is a need for the appropriate environment to encourage investment and stimulate growth in the private sector. Going forward, we need to enhance Malta's competitive position in order to attract a higher volume of capital investment in future. A strong education and skills base, an upgraded infrastructure and a clean and sustainable source of energy are essential elements that would pave the way for future investment.

The financial sector provides an important contribution to output and employment growth in Malta. Going forward, the sector has room for expansion in a range of activities that link it to the domestic economy, in the sense that value is added in Malta by engaging the services of financial experts, lawyers, accountants and so on, but also in catering to demand abroad, such as in the Mediterranean region and beyond. For example, the recently announced initiative to create space for a new commercial activity in the form of facilities for Islamic banking is consistent with this vision for Malta.

Enhancing our competiveness requires a constant search for new areas of activity, as well as strengthening and refining the currently successful ones. It is the only way for us to ensure that the standard of living keeps rising and that the value added of the Maltese economy keeps advancing.

AN ANALYSIS OF MALTESE PAYMENT HABITS

Introduction

Technological and security enhancements play a vital role in facilitating how everyday payments are made. In fact, modern payment channels are continuously being developed, introducing more efficient and convenient methods of payment.[1] However, this may not be fully reflected in everyday payments in Malta as paper-based instruments are still heavily relied on. This conclusion has been confirmed by statistics collated from a survey on local payment habits carried out in the last quarter of 2013 and the first quarter of 2014. The survey results will be an important input in the formulation of a national strategy on the use of various payment instruments.

The survey was carried out on the basis of a systematic sample. A total of 1,111 respondents from 502 households contributed towards the compilation of the data, which were grossed up in order to infer estimates for the population.[2] This study was spearheaded by the Regulation and Oversight Office within the Payments and Banking Department of the Central Bank of Malta. The Statistics Department of the Bank led the fieldwork, which was carried out on the basis of interviews, and inferred the estimates for the population. The habits of the population were also gauged through a one-week payment diary, which supplemented the survey. In their diaries, respondents were asked to provide information about their daily purchases and payment instruments used.

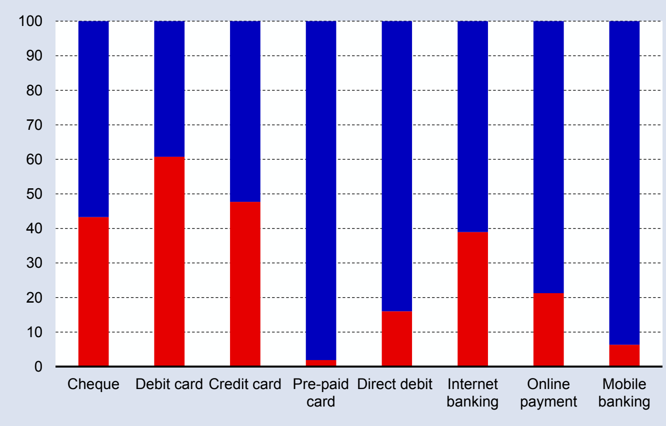
Although paper-based payment products are free for the general user, they are inefficient in terms of return on costs for suppliers of the payment media, even though the provision of free cheque facilities can be part of a profitable marketing package on the part of banks. Still, the results of the survey confirm that the Maltese tend to rely on cash as their preferred payment instrument. Additionally, cheques are also actively used by the Maltese.

The survey results are not directly comparable with information about other countries. Nevertheless, data from other sources within the banking system show that Malta ranked the highest in terms of cheque usage when compared with other EU countries in 2013. Moreover, Malta still lags behind in the use of electronic payment instruments.[3]

Payment instrument access and utilisation

Access to payment instruments is necessary for the utilisation of particular instruments. Accessibility is defined by a person's owning a particular instrument or having direct access to it, as well as having knowledge about its usage. Chart 1 shows the access to different payment instruments in Malta, with data collected reflecting high access to debit and credit cards, cheques and internet banking.

Chart 1
ACCESS TO DIFFERENT PAYMENT CHANNELS
(percentage)



Source: Central Bank of Malta calculations.

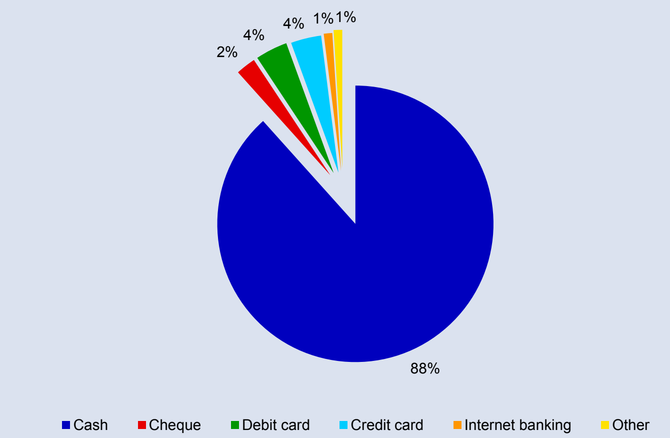
[1] Payment channels, payment modes, payment instruments, payment products and payment mediums are used interchangeably in this article.

[2] The sampling method implies that population results entail a margin of error of ±4.4% with a 95% confidence interval.

[3] Data used for international comparisons can be accessed through the following link: http://www.ecb.europa.eu/press/pdf/pis/pis2013.pdf?06ec75f7173136eb1186fc5c1e3b2d89

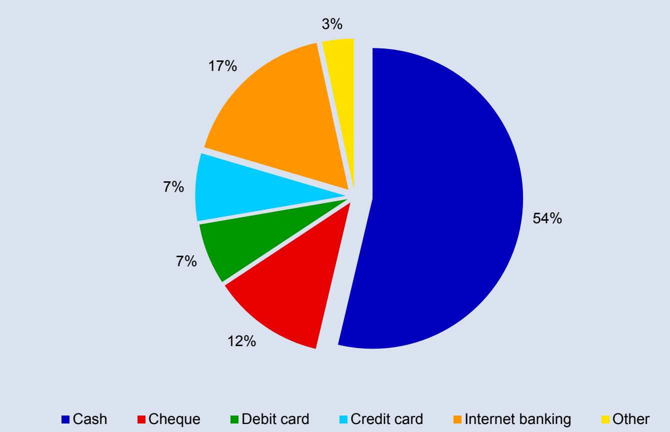
Turning now to the actual use of various methods of payment, the payment diaries provided information about the quantity of transactions carried out using each instrument. As portrayed in Chart 2, cash was the most popular payment channel, accounting for approximately 88% of all transactions. Credit cards followed, with a much lower share than cash, making up approximately 4% of the total volume of transactions. The same was true for debit cards. Transactions using cheques registered a slightly lower volume, close to 2%. Alternative payment instruments, such as internet banking and direct debits, registered relatively minimal use, hence confirming the local dependence on traditional payment channels.

Chart 2
VOLUME PERCENTAGE USE OF PAYMENT INSTRUMENTS



Source: Central Bank of Malta calculations.

Chart 3
VALUE PERCENTAGE USE OF PAYMENT INSTRUMENTS



Source: Central Bank of Malta calculations.

Chart 3 shows the distribution of transactions by value. Although, as shown in Chart 2, cash, at approximately 88%, was the most popular medium by volume, only around 54% of the total value of transactions was made in cash. These results indicate that cash was mainly used for low value payments.

Internet banking, at approximately 17%, ranked second as a percentage of total transactions in terms of value. However, it registered only 1.3% of the total volume of transactions, hence implying that internet payments were preferred for high value transactions. Approximately 12% of the total value of payments was made by cheque. This was followed by credit and debit cards, with approximately 7% take-up in terms of value per payment instrument.

Usage of payment instruments by category of respondent

The following sections shall now analyse the usage of each payment instrument according to the type of respondent. The survey design allowed for analysis in terms of gender, age, type of employment, educational level and incomes of the individual respondents. The results are depicted in Charts 4, 5, 6, 7 and 8.

Chart 4 portrays payment instrument utilisation by gender. Data show that around 94% of respondents used cash for their purchases, with similar rates for both men and women. Debit and credit cards followed, with similar usage rates for males and females. Cheque usage was higher among males than females at 22.8% and 13.5%, respectively. In general, modern payment channels, such as internet banking, online payments, direct debit and pre-paid cards recorded very low usage. Men have a small edge over women in terms of the proportion using these innovative payment instruments.

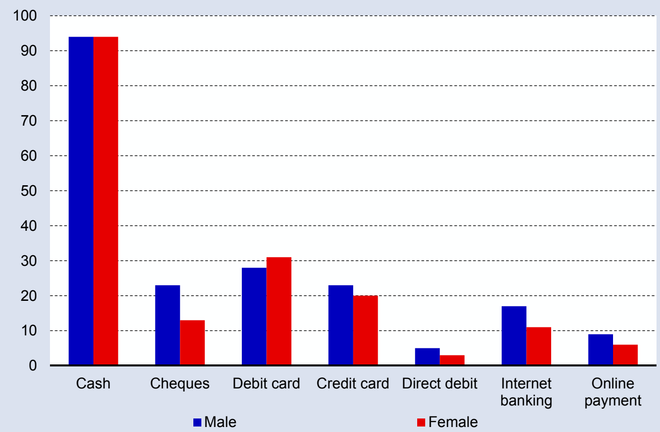
As shown in Chart 5, different age groups have different preferences for payment instruments, possibly because access and degrees of adaptability to financial innovation may vary across age groups. As already observed in Chart 4, Chart 5 shows cash as the main instrument used by all age groups, with use ranging between 89% and 99%. The 25–34 age group registered the lowest cash usage (88.8%), while the 35–44 year age group were the highest cash users (98.9%), followed by those above 55 years (97.1%). The 25–34 age group registered the highest take-up of alternatives to cash but the elderly were the lowest users of modern payment instruments.

An analysis by employment status shows that the self-employed were the lowest users of cash (see Chart 6).[4] In fact, only 85.0% of the self-employed declared that they make use of cash. However, the same category ranked top, at 46.7%, in the usage of cheques. Employed individuals registered the highest card usage, while the unemployed made the least use of financially innovative products, with online payments, direct debits and pre-paid cards being the least favoured channels.

Chart 7, denoting usage by educational level, shows that people with at most a secondary standard of education have a higher tendency to opt for cash as a means of payment, while the post-tertiary category registered a relatively low cash usage (71.9%). Data also show that people with tertiary and post-tertiary levels of education were the highest users of payment instruments other than cash.

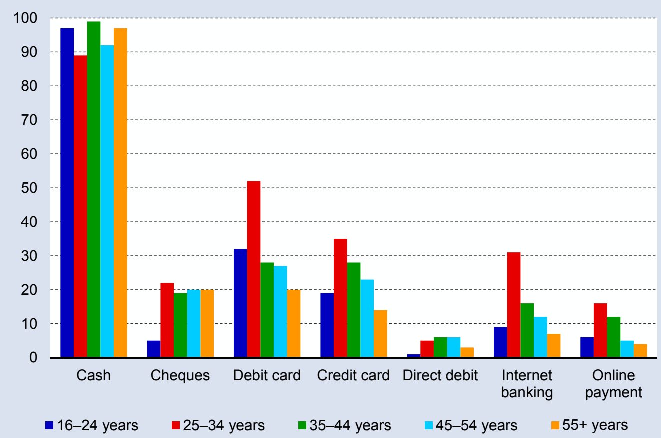
Differences in income also seem to imply a variation in instrument usage. Once again, as shown in

Chart 4
USAGE OF PAYMENT INSTRUMENTS BY GENDER
(percentage)



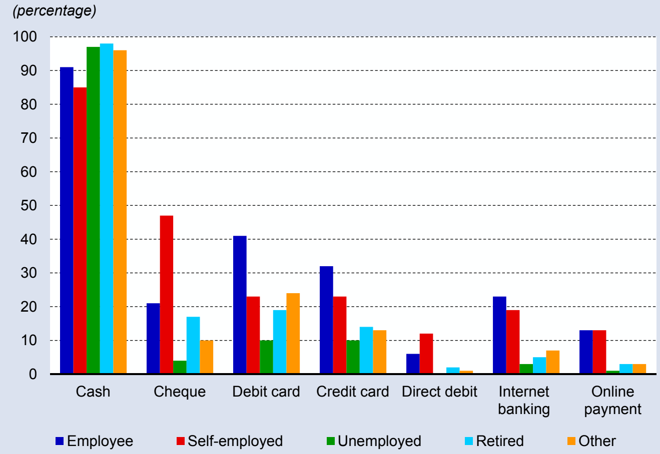
Source: Central Bank of Malta calculations.

Chart 5
USAGE OF PAYMENT INSTRUMENTS BY AGE GROUP
(percentage)



Source: Central Bank of Malta calculations.

Chart 6
USAGE OF PAYMENT INSTRUMENTS BY EMPLOYMENT STATUS
(percentage)



Source: Central Bank of Malta calculations.

[4] The “other” category includes housewives, single parents and people who qualify for social welfare benefits. However, the “unemployed” category may also include people who receive social welfare benefits, such as unemployment benefits.

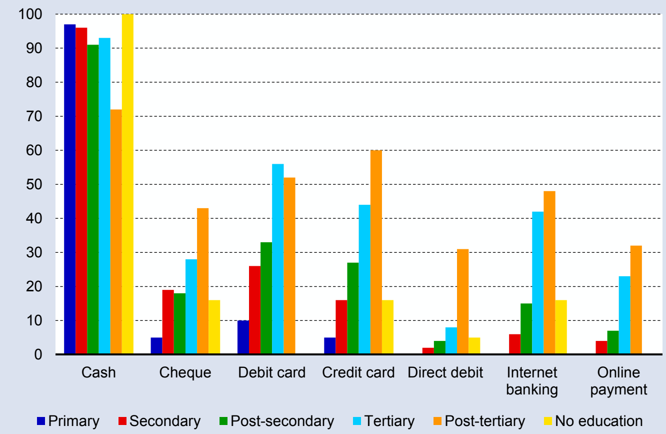
Chart 8, cash was the payment channel mostly used across all income brackets.[5] The €16,501–€21,000 income bracket registered the lowest usage while the €10,001–€12,000 income bracket proved to be the highest at 98.9%. Although cash is used by all income brackets, the results still indicate that low-income earners are more inclined to use cash than high-income earners. Debit and credit cards, and cheques followed as the closest alternatives to cash for all income brackets. However, as depicted in Chart 8, high-income earners are clearly more inclined to use alternative payment instruments. Hence, a positive correlation is evident between income levels and the use of more innovative alternatives to cash.

Cash held for daily purchases

Respondents were asked to report on the amount of cash they normally kept for daily purposes. Data analysis shows that the Maltese favour holding around €20 or €50 for daily use.[6] A total of 11.3% tend to keep €10 while another 11.3% tend to keep €100. Only 1.8% of the population reported not retaining cash for daily use. This cluster of the population ranges between 0% and 3% across all age groups. Chart 9 also indicates that the younger generation tends to keep smaller amounts of cash than older generations.

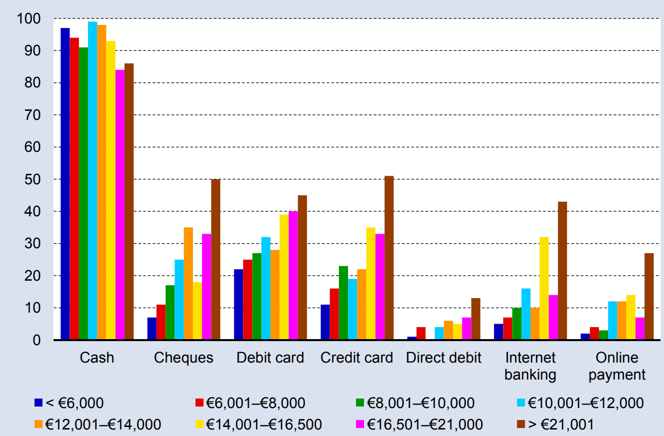
The mean value of cash held by the Maltese was €43 while the median was €50. Based on these results, and taking into account that the number of individuals aged 16 and over in Malta is around 350,000, the total value of cash held for transaction purposes on a particular day in Malta is approximately €15 million. This level of daily cash holdings is not out of line with information

Chart 7
USAGE OF PAYMENT INSTRUMENTS BY LEVEL OF EDUCATION
(percentage)



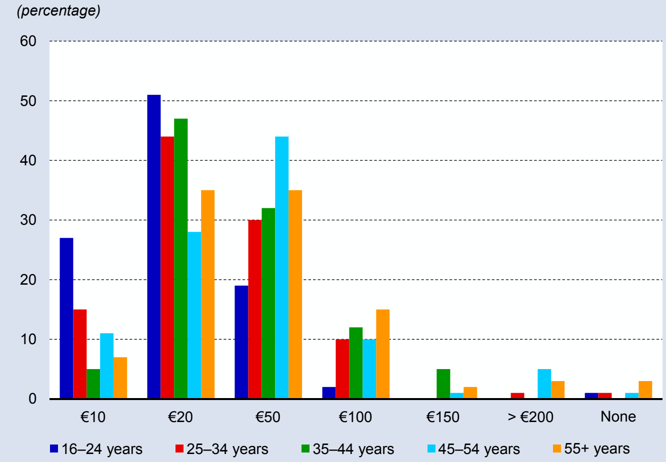
Source: Central Bank of Malta calculations.

Chart 8
USAGE OF PAYMENT INSTRUMENTS BY INCOME BRACKET
(percentage)



Source: Central Bank of Malta calculations.

Chart 9
CASH FOR DAILY USE ACCORDING TO AGE
(percentage)



Source: Central Bank of Malta calculations.

[5] Income earners of less than €6,000 and between €6,000 and €8,000 annually are considered low-income earners. These brackets may include people who receive unemployment and social welfare benefits, as well as pensioners.

[6] Responses that fell between the options available were allocated to the closest amount.

about annual private consumption in Malta or the average wage received by employees. With this amount being kept for transaction purposes, then it follows that a large proportion of currency in issue in Malta is used as a store of value.

Reasons behind payment instrument choice

Generally, people choose a specific payment instrument based on the benefits that such a channel provides. These may include convenience, reliance and accessibility. According to the survey results, the majority of cash users opt for cash mainly because they consider it easy to use and relatively fast. Cheque users opt for them as they find them easy to use.

In the case of debit and credit cards, respondents attributed their preference to the ease of use, as well as protection against counterfeits. Other considerations, especially for credit cards, were reward schemes and the benefit of delaying effective payment. On the other hand, internet banking payments were favoured by users due to their fast execution and the avoidance of fraud, counterfeits and theft.

Another instrument that is yet to gain momentum in Malta is direct debits. Users claimed that it is fast and easy to use as it does not primarily require any further processing from the users' side following the initial mandate. Similar benefits to consumers were also highlighted in the use of online payments.

Alternative payment channels in the next five years

Respondents were also asked to give an indication of their potential use of payment instruments in the forthcoming five years. Internet banking ranked as the channel that has the prospect of the highest increase in usage. Around a quarter of respondents indicated that they would increase their use of internet banking over the forthcoming five years. A slightly smaller proportion of respondents envisaged increasing their use of debit and credit cards over the same period. In contrast, prospective use of direct debits attracted relatively minimal interest when compared with other payment methods. Additionally, although pre-paid cards have been on the market for some time, they do not seem to be very popular. In fact, the anticipated increase in their usage for the forthcoming five years is the lowest compared with all the other instruments.

Payment habits by type of purchase

In compiling payment diaries, respondents were asked to keep a record of their daily purchases of goods and services for a week. Respondents were requested to list the type of payment medium used to buy different types of products or services, to gauge the popularity of the particular payment instrument. Different products and services were split in categories.

Grocery payments

When considering payment for grocery products, cash was the most widely used medium. In fact, nine out of ten transactions carried out within this category were made in cash. Debit and credit cards followed, each accounting for approximately 3% of transactions. Cash was also the preferred instrument for relatively small payments, while cheques, debit and credit cards were the methods preferred for larger grocery payments.

Consumable purchase payments

In evaluating data for payments relating to consumable goods, such as clothing, footwear, stationery and books, cash was once again found to be the most widely used instrument, especially for small value purchases. Approximately 80% of total transactions were cash-based. However, cheques registered the highest mean value of all transactions at €81. Credit and debit cards were more widely used for this category when compared with those used for grocery payments. In fact, debit and credit cards accounted for 8.8% and 7.5% of total purchases of consumables, respectively.

Durable consumer goods purchases

Durable consumer goods include white goods, cars, electronics and furniture. For this particular category, the number of cash transactions was lower when compared with other categories (approximately 62% of transactions). Other channels ranked by popularity were debit cards (13.6%), credit cards (9.7%), cheques (5.3%) and internet banking (4.5%).

Purchases of durable consumer goods that were settled by cheque had an average value of €737, indicating that cheques were the preferred payment instrument when considering large value transactions. The cash payment average value stood at around €63, while for both debit and credit cards the average value amounted to €206 and €154, respectively.

Payment of utility bills

Payment for utility bills in Malta was mainly carried out in cash. In fact, the survey shows that more than eight out of ten transactions were in cash. Internet banking and cheques followed cash in terms of popularity at around 6% and 5%, respectively. With a mean value per transaction of €124, internet banking appeared to rank highest in this respect. The highest usage of direct debits was recorded in this category.

Payment for wellness services

Payments involving wellness services, which include services related to personal care, were mostly made in cash, cheques or cards. Results show that 90.3% of transactions were carried out in cash, 4.3% in cheques and approximately 2% in both debit and credit cards.

Payment for other services

This category incorporates payment for other services, such as health, education, transport services, financial services, insurance and hotels. Here, cash still appeared to be the dominant payment channel in terms of volume (87.4%), followed by cheques (4.4%) and credit cards (3.1%). Debit cards and online payments registered the highest average value per transaction at €251 and €240, respectively.

General findings

In conclusion, the Maltese seem to opt for various payment instruments, depending on the nature of the purchase. The results of the Bank's Payment Habits Study show that people are more inclined to use cash as their primary payment channel for everyday essentials, such as groceries. However, changes were recorded in preferences when purchase amounts were appreciably high, with cheques being one of the top channels when paying for relatively high-value items or one-off purchases.

This survey is a first step towards gaining an understanding of the payment habits of the Maltese. As also mentioned in the Budget Speech for 2015, the Central Bank of Malta, together with other stakeholders shall embark on a National Payments' Strategy to encourage people to shift from traditional payment instruments towards more innovative instruments that are cheaper to provide and more efficient to operate. The findings of this survey may thus be of value in the design of policies drawn up to promote the use of innovative instruments.

ECONOMIC AND FINANCIAL POLICY CALENDAR 2014

This calendar lists important policy developments in the monetary, fiscal and financial fields during the year.

Monetary policy measures of the Eurosystem

1 January: Latvia became the 18th country to adopt the euro as its national currency at the irrevocable conversion rate of €1 = 0.702804 Latvian lats. As a result, the Bank of Latvia became a member of the Eurosystem.

5 June: The European Central Bank (ECB) decided to lower the interest rate on the main refinancing operations (MRO) by 10 basis points to 0.15%. In addition, the rates on the marginal lending facility and on the deposit facility were lowered to 0.40% and -0.10%, respectively, with the latter moving into negative territory for the first time. The ECB further announced the introduction of a series of four-year targeted longer-term refinancing operations (TLTRO). These operations would allow banks to borrow funds from the Eurosystem at favourable interest rates. The amounts borrowed would depend on the total value of their loans to the euro area non-financial private sector, excluding mortgage loans, and future credit developments. The interest rate on the TLTROs would be fixed over the life of each operation at the MRO rate prevailing at the time of take-up, plus a fixed spread of 10 basis points. The ECB also decided that MROs would be conducted as fixed rate tender procedures with full allotment for as long as necessary, and at least until December 2016. The three-month longer-term refinancing operations to be allotted before the end of the reserve maintenance period ending in December 2016 would also be conducted as fixed rate tender procedures with full allotment. Furthermore, the Governing Council extended the existing eligibility of additional assets as collateral and suspended the fine-tuning operations sterilising the liquidity injected under the Securities Markets Programme.

3 July: The ECB announced that as from January 2015 the frequency of the Governing Council's monetary policy meetings would change from a four-week cycle to a six-week cycle. Reserve maintenance periods, during which banks are required to hold minimum reserves with the Eurosystem, were also extended to six weeks.

4 September: The ECB decided to lower the interest rates on the MRO, the marginal lending facility, and the deposit facility by 10 basis points each to 0.05%, 0.30% and -0.20%, respectively. The Governing Council announced the set-up of an asset-backed securities purchase programme (ABSPP), under which the ECB started to purchase a portfolio of simple and transparent asset-backed securities with underlying assets consisting of claims against the euro area non-financial private sector. The Governing Council also decided to launch a third covered bond purchase programme (CBPP3). Eligible assets under this programme consist of a broad portfolio of euro-denominated covered bonds issued by monetary financial institutions domiciled in the euro area.

18 December: The ECB announced that it would publish regular accounts of Governing Council monetary policy discussions as from 22 January 2015. The accounts would outline financial market, economic and monetary developments and would include a summary of the discussion, in an unattributed form, on the economic and monetary analysis and the monetary policy stance. The accounts would be released four weeks after each meeting.

1 January 2015: Lithuania became the 19th EU Member State to adopt the euro as its national currency, at the irrevocably fixed exchange rate of €1 = 3.45280 Lithuanian litas.

22 January 2015: The ECB announced the expansion of its asset-purchasing programme to include bonds issued by euro area central governments, agencies and European institutions to address the historically low inflation environment. The programme is expected to further ease credit conditions prevailing in the euro area and thereby support investment and consumption, and ultimately restore the inflation rate below, but close to the 2% benchmark. The programme will encompass the ABSPP and CBPP3 introduced in 2014. Monthly purchases were set to amount to €60.0 billion and were intended to be carried out until at least September 2016, and in any case until the Governing Council would see a sustained adjustment in the path of inflation consistent with the Bank's inflation target.

ECB supervisory developments

4 September: In line with Regulation ECB/2014/17 ("Single Supervisory Mechanism (SSM) Framework Regulation"), the ECB published the list of credit institutions which it considered significant, together with the list of less significant institutions. The assessment of significance was based on a number of criteria, including the institutions' total asset value and their importance to the economy of the country in which they are located.

26 October: The ECB published the results of its comprehensive assessment exercise, which included an asset quality review and a stress-test exercise. The comprehensive assessment was performed on 130 euro area banks, which accounted for €22.0 trillion assets, representing 82.0% of total banking assets in the euro area as at end-2013. The assessment revealed a capital shortfall of €25.0 billion in 25 banks. A total of 12 of these banks had already covered their shortfall through a €15.0 billion capital increase in 2014.

The comprehensive assessment was conducted on three Maltese credit institutions – Bank of Valletta plc, HSBC Bank Malta plc and Deutsche Bank (Malta) Ltd. The assessment identified no capital shortfalls for these banks in both the baseline and adverse scenarios. This confirmed the banks' soundness and resilience. Each bank's Common Equity Tier 1 (CET1) capital ratio remained above the 8.0% minimum threshold after the asset quality review. Similarly, the results of the stress test show that by 2016 the CET1 capital ratio for each bank would remain well above the 5.5% minimum level.

4 November: The ECB assumed responsibility for the supervision of euro area banks in line with the provisions set out in the SSM framework. The ECB began to directly supervise 120 significant banking groups, including three Maltese banks: Bank of Valletta plc, HSBC Bank Malta plc and Deutsche Bank (Malta) Ltd. Banks not falling directly under the ECB's responsibility will continue to be supervised by national competent authorities, in cooperation with the ECB.

Central Bank of Malta announcements

24 January: Through Legal Notice 29 of 2014, the Government, on the basis of Article 60(2) of the Central Bank of Malta Act, appointed the Central Bank of Malta as the Designate Authority to implement some provisions of Directive 2013/36/EU, known as the Capital Requirements Directive (CRDIV), and Regulation (EU) No. 575/2013, known as the Capital Requirements Regulation (CRR). In particular, the Legal Notice entitled the Bank to implement macro-prudential instruments. In this role, the Bank would set the systemic risk buffer and identify the institutions to which the risk buffer would apply. It would also identify changes in the intensity of macro-prudential or systemic risk in the financial system and draft national measures intended to mitigate such risk. The Legal Notice also empowered the Bank to act jointly with the competent authority when identifying systemically important institutions.

1 May: The Single Euro Payments Area (SEPA) migration in Malta for national credit transfers was completed and the legacy direct credit system closed down. Legacy direct debit arrangements ceased to operate from 1 August 2014, as mandated by the SEPA regulation. SEPA was designed as a market-oriented project, enabling credit transfers and direct debits in euro to take place without any distinction between national and cross-border transactions.

Fiscal and economic policy developments

4 February: Legal Notice 27 of 2014 established the Individual Investor Programme for Malta. This Programme introduced the granting of citizenship through a certificate of naturalisation to foreign individuals and their families, who contribute to the economic development of Malta. The Regulations of the Programme laid out the general requirements and eligibility criteria of the scheme, and established a National Development and Social Fund into which the majority of contributions received under the programme would be paid.

5 March: The European Commission released the results of its in-depth review of macroeconomic imbalances in Malta. The Commission concluded that macroeconomic challenges in Malta no longer constituted substantial risks from the perspective of the Macroeconomic Imbalances Procedure. According to the Commission, the Maltese financial sector did not appear to pose imminent risks to macro-financial stability. Although short-term risks to public debt were contained, the long-term sustainability of public finances remained a concern owing to rising age-related budgetary costs and high contingent liabilities. Meanwhile, the Commission found private sector indebtedness to be adjusting in an orderly fashion, while it also commented favourably on the success of Malta's export performance.

16 April: The Government submitted the *National Reform Programme (NRP)* for Malta to the European Commission, setting out its economic plans in line with the Europe 2020 strategy and describing the implementation of the Country-Specific Recommendations that had been addressed to Malta by the ECOFIN Council in July 2013.

29 April: Parliament enacted Act No. XII of 2014, which amended various laws to implement measures announced in the Budget presented in November 2013.

30 April: The Government submitted the sixth *Update of the Stability Programme* to the European Commission, setting out its budgetary objectives until 2017 and its strategy for correcting the excessive deficit in a sustainable manner. The *Update* foresaw the general government deficit-to-GDP ratio to gradually decline from 2.1% in 2014 to 0.3% in 2017. Government debt was also projected to drop from 69.4% of GDP in 2014 to 63.9% in 2017.

2 June: The European Commission issued a recommendation with regard to Malta's *NRP* and delivered an opinion on Malta's *Update of the Stability Programme*. The Commission recommended that Malta take action between 2014 and 2015 to:

(i) correct its excessive deficit in a sustainable manner by 2014 and ensure the medium-term sustainability of public finances;
(ii) step up pension reform;
(iii) address labour market weaknesses by, for example, reducing the number of early school-leavers and increasing the participation of women in the workforce;
(iv) diversify the economy's energy mix;
(v) increase the efficiency of public procurement procedures, access to capital markets and carry out the planned judicial reform.

The ECOFIN Council approved these recommendations on 20 June. These were subsequently endorsed by the European Council on 26–27 June.

22 July: The Government launched an Investment Registration Scheme through Legal Notice 256 of 2014. The Scheme, which was administered by the Central Bank of Malta, provided individuals and companies the opportunity to register undeclared assets located both locally and abroad. Registration of assets was made against a fee of 7.5% of the value of the asset, while a fee of 5.0% was applied in cases when the assets were repatriated to Malta. On 24 September the scheme was extended to 30 November 2014. The scheme attracted 1,469 valid applications covering €455.8 million worth of eligible assets. Of the total amount registered, €69.8 million, or 15% of the total, was repatriated. The Government received €32 million in net registration fees.

8 August: Parliament enacted Act No XXVII of 2014 entitled the Fiscal Responsibility Act. The Act introduced controls on public expenditure to increase efficiency, accountability and ensure fiscal sustainability. The Act binds the Maltese Government to abide by budgetary and debt rules, and to publish a three-year rolling plan listing its fiscal policies and priorities. The budgetary rule defined by the Act requires the Government's budget to be in balance or in surplus, or the structural budget to converge towards the medium-term budgetary objective. The debt rule requires the debt-to-GDP ratio to be reduced whenever it exceeds 60.0%. The Act also provides for the setting up of an independent Fiscal Council, answerable to Parliament. The Council is to oversee the Government's macroeconomic and fiscal forecasts, strategy and the implementation of the fiscal plan.

17 November: The Minister for Finance presented the 2015 Budget estimates to Parliament. According to these estimates, the general government deficit was set to fall from 2.7% of GDP in 2013 to 2.1% in 2014, and further to 1.6% of GDP in 2015. The deficit was expected to fall further in 2016 to 1.0% of GDP. Government debt has been projected to peak at 70.1% of GDP in 2014 and to start receding in 2015, falling to around 67% of GDP in 2016.

28 November: The European Commission issued its opinion on Malta's Budgetary Plan for 2015. The Commission expressed the view that the Plan was at risk of non-compliance with the provisions of the Stability and Growth Pact, but that Malta could become subject to the preventive arm from 2015 if timely and sustainable correction were achieved.

In reply to the Commission's opinion, the Ministry for Finance pointed out that this opinion did not formally take into account additional fiscal consolidation measures announced in the Budget. The measures were not considered due to timing differences between the submissions of the Draft Budgetary Plan to the Commission and the presentation of the Budget in the Maltese Parliament.

28 November: The European Commission issued its *Alert Mechanism Report* which forms part of the Macroeconomic Imbalance Procedure. With regard to Malta, the *Report* noted improvements in several areas, including favourable external rebalancing, a decline in private debt, robust employment growth and low unemployment. The *Report*, however, cautioned that the sustained decline in Malta's export market share and high growth in nominal unit labour costs might signal a loss of competitiveness.

Issues of Malta Government Securities

14 February: The Government, through Legal Notice 61 of 2014, announced the issue of three Malta Government Stocks (MGS) for a total amount of €100.0 million, subject to an over-allotment option of €60.0 million. The over-allotment option was exercised and the Treasury allotted €7.2 million to the 3.20% MGS 2019 (V) (Fungibility Issue), €24.1 million to the 3.30% MGS 2024 (I), and €128.7 million to the 4.45% MGS 2032 (II).

25 March: The Government, through Legal Notice 89 of 2014, announced the issue of two MGS for a total amount of €35.0 million, subject to an over-allotment option of €20.0 million. The Treasury allotted €30.5 million to the 3.20% MGS 2019 (V) (Fungibility Issue) and €24.5 million to the 4.45% MGS 2032 (II) (Fungibility Issue).

23 May: The Government, through Legal Notice 176 of 2014, announced the issue of two MGS for a total amount of €100.0 million, subject to an over-allotment option of €80.0 million. The Treasury allotted €150.7 million to the 4.30% MGS 2033 (I) at a price of €100.75 per €100 nominal. An additional €29.3 million was allotted to the floating-rate MGS 2018 (VII), which was linked to the six-month EURIBOR plus a spread of 90 basis points. This MGS was issued at an initial price of €100.45 per €100 nominal.

15 July: The Government announced, through Legal Notice 249 of 2014, the issue of two MGS for the total amount of €100.0 million subject to an over-allotment option of €80.0 million. The MGS 2020 (V) and MGS 2034 (I) carry coupons of 2.00% and 4.10%, respectively, and were sold at €101.75 and €100.75 per €100 nominal value. The Treasury received bids totalling €193.5 million from retail investors. It allotted €179.0 million, €6.0 million to the 2.00% MGS 2020 (V) and €172.9 million to the 4.10% MGS 2034 (I).

14 October: the Government announced the issue of €40.0 million MGS through Legal Notice 381 of 2014. The issue, subject to an over-allotment option of €35.0 million, consisted of the 4.10% MGS 2034 (I) Fungible Issue to which €27.15 million was allotted, and the Floating Rate MGS 2020 (VI) linked to the six-month EURIBOR to which €47.85 million was allotted.

Double Taxation Agreements

18 February: Legal Notice 65 of 2014 declared relief from double taxation in relation to various taxes imposed by the Principality of Liechtenstein.

6 May: Legal Notice 151 of 2014 declared relief from double taxation on income tax imposed by the Republic of Moldova.

18 November: Legal Notice 409 of 2014 declared relief from double taxation on various taxes imposed by the Republic of Mauritius.

Financial Sector Developments

Credit institution licences

12 May: The Malta Financial Services Authority (MFSA) announced that Erste Bank (Malta) Limited had surrendered its licence to undertake credit institution activities in terms of the Banking Act. The surrender was entirely voluntary.

14 October: The MFSA granted a banking licence to Satabank plc. The bank was also licensed to carry out payment services, to trade in financial instruments for its own account and to issue electronic money.

23 October: The MFSA granted a banking licence to Yapi Kredi Bank Malta Ltd. The bank is also licensed to carry out payment services, guarantees and commitments, and to trade for its own account in a variety of financial instruments.

Banking and finance legislation

Acts

24 June: Act No. XXII of 2014 amended the Investment Services Act to cater for the implementation of the CRDIV and the CRR.

19 December: Act No XLII of 2014, entitled Local Loans (Registered Stock and Securities) Ordinance (Amendment) Act, amended a number of articles in the Act. The changes allows the Minister for Finance, in pursuance of the Recovery and Resolution Regulations and following a recommendation by the competent authority in consultation with the Resolution Authority, to raise a sum of money through loans for the purpose of preserving financial stability. The Act establishes that the maximum amount that can be borrowed is to be stipulated from time to time by the House of Representatives.

Legal Notices

24 January: Legal Notices 30, 31, and 32 of 2014 established the MFSA as the competent authority in Malta for implementing the CRR and CRDIV, which relate to prudential requirements and supervision of credit institutions and investment firms. The Legal Notices also laid down rules for consolidated supervision, the establishment of significant branches, and the supervision of mixed activity holding companies and their subsidiaries, and of mixed financial holding companies. Legal Notice 29, in turn, appointed the Central Bank of Malta as Designate Authority in terms of some of the provisions of CRR and CRDIV pertaining to macro-prudential supervision.

7 March: Legal Notice 78 of 2014 laid down the arrangements made by the Government of Malta with the Government of the United States of America to prevent fiscal evasion through the exchange of tax information between the two countries, in relation to the Foreign Account Tax Compliance Act (FATCA) enacted in the United States.

28 March: Legal Notice 103 of 2014 amended the Financial Conglomerates Regulations to bring them in line with the provisions of the CRR and the CRDIV.

28 March: Legal Notice 104 of 2014 amended the Insurance Business Regulations to define how the yield on an asset is to be calculated for a variable interest investment that is an equity share in a company.

28 March: Legal Notices 105 and 106 of 2014 implemented Regulation (EU) No 345/2013 on European Venture Capital Funds and Regulation (EU) No 346/2013 on European Social Entrepreneurship Funds, designating the MFSA as the competent authority to implement the provisions of these Regulations.

2 May: Legal Notices 145, 146, and 147 of 2014 amended the Banking Act and the Investment Services Act through the implementation of a number of articles pertaining to Commission Regulation (EU) No 1031/2010, known as the Auctioning Regulation. The amendments allow credit institutions and holders of an investment services licence to apply for admission to bid directly in emission allowance auctions on behalf of their clients, subject to certain conditions. Bids are to be authorised by the MFSA.

11 November: Legal Notice 408 of 2014 amended the Cooperation with Other Jurisdictions on Tax Matters Regulation to take account of obligations found in the FATCA Agreement and the EU

Administrative Cooperation Directive. The amendments related to the sharing of tax-related information with the competent authorities in the United States and in other EU Member States.

28 November: Legal Notice 411 of 2014 introduced the Securitisation Cell Companies Regulations. The Regulations provide the legal framework for segregation of different sets of assets and risk instruments through the set-up of “cells” within a single special purpose vehicle. The cells avoid cross-contamination of risks between different sets of creditors and investors.

30 December: Legal Notice 479 of 2014, titled Financial Markets Act (Credit Rating Agencies) Regulations, implemented the provisions of the EU Regulation (No 1060/2009) on credit rating agencies. It established the MFSA as the competent authority for the purposes of implementing the relevant provisions of the EU Regulation and would apply to credit rating agencies based in or operating from Malta.

International Assessments

17 January: Ratings agency Standard & Poor’s (S&P) affirmed Malta’s BBB+ rating with a stable outlook. This reflected the positive economic performance and the initiation of several reforms, particularly in the energy sector. However, the rating agency highlighted the high government debt burden, which remained a matter of concern.

14 March: Fitch Ratings affirmed Malta’s A rating with a stable outlook. The rating reflected the general economic recovery, improvements in the employment level and a low, stable unemployment rate. The rating agency’s report, however, warned that public finances could pose a drag on Malta’s future credit rating.

11 July: S&P reaffirmed Malta’s credit rating at BBB+/A-2, with a stable outlook. S&P forecast that the Maltese economy would grow by just over 2% on average over the subsequent four years. Growth was expected to be supported by energy reform measures and policies targeting more active female labour participation.

11 September: Fitch Ratings reaffirmed Malta’s credit rating at A with a stable outlook. The rating agency remarked that Malta’s unemployment rate stood below the A median and the euro area average, and that government finances were improving. The rating agency also expected general government gross debt to gradually decline to 70.0% of GDP by 2020.

28 October: Credit rating agency Moody’s reaffirmed Malta’s credit rating at A3. The rating agency highlighted that economic growth had been supported by good export performance, reforms in the energy sector and in the labour market. Moody’s expected expansion in output to be sustained. The rating agency forecast both the general government deficit-to-GDP ratio and general government debt-to-GDP ratio to decline in 2015.

Institutional developments in Europe

28 January: The Economic and Financial Affairs (ECOFIN) Council adopted Directive 2014/17/EU aimed at creating a single market for mortgage credits within the European Union. The directive sought to establish a high level of protection while addressing irresponsible lending and borrowing.

11 March: The ECOFIN Council established the Pericles 2020 Programme, which was aimed at protecting the euro against counterfeiting and related fraud.

24 March: The ECOFIN Council adopted Directive 2014/48/EU aimed at strengthening EU rules on the exchange of information concerning the taxation of savings income. The new directive built on earlier legislation, reflecting changes to savings products and developments in investor behaviour. It thus covered new types of savings income and products, including life insurance contracts, and broadened coverage of investment funds.

14 April: The ECOFIN Council adopted stronger EU rules to clamp down on insider dealing and market manipulation on securities markets. The new market abuse regulation (No 596/2014) extended the scope of earlier rules to include financial instruments traded on more recently created venues, such as multilateral trading facilities. In addition, a new directive (2014/57/EU) established a framework for criminal sanctions.

6 May: The ECOFIN Council adopted Directive 2014/59/EU, which established a framework for the recovery and resolution of credit institutions and investment firms. The Directive harmonised national rules on bank recovery and resolution, and provides national authorities with common powers and instruments to pre-empt bank crises and to resolve failing financial institutions in an orderly manner.

13 May: The ECOFIN Council adopted new rules to promote the integration, competitiveness and efficiency of EU financial markets, amending Directive 2004/39/EC on markets in financial instruments, to ensure that all organised trading is conducted on regulated trading venues.

21 May: Representatives of EU Member States, excluding Sweden and the United Kingdom, signed an inter-governmental agreement on contributions to a Single Resolution Fund that would be established as part of Europe's banking union. The agreement complemented the regulation on the creation of a Single Resolution Mechanism (SRM). The Single Resolution Fund would be fully financed by bank contributions.

8 July: The ECOFIN Council adopted an amendment to EU tax rules to close a loophole that previously allowed corporate groups to exploit mismatches between national tax rules to avoid paying taxes on some types of profits distributed within the group.

15 July: The European Parliament and the Council of the European Union adopted Regulation EU 806/2014 establishing an SRM for failing banks. The SRM incorporates a central decision-making board and a Single Resolution Fund.

26 November: The European Commission announced an Investment Plan aimed at stimulating economic growth and employment in the European Union. The Plan envisaged the creation of a new European Fund for Strategic Investments in partnership with the European Investment Bank, and partly guaranteed with public money, to bring about an additional €315.0 billion in investment over the period 2015–17.

9 December: The ECOFIN Council approved a revision to the Directive on Administrative Cooperation (2011/16/EU), which extended the scope for automatic exchange of information between tax authorities.

PART III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2014

Directors' report

The Directors present their report and the audited financial statements of the Central Bank of Malta (the Bank) for the year ended 31 December 2014.

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 2014, and of its profit for the year then ended. The financial statements have been prepared in accordance with the provisions established by the Governing Council of the European Central Bank under Article 26.4 of the Statute of the European System of Central Banks and of the European Central Bank and in accordance with the requirements of the Central Bank of Malta Act (Cap. 204). The provisions established by the Governing Council are outlined in the Guideline ECB/2010/20 of 11 November 2010 on the legal framework for accounting and financial reporting in the European System of Central Banks (recast), as amended.

Financial results

The Bank's financial statements for the year ended 31 December 2014 are set out on pages A-6 to A-43 and disclose an operating profit of €56.8 million (2013: €58.4 million). The amount payable to the Government of Malta is €48.0 million (2013: €50.0 million).

Board of Directors

The members of the Board of Directors during the year ended 31 December 2014 and up to the date of authorisation for issue of the financial statements were:

Professor Josef Bonnici – Governor
Mr Alfred DeMarco – Deputy Governor Monetary Policy
Mr Alexander Demarco – Deputy Governor Financial Stability (appointed on 1 January 2014)
Ms Philomena Meli
Mr Victor Busuttil
Mr Peter J Baldacchino
Dr Romina Cuschieri

During the financial year under review, Dr Bernadette Muscat was Secretary to the Board.

Statement of Directors' responsibilities in respect of the financial statements

The Board of Directors is responsible for ensuring that the financial statements are drawn up in accordance with the requirements of the Central Bank of Malta Act (Cap. 204). The Bank is required to prepare financial statements in accordance with the requirements of the Guideline ECB/2010/20 of 11 November 2010 on the legal framework for accounting and financial reporting in the European System of Central Banks (recast), as amended.

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 2014 and of the profit for the year then ended.

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 controls 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.

The financial statements of the Central Bank of Malta for the year ended 31 December 2014 are included in the Annual Report 2014, which is published in hard-copy printed form and may be made available on the Bank's website. The Directors are responsible for the maintenance and integrity of the Annual Report on the website in view of their responsibility for the controls over, and the security of, the website. Access to information published on the Bank's website is available in other countries and jurisdictions, where legislation governing the preparation and dissemination of financial statements may differ from requirements or practice in Malta.

Auditors

PricewaterhouseCoopers were appointed as the auditors of the Bank with effect from this financial year and signify their willingness to continue in office.

By order of the Board

Professor Josef Bonnici Governor	Mr Alfred DeMarco Deputy Governor	Mr Alexander Demarco Deputy Governor

Central Bank of Malta
Pjazza Kastilja
Valletta VLT 1060
Malta

13 March 2015

Independent Auditor's report

To the Board of Directors of the Central Bank of Malta

Report on the Financial Statements

We have audited the financial statements of the Central Bank of Malta on pages A-6 to A-43, which comprise the Balance Sheet as at 31 December 2014 and the Profit and Loss account for the year then ended and a summary of significant accounting policies and other explanatory information.

Directors' responsibility for the financial statements

As explained more comprehensively in the Statement of Directors' responsibilities in respect of the financial statements on page A-2, the Directors are responsible for the preparation of financial statements that give a true and fair view in accordance with the provisions established by the Governing Council of the European Central Bank outlined in the Accounting Guideline (ECB/2010/20 as amended by ECB/2011/27, ECB/2012/29 and ECB2014/54) on the legal framework for accounting and financial reporting in the European System of Central Banks adopted by the Governing Council on 11 November 2010 and in accordance with the requirements of the Central Bank of Malta Act (Cap. 204). The Directors are also responsible for such internal control as the Directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's 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 about whether the financial statements are free from 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 auditor's judgement, 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 auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view 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.

Opinion

In our opinion the financial statements:

- give a true and fair view of the financial position of the Bank as at 31 December 2014, and of its financial performance for the year then ended in accordance with the requirements of the Accounting Guideline (ECB/2010/20 as amended by ECB/2011/27, ECB/2012/29 and ECB/2014/54) on the legal framework for accounting and financial reporting in the European System of Central Banks adopted by the Governing Council on 11 November 2010; and
- have been properly prepared in accordance with the requirements of the Central Bank of Malta Act (Cap. 204).

pwc

78, Mill Street
Qormi
Malta

F Axisa

Fabio Axisa
Partner

13 March 2015

Balance Sheet as at 31 December 2014

	Assets	2014 €'000	2013 €'000
A 1	**Gold and gold receivables**	**4,547**	**12,517**
A 2	**Claims on non-euro area residents denominated in foreign currency**	**518,901**	**418,795**
A 2.1	Receivables from the IMF	154,542	157,759
A 2.2	Balances with banks and security investments, external loans and other external assets	364,359	261,036
A 3	**Claims on euro area residents denominated in foreign currency**	**105,516**	**137,523**
A 4	**Claims on non-euro area residents denominated in euro**	**837,405**	**607,233**
A 4.1	Balances with banks, security investments and loans	837,405	607,233
A 4.2	Claims arising from the credit facility under ERM II	-	-
A 5	**Lending to euro area credit institutions related to monetary policy operations denominated in euro**	**411,320**	**200,050**
A 5.1	Main refinancing operations	6,800	6,000
A 5.2	Longer-term refinancing operations	404,520	194,050
A 5.3	Fine-tuning reverse operations	-	-
A 5.4	Structural reverse operations	-	-
A 5.5	Marginal lending facility	-	-
A 5.6	Credits related to margin calls	-	-
A 6	**Other claims on euro area credit institutions denominated in euro**	**358**	**15,441**
A 7	**Securities of euro area residents denominated in euro**	**1,399,875**	**1,435,524**
A 7.1	Securities held for monetary policy purposes	67,108	90,445
A 7.2	Other securities	1,332,767	1,345,079
A 8	**General government debt denominated in euro**	**-**	**-**
A 9	**Intra-Eurosystem claims**	**53,411**	**52,166**
A 9.1	Participating interest in ECB	15,859	15,367
A 9.2	Claims equivalent to the transfer of foreign reserves	37,552	36,799
A 9.3	Claims related to the issuance of ECB debt certificates*	-	-
A 9.4	Net claims related to the allocation of euro banknotes within the Eurosystem	-	-
A 9.5	Other claims within the Eurosystem (net)	-	-
A 10	**Items in course of settlement**	**5,930**	**6,163**
A 11	**Other assets**	**989,077**	**724,639**
A 11.1	Coins of euro area	194	258
A 11.2	Tangible and intangible fixed assets	23,806	21,499
A 11.3	Other financial assets	911,634	645,804
A 11.4	Off-balance sheet instruments revaluation differences	-	433
A 11.5	Accruals and prepaid expenses	46,143	44,580
A 11.6	Sundry	7,300	12,065
Total Assets		**4,326,340**	**3,610,051**

* Only an ECB balance sheet item

	Liabilities	2014 €'000	2013 €'000
L 1	**Banknotes in circulation**	**864,057**	**803,195**
L 2	**Liabilities to euro area credit institutions related to monetary policy operations denominated in euro**	**499,098**	**1,144,040**
L 2.1	Current accounts (covering the minimum reserve system)	257,271	327,300
L 2.2	Deposit facility	241,827	146,740
L 2.3	Fixed-term deposits	-	670,000
L 2.4	Fine-tuning reverse operations	-	-
L 2.5	Deposits related to margin calls	-	-
L 3	**Other liabilities to euro area credit institutions denominated in euro**	**-**	-
L 4	**Debt certificates issued***	**-**	-
L 5	**Liabilities to other euro area residents denominated in euro**	**341,991**	**340,040**
L 5.1	General government	297,316	299,653
L 5.2	Other liabilities	44,675	40,387
L 6	**Liabilities to non-euro area residents denominated in euro**	**3,407**	**1,828**
L 7	**Liabilities to euro area residents denominated in foreign currency**	**50,264**	**61,105**
L 8	**Liabilities to non-euro area residents denominated in foreign currency**	**-**	**2**
L 8.1	Deposits, balances and other liabilities	-	2
L 8.2	Liabilities arising from the credit facility under ERM II	-	-
L 9	**Counterpart of special drawing rights allocated by the IMF**	**113,757**	**106,688**
L 10	**Intra-Eurosystem liabilities**	**1,929,665**	**709,349**
L 10.1	Liabilities equivalent to the transfer of foreign reserves*	-	-
L 10.2	Liabilities related to the issuance of ECB debt certificates	-	-
L 10.3	Net liabilities related to the allocation of euro banknotes within the Eurosystem	2,575	37,370
L 10.4	Other liabilities within the Eurosystem (net)	1,927,090	671,979
L 11	**Items in course of settlement**	**-**	-
L 12	**Other liabilities**	**94,467**	**49,754**
L 12.1	Off-balance sheet instruments revaluation differences	10,503	-
L 12.2	Accruals and income collected in advance	28,456	33,872
L 12.3	Sundry	55,508	15,882
L 13	**Provisions**	**34,700**	**19,700**
L 14	**Revaluation accounts**	**18,559**	**9,851**
L 15	**Capital and reserves**	**328,375**	**314,499**
L 15.1	Capital	20,000	20,000
L 15.2	Reserves	308,375	294,499
L 16	**Profit for the year**	**48,000**	**50,000**
Total Liabilities		**4,326,340**	**3,610,051**

* Only an ECB balance sheet item

Profit and Loss account for the year ended 31 December 2014

		2014	2013
		€'000	€'000
1.1	Interest income	67,741	78,377
1.2	Interest expense	(2,652)	(4,975)
1	**Net interest income**	**65,089**	73,402
2.1	Realised gains/losses arising from financial operations	16,602	12,756
2.2	Write-downs on financial assets and positions	(475)	(9,018)
2.3	Transfer to/from provisions for foreign exchange rate, interest rate, credit and gold price risks	(15,000)	(8,300)
2	**Net result of financial operations, write-downs and risk provisions**	**1,127**	(4,562)
3.1	Fees and commissions income	162	87
3.2	Fees and commissions expense	(682)	(631)
3	**Net income/expense from fees and commissions**	**(520)**	(544)
4	**Income from equity shares and participating interests**	**834**	1,633
5	**Net result of pooling of monetary income**	**2,354**	(485)
6	**Other income**	**5,199**	4,907
	Total net income	**74,083**	74,351
7	**Staff costs**	**(10,520)**	(9,955)
8	**Administrative expenses**	**(5,687)**	(5,073)
9	**Depreciation of tangible and intangible fixed assets**	**(655)**	(610)
10	**Banknote production services**	**(458)**	(283)
11	**Other expenses**	**(6)**	(7)
	Profit for the year	**56,757**	58,423
	Transfer to reserves for risks and contingencies	**(8,757)**	(8,423)
	Payable to the Government of Malta in terms of article 22(2) of the Central Bank of Malta Act (Cap. 204)	**48,000**	50,000

The financial statements on pages A-6 to A-43 were approved for issue by the Board of Directors on 13 March 2015 and are signed on its behalf by:

Professor Josef Bonnici
Governor

Mr Alfred DeMarco
Deputy Governor

Mr Alexander Demarco
Deputy Governor

Mr Raymond A. Bonnici
Director Corporate Services

Mr Robert Caruana
Financial Controller

Notes to the financial statements for the year ended 31 December 2014

General notes to the financial statements

1 The Eurosystem

On 1 January 2008, the Central Bank of Malta (the Bank) became part of the Eurosystem and took over joint responsibility for monetary policy and for exercising the common strategic goals of the European System of Central Banks (ESCB).[1]

2 Basis of preparation

The Bank is required under article 21(5) of the Central Bank of Malta Act (Cap. 204) (the Act) to prepare its financial statements in accordance with the provisions established by the Governing Council of the European Central Bank (ECB) under Article 26.4 of the Statute of the European System of Central Banks and of the European Central Bank (the Statute). These provisions are outlined in the Guideline ECB/2010/20 (recast) issued on 11 November 2010, as amended (Guideline ECB/2010/20 as amended).[2] In the absence of requirements and guidance provided by Guideline ECB/2010/20 as amended, that specifically apply to transactions, other events or conditions, the requirements of International Financial Reporting Standards (IFRS) as adopted by the EU are applied.

These financial statements have been drawn up so as to give a true and fair view of the state of affairs of the Bank as at 31 December 2014 and of its profit for the year then ended. The accounts have been prepared on a historical cost basis, modified to include the revaluation of gold, foreign currency instruments, securities (other than securities classified as held-to-maturity, non-marketable securities, and securities held for monetary policy purposes that are accounted for at amortised cost), as well as financial instruments, both on-balance sheet and off-balance sheet, at mid-market rates and prices.

3 Accounting policies

(a) Basic accounting principles

The basic accounting principles applied by the Eurosystem and the Bank in the preparation of these financial statements are:

- economic reality and transparency;
- prudence;
- post-balance sheet events;
- materiality;
- going concern;
- accrual; and
- consistency and comparability.

(b) Recognition of assets and liabilities

An asset or liability is only recognised in the balance sheet when it is probable that any associated future economic benefit will flow to or from the Bank, substantially all of the associated risks and rewards have been transferred to the Bank, and the cost or value of the asset or the amount of the obligation can be measured reliably.

---

[1] The European Central Bank (ECB), together with national central banks (NCBs), shall constitute the European System of Central Banks (ESCB). The ECB together with the NCBs of the Member States whose currency is the euro, which constitute the Eurosystem, shall conduct the monetary policy of the Union, as per Article 282.1 of the Treaty of the Functioning of the European Union. The Eurosystem and the ESCB will co-exist as long as there are EU Member States outside the euro area.

[2] Amended by Guideline ECB/2011/27 of 21 December 2011 OJ L 19, 24.1.2012, p. 37, by Guideline ECB/2012/29 of 10 December 2012 OJ L 356, 22.12.2012. p. 94 and by Guideline ECB/2014/54 of 15 December 2014 OJ L 68, 13.3.2015, p. 69-87.

(c) Recording of transactions

Foreign exchange transactions, comprising spot and forward deals in gold and foreign currencies, are recorded off-balance sheet on trade date at the prevailing spot exchange rate for ascertaining the average acquisition costs and the realised gains and losses. Accordingly, purchases and sales of foreign currency affect the net foreign currency position on the trade date and realised gains and losses arising from the net reduction in foreign currency positions are calculated on trade date. On settlement date, these transactions are recorded on-balance sheet at the original spot exchange rates. In the case of foreign exchange swaps, spot and forward amounts are translated to euro at the same exchange rate, and accordingly these contracts do not affect foreign currency positions.

All security transactions are recorded on-balance sheet on settlement date at the applicable exchange rate. Accrued interest, premiums and discounts related to financial assets and liabilities are calculated and booked daily from the settlement date at daily exchange rates, as applicable, and the foreign currency position is affected daily by these accruals denominated in foreign currency.

All other transactions are recorded in the balance sheet at market exchange rates prevailing on the day of the transaction.

(d) Balance sheet valuation rules

Financial assets and liabilities denominated in foreign currency, including off-balance sheet positions, are revalued at the prevailing mid-market exchange rates at the balance sheet date. Securities and Treasury bills other than those classified as held-to-maturity, non-marketable securities, and securities held for monetary policy purposes that are accounted for at amortised cost, are revalued at the prevailing mid-market prices at the balance sheet date.

Gold balances are revalued at market prices prevailing at the year-end. No distinction is made between price and currency revaluation differences for gold, but a single gold revaluation difference is accounted for on the basis of the euro price per defined unit of weight of gold derived from the euro/US dollar exchange rate at the balance sheet date.

Foreign currency positions (including off-balance sheet transactions) are revalued on a currency-by-currency basis. In the case of securities, revaluation is carried out on a code-by-code basis (same ISIN number/type) and is treated separately from exchange rate revaluation.

All other assets and liabilities are presented at purchase price or, where applicable, at their nominal value. The Bank's participating interest in the ECB is measured at cost.

(e) Cost of transactions

The average cost method is used on a daily basis for calculating the acquisition cost of assets and liabilities that are subject to price and/or exchange rate movements. The average cost price of securities and/or the average rate of the foreign currency position are adjusted by unrealised losses taken to the profit and loss account at the end of the year.

All securities are initially recorded at acquisition cost. For the purpose of calculating the average purchase cost of a security, all purchases made during the day are added to the cost of the previous day's holding to produce a new weighted average price before applying the sales for the same day.

In the case of long foreign currency or gold positions, net inflows made during the day are added at the average cost of the inflows for each respective currency or gold, to the previous day's holding to produce a new weighted average cost. Where a short position exists, the reverse treatment applies whereby the average cost is affected by net outflows.

(f) Income recognition

Income and expenses are recognised in the period in which they are earned or incurred.

(i) Interest income and expense

Interest income and expense are recognised in the profit and loss account for all interest-bearing assets and liabilities. Premiums or discounts arising from the difference between the average acquisition cost and the redemption price on securities are presented as part of interest income and are amortised over the remaining term of the security using either the straight-line method or the internal rate of return method. The internal rate of return method is used in the case of discount securities with a remaining maturity of more than one year at the time of acquisition. Interest accruals on foreign currency assets and liabilities are converted at the mid-market rate on each business day and are included in the respective foreign currency position to determine the average book value, as applicable.

Accordingly, interest income includes coupons earned on securities and amortised premiums or discounts on Treasury bills and other instruments. In respect of forward exchange contracts, the difference between the deemed spot exchange rate of the forward contract and the deal rate is considered as interest income or expense and is amortised on a straight-line basis from the trade date to settlement date.

(ii) Gains and losses arising from foreign exchange, gold and securities

Realised gains and realised losses can only arise in the case of transactions leading to a reduction in foreign currency positions or on the sale of securities.

In the case of foreign currency or gold positions, inflows and outflows are compared against each other to determine any realised gains or losses. The resulting net inflow or outflow, apart from changing the position in that currency, will give rise to either a change in the average cost of that currency or to the realisation of a further profit or loss depending on whether the Bank has a long or short position in that currency respectively. Every day, a weighted average price is calculated, firstly on inflows and secondly on outflows. The realised gain or loss is calculated by applying the difference between these average prices to the lower of the day's inflows or outflows.

For long positions, where outflows exceed inflows, a second realised gain or loss is calculated, equating to the difference between the net outflows of the day valued at the average outflow price and at the average cost of the day's opening position. Where inflows exceed outflows, the net inflow is added to the position held at the beginning of the day, thus changing the average cost of the position. For short positions, the reverse accounting treatment is applied.

In the case of securities, realised gains or losses are derived by comparing the transaction value with the average cost of the respective security.

Realised gains and losses are taken to the profit and loss account.

Unrealised revaluation gains and unrealised revaluation losses arise as a result of the revaluation of assets and liabilities by comparing the market value with the average book value. Unrealised gains are not recognised as income but are transferred directly to a revaluation account. Unrealised losses, except as explained in accounting policy (h) (ii), are taken to the profit and loss account when they exceed previous unrealised gains registered in the corresponding revaluation account. Unrealised losses recorded in the profit and loss account in previous years are not reversed against new unrealised gains in subsequent years. Unrealised losses in any one security or in any foreign currency (including gold holdings) are not netted against unrealised gains in other securities or foreign currency.

(g) Off-balance sheet instruments

Spot and forward foreign exchange contracts and daily changes in the variation margins of future contracts are included in the net foreign currency position for the purpose of calculating the average cost of currencies and determining realised foreign exchange gains and losses. Futures are accounted for and revalued on an item-by-item basis. Daily changes in the variation margins of open futures contracts, representing realised gains and losses, are recorded in the profit and loss account.

Gains and losses arising from off-balance sheet instruments are recognised and treated in a similar manner to on-balance sheet instruments. Realised and unrealised gains and losses are measured and accounted for in the manner outlined in accounting policy (f) 'Income recognition' above.

Unrealised valuation gains or losses on spot and forward foreign exchange contracts are recorded from the trade date to the settlement date under asset sub-item A11.4 'Off-balance sheet instruments revaluation differences' and under liability sub-item L12.1 'Off-balance sheet instruments revaluation differences' as applicable.

(h) Securities

(i) Securities held for monetary policy purposes

The Governing Council decided during 2014 that the securities currently held for monetary policy purposes shall be accounted for at amortised cost (subject to impairment), regardless of the holding intention. The new valuation approach did not result in any adjustment of the comparative numbers given that these securities were already valued accordingly.

(ii) Securities held for other than monetary policy purposes

Marketable securities classified as held-to-maturity are measured at amortised cost subject to impairment. Held-to-maturity securities are securities with fixed or determinable payments and a fixed maturity, which the Bank intends to hold until maturity.

Marketable securities other than those held-to-maturity and similar assets are valued either at the mid-market prices or on the basis of the relevant yield curve prevailing at the balance sheet date, on a security by security basis. For the year ending 31 December 2014, mid-market prices at that date were used.

The Bank holds financial instruments which are designated as part of an earmarked portfolio comprising investments held as a counterpart to the Bank's capital and statutory reserves. The Bank also holds securities forming part of another earmarked portfolio comprising Malta Government securities and Treasury bills purchased on the secondary market in its role as a market maker. These two earmarked portfolios are measured at mid-market prices prevailing at the balance sheet date. Unrealised gains are reflected on-balance sheet in the liability sub-item L12.3 'Sundry other liabilities', while unrealised losses are recognised in asset sub-item A11.6 'Sundry other assets'.

(i) 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 on the assets side of the balance sheet; the counterparty liability is included as a collateralised inward deposit on the liabilities side of the balance sheet, as appropriate. Securities purchased under agreements to resell (reverse repos) are recorded as a collateralised outward loan on the assets side of the balance sheet, 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 term of the agreement on a straight-line basis. Securities lent to counterparties are also retained in the financial statements.

(j) Claims on the International Monetary Fund (IMF)

The IMF Reserve Tranche Position, Special Drawing Rights (SDR) and other claims on the IMF are translated into euro at the year-end ECB euro/SDR exchange rate. The IMF euro holdings are revalued against the SDR at the prevailing representative rate for the euro as quoted by the IMF at the close of business on the last working day of the year.

The IMF Reserve Tranche Position is presented on a net basis representing the difference between the national quota and the holdings in euro at the disposal of the IMF. The euro account for administrative expenses is included under item L6 'Liabilities to non-euro area residents denominated in euro'.

(k) Euro coins

Subsequent to the agency agreement between the Bank and the Government of Malta, the face value of the euro coins issued by the Bank gives rise to a reserve in the form of a capital contribution by the Government. Deposits of euro coins with the Bank constitute a reversal of the capital contribution.

(l) Demonetised Maltese lira currency notes

Demonetised Maltese lira currency notes shall, until ten years following the expiration of the period mentioned in the notice of demonetisation, be redeemable by the Bank on demand for euro at the conversion rate of the Maltese lira for the euro of 0.4293 as established by Council Regulation (EC) No 1134/2007 of 10 July 2007 and without charge.

In accordance with article 62(3) 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, any unpresented demonetised Maltese lira currency 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, shall be apportioned to the profits of the Bank over the remaining period until the expiration of the ten-year period.

(m) Tangible and intangible fixed assets

Tangible and intangible fixed assets are stated at historical cost less depreciation, with the exception of land and works of art which are stated at historical cost. Historical cost includes expenditure that is directly attributable to the acquisition of the items. Subsequent costs are included in the carrying amount of the asset 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.

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%

Tangible and intangible fixed assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The carrying amount of an asset is written down immediately to its recoverable amount if that carrying amount is greater than its estimated recoverable amount.

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 the carrying amount. These are included in the profit and loss account in the year when the asset is derecognised.

(n) Provisions

Provisions are recognised by the Bank in accordance with Guideline ECB/2010/20 as amended by Guideline ECB/2012/29.[3] Taking into due consideration the nature of its activities, the Bank may establish a provision for foreign exchange rate, interest rate, credit and gold price risks and for other purposes on its balance sheet. The Bank decides on the size and use of the provision on the basis of a reasoned estimate of its risk exposure.

(o) Fixed income investment funds

Fixed income investment funds are measured on a net asset value basis. The underlying assets and liabilities are measured at fair value. Gains and losses arising on measurement of these investment funds are accounted for in accordance with the Guideline ECB/2010/20 as amended in the manner outlined in accounting policy 3 (f) 'Income recognition' above.

(p) Post-balance sheet events

The values of assets and liabilities are, in principle, adjusted for events that occur between the annual balance sheet date and the date of authorisation for issue of the financial statements, if such events materially affect the condition of assets and liabilities at the balance sheet date.

Post-balance sheet events that do not affect the condition of assets and liabilities at the balance sheet date are disclosed in the notes.

4 Capital key

The capital key determines the allocation of the ECB share capital to the national central banks (NCBs) on the basis of population and gross domestic product in equal share. It is adjusted every five years and whenever a new member state joins the European Union in accordance with the requirements of the Statute. The capital key of the Bank during the financial year ended 31 December 2014 was 0.0648% (2013: 0.0635%). The Eurosystem capital key, which is the respective NCB's share of the total share capital held by euro area NCBs, is used as the basis for the allocation of monetary income and the financial results of the ECB among the eighteen[4] Eurosystem NCBs. The Bank's share during the financial year ended 31 December 2014 was 0.0926% (2013: 0.0913%).

5 Change to the capital key

On 1 January 2014, the ESCB experienced a quinquennial capital key change in accordance with Article 29.3 of the Statute. On the same date, Latvijas Banka joined the Eurosystem and paid its capital share in full.

6 Banknotes in circulation

The ECB and the euro area NCBs, which together comprise the Eurosystem, issue euro banknotes.[5] The total value of euro banknotes in circulation is allocated to the Eurosystem central banks on the last working day of each month in accordance with the banknote allocation key.[6]

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation, whereas the remaining 92% has been allocated to the NCBs according to their weightings in the capital key of the ECB. In the year under review, the Bank had a 0.0850% share (2013: 0.0840%) of the euro banknotes in circulation in accordance with the banknote allocation key. The share of banknotes allocated to each NCB is disclosed in the balance sheet under liability item L1 'Banknotes in circulation'.

---

[3] Guideline of the ECB of 10 December 2012 amending Guideline ECB/2010/20 on the legal framework for accounting and financial reporting in the ESCB (2012/833/EU) OJ L 356, 22.12.2012, p. 94.

[4] Lietuvos Bankas joined the Eurosystem on 1 January 2015 bringing the total number of Eurosystem NCBs to nineteen.

[5] ECB Decision of 13 December 2010 on the issue of euro banknotes (recast) (ECB/2010/29), OJ L 35, 9.2.2011, p. 26, as amended.

[6] Banknote allocation key means the percentages that result from taking into account the ECB's share in the total euro banknote issue and applying the subscribed capital key to the NCBs' share in such total.

The difference between the value of the euro banknotes allocated to each NCB in accordance with the banknote allocation key and the value of the euro banknotes that it actually puts into circulation, as reduced by banknotes withdrawn from circulation, gives rise to intra-Eurosystem balances remunerated[7] on a daily basis at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations (MRO). If the value of the euro banknotes actually issued is greater than the value according to the banknote allocation key, the excess is recorded in the balance sheet under liability sub-item L10.3 'Net liabilities related to the allocation of euro banknotes within the Eurosystem'. If the value of the euro banknotes actually issued is less than the value according to the banknote allocation key, the shortfall is recorded in the balance sheet under asset sub-item A9.4 'Net claims related to the allocation of euro banknotes within the Eurosystem'.

In the cash changeover year[8] and in the subsequent five years, the intra-Eurosystem balances arising from the allocation of euro banknotes are adjusted in order to avoid significant changes in the NCB's relative income positions as compared to previous years. The adjustments are effected by taking into account the differences between the average value of the banknotes which the NCB had in circulation in the reference period,[9] and the average value of banknotes which would have been allocated to it during that period in accordance with its capital key. The adjustments are reduced in annual stages until the first day of the sixth year after the cash changeover year, when income on banknotes will be allocated fully in proportion to the NCB's paid-up shares in the ECB's capital.

The interest income and expense on these balances is cleared through the accounts of the ECB and is disclosed in the profit and loss account under item 1 'Net interest income'.

7 ECB profit distribution

The Governing Council of the ECB has decided that the seigniorage income of the ECB, which arises from the 8% share of euro banknotes allocated to the ECB, as well as income arising from securities purchased under the securities markets programme (SMP), the outright monetary transactions (OMT), the asset-backed securities purchase programme (ABSPP) and the third covered bond purchase programme (CBPP3) shall be due in full to the NCBs in the same financial year it accrues. Unless otherwise decided by the Governing Council, the ECB shall distribute this income in January of the following year in the form of an interim distribution of profit.[10] It is distributed in full unless the ECB's net profit for the year is less than its combined income earned on euro banknotes in circulation and the aforementioned asset purchase programmes, and subject to any decisions by the Governing Council to make transfers to the provision for foreign exchange rate, interest rate, credit and gold price risks. The Governing Council may also decide to charge costs incurred by the ECB in connection with the issue and handling of euro banknotes against income earned on euro banknotes in circulation.

The amount distributed to the Bank is disclosed in the profit and loss account under item 4 'Income from equity shares and participating interests'.

8 Intra-Eurosystem balances/Intra-ESCB balances

Intra-Eurosystem balances result mostly from cross-border payments in the EU that are settled in central bank money in euro. These transactions are for the most part initiated by private entities. They are primarily settled in the Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET2) and give rise to bilateral balances in the TARGET2 accounts of EU central banks. These bilateral balances

[7] ECB Decision of 25 November 2010 on the allocation of monetary income of the NCBs of Member States whose currency is the euro (ECB/2010/23) (recast) OJ L 35, 9.2.2011, p. 17, as amended by Decision of the ECB (ECB/2014/56) OJ L 53, 25.2.2015, p. 24.

[8] Cash changeover year refers to the year in which the euro banknotes are introduced as legal tender in the respective Member State, for Latvijas Banka this is 2014.

[9] The reference period refers to 24 months which start 30 months before the day on which euro banknotes become legal tender in the respective Member State.

[10] ECB Decision of 25 November 2010 on the interim distribution of the income of the ECB on euro banknotes in circulation and arising from securities purchased under the SMP (ECB/2010/24) OJ L 6, 11.1.2011, p. 35, as amended by Decision of the ECB (ECB/2014/57), 15.12.2014 OJ L 53, 25.2.2015, p. 24.

are netted out and then assigned to the ECB on a daily basis, leaving each NCB with a single net bilateral position vis-à-vis the ECB only. Intra-Eurosystem balances of the Bank vis-à-vis the ECB arising from TARGET2, as well as other intra-Eurosystem balances denominated in euro (e.g. interim profit distributions to NCBs and monetary income results), are presented on the balance sheet of the Bank as a single net asset or liability position and disclosed under A9.5 'Other claims within the Eurosystem (net)' or L10.4 'Other liabilities within the Eurosystem (net)'. Intra-ESCB balances versus non-euro area NCBs not arising from TARGET2 are disclosed either under A4 'Claims on non-euro area residents denominated in euro' or L6 'Liabilities to non-euro area residents denominated in euro'.

Intra-Eurosystem claims arising from the Bank's participating interest in the ECB are reported under A9.1 'Participating interest in ECB'.

Intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are reported as a single net asset or liability under A9.5 'Other claims within the Eurosystem (net)' or L10.4 'Other liabilities within the Eurosystem (net)' as appropriate, see 'Banknotes in circulation' in note 6 above.

Intra-Eurosystem balances arising from the transfer of foreign reserve assets to the ECB by NCBs joining the Eurosystem are denominated in euro and reported under A9.2 'Claims equivalent to the transfer of foreign reserves'.

Notes to the balance sheet

Assets

A 1 Gold and gold receivables

The Bank's gold balances consist of correspondent accounts with foreign banks, holdings with counterparties and numismatic coins. During the year ended 31 December 2014, the Bank liquidated 9,600 troy ounces of gold holdings with foreign banks and disposed of 164 troy ounces attributable to numismatic coins. On the balance sheet date, gold was revalued at €987.769 (2013: €871.220) per fine troy ounce. The resultant unrealised valuation gains of €536,516 are disclosed under L14 'Revaluation accounts' as compared to the unrealised valuation write-down of €4,525,791 disclosed in Note 2.2 'Write downs on financial assets and positions' to the profit and loss account in 2013.

	€'000	Fine troy ounces
Balance as at 31 December 2013	12,517	14,367
Net transactions during the year	(8,507)	(9,764)
Increase in valuation on 31 December 2014	537	-
Balance as at 31 December 2014	**4,547**	**4,603**

A 2 Claims on non-euro area residents denominated in foreign currency

These claims consist of receivables from the IMF and claims on counterparties resident outside the euro area denominated in foreign currency as follows:

	2014	2013	Change
	€'000	€'000	€'000
US dollar	**338,621**	248,804	89,817
Great Britain pound	**15,840**	6,837	9,003
Special drawing rights	**154,542**	157,759	(3,217)
Other	**9,898**	5,395	4,503
Total	**518,901**	418,795	100,106

A 2.1 Receivables from the IMF

(a) IMF quota

Malta's membership subscription to the IMF amounts to SDR102,000,000 (2013: SDR102,000,000). The Bank's financial position relating to this subscription at 31 December 2014 is reflected in the balance sheet as follows:

The net reserve tranche position included in the table below is equivalent to SDR38,295,734 (2013: SDR37,251,368). This amount is a claim on the IMF and represents the difference between the quota of SDR102,000,000 and the balances in euro at the disposal of the IMF.

During the period under review, Malta's net reserve tranche increased by SDR1,044,366 mainly due to a purchase, reflecting a transfer of euro to a borrowing member under the IMF financial transaction plan.

	2014	2013	Change
	€'000	€'000	€'000
Reserve tranche position (net)	**45,664**	41,658	4,006
SDR holdings	**100,764**	100,053	711
IMF borrowing agreement	**8,114**	16,048	(7,934)
Total	**154,542**	157,759	(3,217)

On 15 December 2010, the Board of Governors of the IMF adopted Resolution No. 66-2 on the Fourteenth General Review of Quotas which proposes increases in the quotas of all IMF members. Each member shall pay the IMF the increase in its quota within 30 days of the later of its consent or the date on which the requirements for the effectiveness of the increase in quota are met. Malta consented to this quota increase on 29 December 2011. While the required threshold for the quota increase has been attained, for the proposed amendment on reform of the Executive Board to enter into force, a threshold of 85% of the total voting power of the IMF membership is required. 146 members having 77.07% of total voting power have accepted[11] the amendment. However, until the required number of acceptances to the reform of the IMF Executive Board is achieved, the proposed quota increase will not become effective.

Malta's quota will increase by SDR66,300,000 to SDR168,300,000. Twenty-five per cent of the quota increase amounting to SDR16,575,000 will be paid in reserve assets, either in SDRs or in the currencies specified by the IMF. The remaining seventy-five per cent will be credited to the IMF No. 1 account held with the Bank.

(b) Malta's SDR position in the IMF

In November 2009, the Bank entered into a two-way voluntary trading arrangement with the IMF. Under this arrangement the Bank stands ready to buy and sell SDRs against euro, subject to certain limits, in transactions that the IMF arranges between prospective buyers and sellers of SDRs. During 2014, there were net sales of SDR5,000,000 under this agreement (2013: net sales of SDR1,600,000). Malta's SDR holdings, as at 31 December 2014, including interest of SDR36,331 received thereon, stood at SDR84,505,053 (2013: SDR89,468,722).

The total SDRs allocated to Malta remained unchanged from 2010 at SDR95,401,757 to which a corresponding liability exists in the form of a restricted demand deposit of the Government of Malta included under liability item L9 'Counterpart of special drawing rights allocated by the IMF' together with other SDRs acquired in accordance with IMF requirements and procedures. SDRs allocated to Malta cannot be withdrawn unless such advice is received from the IMF.

(c) IMF interest on the SDR position

The net Reserve Tranche Position, SDR holdings and the SDR allocation are subject to SDR interest rates quoted by the IMF on a weekly basis. The IMF current accounts are not subject to interest.

[11] As at 27 January 2015.

(d) Bilateral Borrowing Agreement

In February 2010, the IMF and the Bank signed an agreement for the provision to the IMF of an SDR denominated amount up to the equivalent of €120,000,000 as part of a commitment made by the EU in 2009 to support the IMF's lending capacity. The total term of this interest-bearing agreement shall not exceed four years. As at 31 December 2014, the amount still outstanding under this facility stood at €8,114,280 (2013: €16,047,613) equivalent to SDR6,805,000 (2013: SDR14,350,000). On 29 March 2013, the IMF Executive Board decided that, as of 1 April 2013, the IMF will cease to make drawings under the 2010 Bilateral Loan Agreement.

In January 2013, the IMF and the Bank signed a new bilateral borrowing agreement whereby the Bank has agreed to lend to the IMF an SDR denominated amount up to €260,000,000. The total term of this interest bearing agreement will not exceed four years. Up to 31 December 2014, no amounts have been utilised under this agreement.

A 2.2 Balances with banks and security investments, external loans and other external assets

These assets principally include security investments issued by non-euro area residents and balances with banks.

	2014	2013	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**273,912**	180,451	93,461
Held-to-maturity debt securities	**54,496**	47,666	6,830
Fixed-term deposits with banks	**-**	24,125	(24,125)
Current accounts and overnight deposits with banks	**35,632**	8,105	27,527
Other external assets	**319**	689	(370)
Total	**364,359**	261,036	103,323

A 3 Claims on euro area residents denominated in foreign currency

These foreign currency assets mainly comprise investments in marketable debt securities issued by euro area residents and balances with banks within the euro area as follows:

	2014	2013	Change
	€'000	€'000	€'000
US dollar	**92,648**	137,499	(44,851)
Great Britain pound	**12,868**	24	12,844
Total	**105,516**	137,523	(32,007)

During 2014, the ECB conducted the regular US dollar liquidity-providing operations with maturities of one week. Moreover, until April 2014, the ECB also conducted these operations with a three-month tenor. The US dollars were provided by the Federal Reserve to the ECB by means of a temporary swap line with the aim of offering short-term US dollar funding to Eurosystem counterparties. The ECB simultaneously entered into back-to-back swap transactions with NCBs that have adopted the euro, which used the resulting funds to conduct liquidity-providing operations with the Eurosystem counterparties in the form of reverse and swap transactions. As at 31 December 2013 and 2014, the Bank did not have any claims arising from these operations.

	2014	2013	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**91,806**	107,493	(15,687)
Fixed-term deposits with banks	**12,839**	29,730	(16,891)
Current accounts and overnight deposits with banks	**871**	300	571
Total	**105,516**	137,523	(32,007)

A 4 Claims on non-euro area residents denominated in euro

These claims include marketable debt securities issued by non-euro area residents and balances with banks outside the euro area.

	2014	2013	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**257,047**	194,723	62,324
Held-to-maturity debt securities	**578,883**	290,659	288,224
Fixed-term deposits with banks	**-**	120,000	(120,000)
Current accounts and overnight deposits with banks	**1,475**	1,851	(376)
Total	**837,405**	607,233	230,172

A 5 Lending to euro area credit institutions related to monetary policy operations denominated in euro

This item reflects operations carried out by the Bank within the framework of the single monetary policy of the Eurosystem.

The total Eurosystem holding of monetary policy assets amounts to €630,340,809,644 (2013: €752,288,220,516) of which the Bank holds €411,320,000 (2013: €200,050,000). In accordance with Article 32.4 of the Statute, losses from monetary policy operations (if they were to materialise) are shared in full by the Eurosystem NCBs in proportion to the prevailing ECB capital key shares.

Losses can only materialise if both the counterparty fails and the recovery of funds received from the resolution of the collateral provided by the counterparty is not sufficient. It should be noted that in relation to specific collateral which can be accepted by NCBs at their own discretion, risk sharing has been excluded by the Governing Council of the ECB.

A 5.1 Main refinancing operations

Main refinancing operations are regular liquidity-providing reverse transactions carried out by the Eurosystem NCBs with a weekly frequency and generally a maturity of one week, normally by means of standard tenders. Since October 2008, these operations were conducted as fixed rate tender procedures with full allotment. These operations play a key role in achieving the aims of steering interest rates, managing market liquidity and signalling the monetary policy stance.

All counterparties that fulfil the general eligibility criteria may submit bids within a specified timeframe. Participation in MROs requires the availability of eligible collateral.

During 2014, the aggregate MROs carried out with the Bank during the year amounted to €514,000,000 (2013: €3,565,800,000) while outstanding MROs at the end of the year amounted to €6,800,000 (2013: €6,000,000).

The following table highlights the changes in the MRO rate during 2013 and 2014 as decided by the Governing Council:

With effect from:	Changes in basis points (bps)	Effective rate (%)
	2013	
1 January		0.75
8 May	-25 bps	0.50
13 November	-25 bps	0.25
	2014	
11 June	**-10 bps**	**0.15**
10 September	**-10 bps**	**0.05**

A 5.2 Longer-term refinancing operations

Longer-term refinancing operations (LTROs) are regular liquidity-providing reverse transactions carried out in the form of variable or fixed rate tender procedure, with a monthly frequency and a maturity of three months. These operations aim to provide counterparties with additional longer-term refinancing. Participation in LTROs requires the availability of eligible collateral.

During the year, the 3-month LTROs were conducted at fixed rate tender procedures with full allotment, with the rate fixed at the average rate of the MROs over the life of the respective operation. Moreover, the maintenance period operations that are conducted on the last day of the reserve maintenance period remained in operation until June 2014. The maintenance period operations were conducted at fixed rate full allotment.

During 2014, banks had the option to pay back part or the entire amount from the thirty-six-month LTROs conducted in December 2011 and March 2012.

Moreover, during 2014, the Governing Council of the ECB announced a series of targeted longer-term refinancing operations (TLTROs) aimed at improving bank lending to the euro area non-financial private sector excluding loans to households for house purchases, over a window of two years. To this effect, the ECB conducted the first two TLTROs in September and December 2014. The interest rate on the TLTROs will be fixed over the life of the operation at the MRO rate prevailing at the time of take-up, plus a spread of 10 basis points.

The aggregate LTROs carried out during 2014 amounted to €308,470,000 (2013: €73,200,000), while outstanding LTROs at the end of the year amounted to €404,520,000 (2013: €194,050,000).

A 5.3 Fine-tuning reverse operations

Fine-tuning reverse operations aim to regulate the market liquidity situation and steer interest rates, particularly to smooth the effects on interest rates caused by unexpected market fluctuations. Owing to their nature, they are executed on an ad hoc basis. No fine-tuning reverse operations were conducted by the ECB during 2013 and 2014.

A 5.4 Structural reverse operations

These are reverse open-market transactions through standard tenders to enable the Eurosystem to adjust its structural liquidity position vis-à-vis the financial sector. No structural operations were conducted by the ECB during 2013 and 2014.

A 5.5 Marginal lending facility

Marginal lending facilities may be used by counterparties to obtain overnight liquidity from NCBs at a pre-specified interest rate against eligible assets. During 2014, the aggregate volume of such transactions with the Bank amounted to €48,000,000 (2013: €20,000,000). There were no outstanding balances as at 31 December 2013 and 2014. The following table highlights the changes in the marginal lending facility rate during 2013 and 2014 as decided by the Governing Council:

With effect from:	Changes in basis points (bps)	Effective rate (%)
	2013	
1 January		1.50
8 May	-50 bps	1.00
13 November	-25 bps	0.75
	2014	
11 June	**-35 bps**	**0.40**
10 September	**-10 bps**	**0.30**

A 5.6 Credits related to margin calls

This sub-item refers to cash paid to counterparties in those instances where the market value of the collateral exceeds an established trigger point implying an excess of collateral with respect to outstanding monetary policy operations.

Since the Bank operates a general pooling system, no payments to counterparties are effected.

A 6 Other claims on euro area credit institutions denominated in euro

This item includes claims on credit institutions within the euro area which do not relate to monetary policy operations, consisting mainly of balances and placements with banks.

	2014	2013	Change
	€'000	€'000	€'000
Fixed-term deposits with banks	**-**	15,000	(15,000)
Current accounts and overnight deposits	**358**	441	(83)
Total	**358**	15,441	(15,083)

A 7 Securities of euro area residents denominated in euro

This item consists of securities held for monetary policy purposes as well as other securities.

A 7.1 Securities held for monetary policy purposes

This sub-item contains securities acquired within the scope of the Eurosystem monetary policy purchase programmes for covered bonds, public debt securities acquired in the scope of the SMP as well as outright transactions in secondary sovereign bond markets (known as OMT).

Under the first covered bond purchase programme,[12] the ECB and the NCBs purchased euro-denominated covered bonds issued in the euro area. The purchases under this programme were fully implemented by the end of June 2010.

Under the second covered bond purchase programme,[13] the ECB and the NCBs purchased euro-denominated covered bonds issued in the euro area with the objective of easing funding conditions for credit institutions and enterprises, as well as encouraging credit institutions to maintain and expand lending to their clients. The programme ended on 31 October 2012.

On 2 October 2014 the Governing Council announced the technical features of the third covered bond purchase programme.[14] Under this programme, the ECB and the NCBs started to purchase euro-denominated covered bonds issued in the euro area with the objective of easing funding conditions for credit institutions. This programme will last at least two years.

Under the SMP, established in May 2010, the ECB and the NCBs were able to purchase euro area public and private debt securities in order to address the malfunctioning of certain segments of the euro area debt securities markets, and to restore the proper functioning of the monetary policy transmission mechanism. In September 2012 the Governing Council decided to terminate purchases under the SMP with immediate effect. The Bank decided to participate in the SMP as follows:

	2014		2013		Change	
	Amortised cost	**Market value**	Amortised cost	Market value	Amortised cost	Market value
	€'000	**€'000**	€'000	€'000	€'000	€'000
Securities market programme	**67,108**	**46,581**	90,445	50,020	(23,337)	(3,439)

Under the asset-backed securities programme (ABSPP) established in October 2014, the Eurosystem may purchase senior and guaranteed mezzanine tranches of asset-backed securities in both primary and secondary markets in order to support the provision of credit to the euro area economy. The initial purchases are being made by the ECB. This programme will last at least two years.

The Governing Council assesses on a regular basis the financial risks associated with the securities held under the SMP, the three covered bond purchase programmes and the ABSPP. The total Eurosystem NCBs' holding of such securities amounts to €199,454,333,708, of which the Bank holds €67,107,940 as shown in the table above. In accordance with Article 32.4 of the ESCB Statute, losses from holdings of securities, if they were to materialise, are shared in full by the Eurosystem NCBs, in proportion to the prevailing ECB capital key shares.

As a result of the impairment test conducted as at 31 December 2014 on securities purchased under the programmes, the Governing Council decided that all future cash flows on these securities are expected to be received.

[12] ECB Decision of 2 July 2009 on the implementation of the CBPP (ECB/2009/16), OJ L 175, 4.7.2009, p. 18.
[13] ECB Decision of 3 November 2011 on the implementation of the second CBPP (ECB/2011/17), OJ L 297, 16.11.2011, p. 70.
[14] ECB Decision of 15 October 2014 on the implementation of the third covered bond purchase programme (ECB/2014/40), OJ L 335, 22.10.2014, p. 22.

A 7.2 Other securities

This item comprises all the Bank's holdings of debt securities issued by euro area residents that are not used in monetary policy operations and are not part of investment portfolios earmarked for specific purposes.

	2014	2013	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**331,416**	359,550	(28,134)
Held-to-maturity debt securities	**1,001,351**	985,529	15,822
Total	**1,332,767**	1,345,079	(12,312)

A 9 Intra-Eurosystem claims

This item consists of claims arising from the Bank's share in the ECB's net equity and claims equivalent to the transfer of foreign reserves to the ECB. It may also include net claims related to the allocation of euro banknotes within the Eurosystem and other net claims within the Eurosystem.

A 9.1 Participating interest in ECB

Pursuant to Article 28 of the Statute, the ESCB NCBs are the sole subscribers to the capital of the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29 of the Statute and are subject to adjustment every five years. The most recent adjustment took effect on 1 January 2014.

Consequently, on 1 January 2014, the share that the Bank held in the subscribed capital of the ECB increased from 0.0635% to 0.0648% and sub-item A9.1 'Participating interest in the ECB' increased from €6,873,879 to €7,014,605.

Based on the Council Decision 2003/517/EC of 15 July 2003 on the statistical data to be used for the determination of the key for subscription of the capital of the ECB,[15] the capital key shares of NCBs were adjusted as follows on 1 January 2014, by means of transfers among the NCBs:

	Key for subscription of the ECB's capital until 31 December 2013	Key for subscription of the ECB's capital from 1 January 2014
Nationale Bank van België/ Banque Nationale de Belgique	2.4176	2.4778
Deutsche Bundesbank	18.7603	17.9973
Eesti Pank	0.1780	0.1928
Central Bank of Ireland	1.1111	1.1607
Bank of Greece	1.9483	2.0332
Banco de España	8.2533	8.8409
Banque de France	14.1342	14.1792
Banca d'Italia	12.4570	12.3108
Central Bank of Cyprus	0.1333	0.1513
Latvijas Banka	-	0.2821
Banque centrale du Luxembourg	0.1739	0.2030
Central Bank of Malta	0.0635	0.0648
De Nederlandsche Bank	3.9663	4.0035
Oesterreichische Nationalbank	1.9370	1.9631
Banco de Portugal	1.7636	1.7434
Banka Slovenije	0.3270	0.3455
Národná banka Slovenska	0.6881	0.7725
Suomen Pankki	1.2456	1.2564
Subtotal for euro area NCBs	**69.5581**	**69.9783**
Българска народна банка (Bulgarian National Bank)	0.8644	0.8590
Česká národní banka	1.4539	1.6075
Danmarks Nationalbank	1.4754	1.4873
Hrvatska narodna banka	0.5945	0.6023
Latvijas Banka	0.2742	-
Lietuvos bankas	0.4093	0.4132
Magyar Nemzeti Bank	1.3740	1.3798
Narodowy Bank Polski	4.8581	5.1230
Banca Naţională a României	2.4449	2.6024
Sveriges Riksbank	2.2612	2.2729
Bank of England	14.4320	13.6743
Subtotal for non-euro area NCBs	**30.4419**	**30.0217**
Total	**100**	**100**

[15] OJ L 181, 19.7.2003, p. 43.

	Subscribed capital until 31 December 2013	Paid-up capital until 31 December 2013	Subscribed capital from 1 January 2014	Paid-up capital from 1 January 2014
Nationale Bank van België/ Banque Nationale de Belgique	261,705,371	261,705,371	268,222,025	268,222,025
Deutsche Bundesbank	2,030,803,801	2,030,803,801	1,948,208,997	1,948,208,997
Eesti Pank	19,268,513	19,268,513	20,870,614	20,870,614
Central Bank of Ireland	120,276,654	120,276,654	125,645,857	125,645,857
Bank of Greece	210,903,613	210,903,613	220,094,044	220,094,044
Banco de España	893,420,308	893,420,308	957,028,050	957,028,050
Banque de France	1,530,028,149	1,530,028,149	1,534,899,402	1,534,899,402
Banca d'Italia	1,348,471,131	1,348,471,131	1,332,644,970	1,332,644,970
Central Bank of Cyprus	14,429,734	14,429,734	16,378,236	16,378,236
Latvijas Bankas	-	-	30,537,345	30,537,345
Banque centrale du Luxembourg	18,824,687	18,824,687	21,974,764	21,974,764
Central Bank of Malta	6,873,879	6,873,879	7,014,605	7,014,605
De Nederlandsche Bank	429,352,255	429,352,255	433,379,158	433,379,158
Oesterreichische Nationalbank	209,680,387	209,680,387	212,505,714	212,505,714
Banco de Portugal	190,909,825	190,909,825	188,723,173	188,723,173
Banka Slovenije	35,397,773	35,397,773	37,400,399	37,400,399
Národná banka Slovenska	74,486,874	74,486,874	83,623,180	83,623,180
Suomen Pankki	134,836,288	134,836,288	136,005,389	136,005,389
Subtotal for euro area NCBs*	**7,529,669,242**	**7,529,669,242**	**7,575,155,922**	**7,575,155,922**
Българска народна банка (Bulgarian National Bank)	93,571,361	3,508,926	92,986,811	3,487,005
Česká národní banka	157,384,778	5,901,929	174,011,989	6,525,450
Danmarks Nationalbank	159,712,154	5,989,206	161,000,330	6,037,512
Hrvatska narodna banka	64,354,667	2,413,300	65,199,018	2,444,963
Latvijas Banka	29,682,169	1,113,081	-	-
Lietuvos bankas	44,306,754	1,661,503	44,728,929	1,677,335
Magyar Nemzeti Bank	148,735,597	5,577,585	149,363,448	5,601,129
Narodowy Bank Polski	525,889,668	19,720,863	554,565,112	20,796,192
Banca Naţională a României	264,660,598	9,924,772	281,709,984	10,564,124
Sveriges Riksbank	244,775,060	9,179,065	246,041,586	9,226,559
Bank of England	1,562,265,020	58,584,938	1,480,243,942	55,509,148
Subtotal for non-euro area NCBs*	**3,295,337,826**	**123,575,168**	**3,249,851,149**	**121,869,417**
Total*	**10,825,007,070**	**7,653,244,411**	**10,825,007,070**	**7,697,025,340**

*Due to rounding, subtotals and totals may not correspond to the sum of all figures shown.

As a result of the aforementioned capital key changes, the relative shares of NCBs in the accumulated net profits of the ECB (also referred to as net equity) as at 1 January 2014 changed. Sub-item A9.1 'Participating interest in the ECB', also reflects the increase in the Bank's share amounting to €351,825 (2013: €243,101) totalling €8,844,497 (2013: €8,492,672).

A 9.2 Claims equivalent to the transfer of foreign reserves

This asset represents the Bank's claims arising from the transfer of foreign reserve assets to the ECB, when the Bank joined the Eurosystem. The remuneration of these claims is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations, adjusted to reflect a zero return on the gold component.

The adjustments to the capital key weightings of the ECB on 1 January 2014 also resulted in the adjustment of the claim of the Bank with respect to the foreign reserve assets transferred to the ECB as disclosed in the table below. In order to reflect its increased capital key share, the euro-denominated claim of the Bank increased from €36,798,912 to €37,552,276 on 1 January 2014.

	Claim equivalent to the transfer of foreign reserves until 31 December 2013	**Claim equivalent to the transfer of foreign reserves from 1 January 2014**
Nationale Bank van België/ Banque Nationale de Belgique	1,401,024,415	1,435,910,943
Deutsche Bundesbank	10,871,789,515	10,429,623,058
Eesti Pank	103,152,856	111,729,611
Central Bank of Ireland	643,894,039	672,637,756
Bank of Greece	1,129,060,170	1,178,260,606
Banco de España	4,782,873,430	5,123,393,758
Banque de France	8,190,916,316	8,216,994,286
Banca d'Italia	7,218,961,424	7,134,236,999
Central Bank of Cyprus	77,248,740	87,679,928
Latvijas Banka	-	163,479,892
Banque centrale du Luxembourg	100,776,864	117,640,617
Central Bank of Malta	36,798,912	37,552,276
De Nederlandsche Bank	2,298,512,218	2,320,070,005
Oesterreichische Nationalbank	1,122,511,702	1,137,636,925
Banco de Portugal	1,022,024,594	1,010,318,483
Banka Slovenije	189,499,911	200,220,853
Národná banka Slovenska	398,761,127	447,671,807
Suomen Pankki	721,838,191	728,096,904
Total*	**40,309,644,424**	**40,553,154,707**

*Due to rounding, totals may not correspond to the sum of all figures shown.

A 9.4 Net claims related to the allocation of euro banknotes within the Eurosystem

This sub-item reflects claims which would arise from application of the banknote allocation key (see note 6 'Banknotes in circulation' in the general notes to the financial statements). As at the end of 2013 and 2014, the Bank had no claims in this respect but had a liability which is presented in liability sub-item L10.3 'Net liabilities related to the allocation of euro banknotes within the Eurosystem'.

A 9.5 Other claims within the Eurosystem (net)

As at 31 December 2013 and 2014, the Bank's claims were netted off from liability sub-item L10.4 'Other liabilities within the Eurosystem (net)'.

A 10 Items in course of settlement

These assets comprise transactions which are not yet settled as at the end of the financial year.

A 11 Other assets

A 11.1 Coins of euro area

This item represents the Bank's holdings of euro coins issued by euro area countries.

A 11.2 Tangible and intangible fixed assets

Tangible and intangible fixed assets principally comprise the Bank's premises, equipment, computer hardware and software.

	Land and buildings	Computer equipment and other assets	Total
	€'000	€'000	€'000
Cost			
As at 31 December 2013	24,538	5,762	30,300
Additions	2,219	743	2,962
Derecognition of assets	(1,776)	-	(1,776)
As at 31 December 2014	**24,981**	**6,505**	**31,486**
Accumulated depreciation			
As at 31 December 2013	4,245	4,556	8,801
Charge for the year	212	443	655
Derecognition of assets	(1,776)	-	(1,776)
As at 31 December 2014	**2,681**	**4,999**	**7,680**
Net book value			
As at 31 December 2013	20,293	1,206	21,499
As at 31 December 2014	**22,300**	**1,506**	**23,806**

The derecognition of assets effected in 2014 relates to a building which is no longer in use by the Bank.

The net book value as at 31 December 2014 includes an amount of €3,229,370 (2013: €1,460,422) related to assets which are not yet available for use.

A 11.3 Other financial assets

Other financial assets comprise debt securities and investments held by the Bank as part of an earmarked portfolio as a counterpart to the Bank's capital and statutory reserves (see note 3 (h) (ii) of the General notes to the financial statements). During the year, the Bank decided to transfer marketable debt securities which were part of the earmarked portfolio and measured at mid-market prices, to the held-to-maturity portfolios in asset sub-items A4.1 'Balances with banks, security investments and loans', and A7.2 'Other securities'. The transfer was effected at the market values on the date of transfer amounting to €209,434,930.

The Bank also held another earmarked portfolio comprising Malta Government securities and Treasury bills purchased on the secondary market by the Bank in its role as market maker.

In November 2012, the Bank's Board of Directors approved the investment by the Bank in two fixed income investment programmes to be managed by external asset managers in the form of contractual funds. The objective of these investment programmes is to achieve higher levels of diversification in investment style and exposure whilst also increasing the volume of assets under management. During 2013, the Bank implemented both programmes and during 2014 the investment in these funds was increased by a further €50,000,000. The contractual funds are measured in the balance sheet at the net asset value of the respective fund.

	2014	2013	Change
	€'000	€'000	€'000
Earmarked investments	**207,058**	61,708	145,350
Earmarked Malta Government stocks	**398,349**	331,813	66,536
Fixed income investment funds	**306,227**	252,283	53,944
Total	**911,634**	645,804	265,830

A 11.4 Off-balance sheet instruments revaluation differences

This sub-item reflects unrealised revaluation gains arising on off-balance sheet positions, mainly foreign exchange swap transactions outstanding as at the balance sheet date. At 31 December 2014, these unrealised gains amounted to €498 (2013: €433,286).

A 11.5 Accruals and prepaid expenses

This sub-item consists of accrued interest income of €46,142,796 (2013: €44,580,176) on income-earning assets, including an amount of €53,196 (2013: €275,956) attributable to interest on intra-Eurosystem claims.

A 11.6 Sundry

Sundry assets consist mainly of loans and other assets together with realised gains attributable to off-balance sheet positions, principally foreign exchange forward transactions outstanding at the year end, which gains arose from the conversion of such transactions into their euro equivalent at the respective currency's average cost on the balance sheet date, compared with the euro amounts at which the transactions were initially recorded.

Liabilities

L 1 Banknotes in circulation

This item consists of the Bank's share of the total euro banknotes in circulation (see note 6 'Banknotes in circulation' in the general notes to the financial statements).

During 2014, the total value of banknotes in circulation within the Eurosystem increased by 6.3% from €956,185,499,325 at 31 December 2013 to €1,016,537,995,180 at 31 December 2014. According to the banknote allocation key, the Bank had an allocated amount of euro banknotes in circulation of €864,057,300 at the end of the year compared to €803,195,400 at the end of 2013.

The value of the euro banknotes actually issued by the Bank in 2014 increased by 3.1% from €840,565,030 to €866,631,800 at year end. As this is more than the allocated amount, the difference of €2,574,500 (2013: €37,369,630) is shown under liability sub-item L10.3 'Net liabilities related to the allocation of euro banknotes within the Eurosystem'.

L 2 Liabilities to euro area credit institutions related to monetary policy operations denominated in euro

These interest-bearing liabilities arise from the monetary policy operations conducted by the Bank on behalf of the Eurosystem.

	2014	2013	Change
	€'000	€'000	€'000
Current accounts (covering the minimum reserve system)	**257,271**	327,300	(70,029)
Deposit-facility	**241,827**	146,740	95,087
Fixed term deposits	**-**	670,000	(670,000)
Total	**499,098**	1,144,040	(644,942)

L 2.1 Current accounts (covering the minimum reserve system)

These accounts include deposits by the credit institutions which are utilised to meet the minimum reserve requirement and settlement of payments. The main criterion for including these deposits within this sub-item is that the respective credit institutions must appear in the list of institutions which are subject to the minimum reserve regulations of the Eurosystem. Minimum reserve requirements have to be met on average over the reserve maintenance period in accordance with the schedule published by the ECB. Since 1 January 1999, the minimum reserve balances have been remunerated at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations. Since June 2014 the reserves held in excess of the minimum requirements are remunerated at the lower of either zero per cent or the deposit facility rate.

L 2.2 Deposit facility

The overnight deposit facility is available to eligible counterparties to make overnight deposits with NCBs at pre-specified rates. Under normal circumstances, the interest rate on the facility provides a floor for the overnight market interest rate. During 2014, the aggregate volume of such transactions with the Bank amounted to €57,881,787,591 (2013: €114,732,820,879). The outstanding balance as at year-end amounted to €241,827,188 (2013: €146,739,832).

The following table highlights the changes in the overnight deposit facility rate during 2014 as decided by the Governing Council of the ECB.

With effect from:	Changes in basis points (bps)	Effective rate (%)
	2013	
1 January	-	0.00
	2014	
11 June	**-10bps**	**-0.10**
10 September	**-10bps**	**-0.20**

L 2.3 Fixed-term deposits

These liabilities relate to liquidity-absorbing fine-tuning operations for a fixed-term at variable rate tender. No liquidity-absorbing fine-tuning operations were conducted by the ECB during 2013 and 2014. Accordingly, there were no outstanding liquidity-absorbing fine-tuning operations at the end of the year.

Weekly seven-day liquidity-absorbing operations were conducted to sterilise the liquidity provided through the SMP, with an intended volume covering the amount of securities settled by the previous week. The aggregate volume of such transactions with the Bank during the year amounted to €17,605,517,537 (2013: €19,966,617,650). This operation was terminated by the Governing Council of the ECB as from June 2014. Accordingly, there was no outstanding balance as at 31 December 2014 (2013: €670,000,000).

L 2.4 Fine-tuning reverse operations

Fine-tuning liquidity-absorbing reverse operations are executed on an ad hoc basis with the purpose of managing the liquidity situation in the market and setting interest rates. Liquidity-absorbing fine-tuning reverse operations are executed, as a rule, through bilateral procedures. Moreover, their frequency and maturity are not standardised. No fine-tuning absorption reverse operations were conducted during 2013 and 2014, and accordingly there were no outstanding operations at the end of the year.

L 2.5 Deposits related to margin calls

This sub-item refers to cash received from counterparties in those instances where the market value of the collateral pledged has fallen below an established trigger point, implying a shortfall of collateral to cover the outstanding monetary policy operations. No instances of deposits related to margin calls were recorded during 2014. Deposits related to margin calls were used marginally by counterparties during 2013, on those instances where their respective pool of collateral fell below the mentioned trigger level. No margin calls were outstanding as at the end of 2013 and 2014.

L 5 Liabilities to other euro residents denominated in euro

L 5.1 General government

This liability includes current and sinking fund accounts denominated in euro held by the Government of Malta. These balances are repayable on demand and are remunerated in accordance with the provisions established by the Governing Council of the ECB.[16]

[16] ECB Decision of 20 February 2014 on the prohibition of monetary financing and the remuneration of government deposits by national central banks (ECB/2014/8), OJ L 159, 28.5.2014, p. 54; and Guideline of the ECB of 20 February 2014 on domestic assets and liability management operations by the national central banks (2014/304/9) OJ L 159, 28.5.2014, p. 56; and Guideline of the ECB of 5 June 2014 amending Guideline ECB/2014/9 on domestic assets and liability management operations by the national central banks (ECB/2014/22), OJ L 168, 7.6.2014, p. 118; and ECB Decision of 5 June 2014 on the remuneration of deposits, balances and holdings of excess reserves (ECB/2014/23), OJ L 168, 7.6.2014, p. 115.

	2014	2013	Change
	€'000	€'000	€'000
Current accounts	**216,906**	242,944	(26,038)
Sinking fund accounts	**80,410**	56,709	23,701
Total	**297,316**	299,653	(2,337)

L 5.2 Other liabilities

This sub-item includes current accounts which are repayable on demand and fixed-term deposits denominated in euro held by Maltese public sector corporations. These balances are remunerated in accordance with the provisions established by the Governing Council of the ECB.[17]

L 6 Liabilities to non-euro area residents denominated in euro

This item includes balances denominated in euro held by international and supranational organisations and by non-Eurosystem central banks, including the IMF No. 2 current account for administrative expenses (see note 3 (j) 'Claims on the International Monetary Fund' in the general notes to the financial statements). Whereas the IMF account is non-interest bearing, the other balances are remunerated in accordance with the provisions established by the Governing Council of the ECB.[18]

L 7 Liabilities to euro area residents denominated in foreign currency

Balances held by the Government of Malta which are repayable on demand and other customer deposits are included in this item. Deposits by banks are subject to fixed interest rates. All other balances are remunerated in accordance with the provisions established by the Governing Council of the ECB.[19]

	2014	2013	Change
	€'000	€'000	€'000
Government of Malta current accounts	**34,580**	27,255	7,325
Government of Malta sinking funds accounts	**391**	569	(178)
Liabilities to banks	**12,841**	7,253	5,588
Other current accounts and fixed-term deposits	**2,452**	26,028	(23,576)
Total	**50,264**	61,105	(10,841)

L 8 Liabilities to non-euro area residents denominated in foreign currency

This item includes deposits, balances and other liabilities denominated in foreign currency.

L 9 Counterpart of special drawing rights allocated by the IMF

This item represents the counterpart of special drawing rights allocated by the IMF to Malta (see note A2.1 (b) 'Receivables from the IMF' above).

[17] See footnote 16.
[18] See footnote 16.
[19] See footnote 16.

L 10 Intra-Eurosystem liabilities

This item represents the Bank's liabilities to the ECB and to the other Eurosystem NCBs.

L 10.3 Net liabilities related to the allocation of euro banknotes within the Eurosystem

This sub-item consists of the liability of the Bank vis-à-vis the Eurosystem relating to the excess of euro banknotes issued by the Bank over and above the amount allocated to the Bank by the ECB in accordance with the banknote allocation key (see note L1 'Banknotes in circulation' above). The decrease in the excess euro banknotes reflects the relatively higher increase (6.3%) in banknotes put into circulation by the Eurosystem as a whole during 2014, as compared to the additional banknotes issued by the Bank (3.1%).

L 10.4 Other liabilities within the Eurosystem (net)

These liabilities comprise balances attributable to the transfers issued and received through TARGET2 by the ESCB NCBs, including the ECB, plus the balances held with Eurosystem NCBs through correspondent accounts. Also included are balances resulting from the pooling and allocation of monetary income within the Eurosystem pending settlement reflecting the difference between monetary income to be pooled and that distributed (see note 5 'Net result of pooling of monetary income' to the profit and loss account), and balances with the ECB in respect of any amounts receivable or refundable, including the amount due to the Bank in respect of the ECB's interim profit distribution.

The remuneration of the credit balance in respect of TARGET2 is calculated daily at the latest available interest rate used by the Eurosystem in its tenders for main refinancing operations.

	2014	2013	Change
	€'000	€'000	€'000
TARGET2 balance	**1,930,223**	672,468	1,257,755
Net result from pooling of monetary income	**(2,354)**	761	(3,115)
ECB profit distribution	**(779)**	(1,250)	471
Total	**1,927,090**	671,979	1,255,111

L 12 Other liabilities

L 12.1 Off-balance sheet instruments revaluation differences

This item reflects unrealised revaluation losses arising on off-balance sheet positions, mainly foreign exchange swap transactions outstanding as at the balance sheet date.

L 12.2 Accruals and income collected in advance

These liabilities include the balance of demonetised Maltese lira currency notes which have not yet been presented, as adjusted for amounts recognised as income in the profit and loss account. This balance is presented as deferred income (see note 3 (l) 'Demonetised Maltese lira currency notes' in the general notes to the financial statements) and is recognised as income over the period until the date when these currency notes cease to be exchangeable at the Bank. This sub-item also includes accrued interest expense on interest-bearing liabilities, and other accrued expenses.

	2014	2013	Change
	€'000	€'000	€'000
Deferred income in respect of demonetised			
Maltese lira currency notes	**27,090**	32,770	(5,680)
Accrued interest payable	**244**	177	67
Other	**1,122**	925	197
Total	**28,456**	33,872	(5,416)

L 12.3 Sundry

Sundry liabilities mainly include unrealised revaluation gains attributable to Malta Government stocks held as part of the earmarked portfolio amounting to €38,250,888 (2013: €11,018,921). These liabilities also include realised losses attributable to off-balance sheet positions, principally foreign exchange swap and forward transactions outstanding on 31 December 2014, which losses arose from the conversion of such transactions into their euro equivalents at the respective currency's average cost on the balance sheet date, compared with the euro amounts at which the transactions were initially recorded. This sub-item also includes an amount of €3,264,903 reflecting the unrealised revaluation gains on marketable debt securities which formed part of the earmarked portfolio[20] and were transferred to held-to-maturity portfolios (refer to note A11.3 'Other financial assets'). The balance of these unrealised gains is being amortised on a straight line basis over the term of the respective security and is recognised within net interest income (see Profit and loss item 1.1 'Interest income').

L 13 Provisions

This item mainly includes a provision of €33,900,000 (2013: €18,900,000) approved by the Board of Directors in accordance with the amendment to the Guideline which came into force on 31 December 2012 to cover interest rate, credit, foreign exchange and gold price risks. The interest rate risk calculations are based on the Option Adjusted Duration (OAD) of the marketable securities other than those held to maturity. OAD is an interest-rate risk sensitivity measure that quantifies the potential loss in capital value resulting from an upward shift in yields. The credit risk calculation is based on the Expected Value (EV) of credit losses on securities, computed on the basis of probabilities of default (PD) and loss-given-default (LGD) for a projected holding period for marketable securities after having categorised them into rating classes. The provision for foreign exchange and gold price risks are based on management's tolerance for losses in these markets.

As at 31 December 2013 and 2014, there were no outstanding Eurosystem provisions as during 2013 the balance of €276,644 was reversed in full.

L 14 Revaluation accounts

The revaluation accounts include the unrealised revaluation gains arising from the valuation of foreign currency on and off-balance sheet positions, gold, marketable securities and other instruments at year-end.

	2014	2013	Change
	€'000	€'000	€'000
Gold	**537**	-	537
Foreign currency positions	**116**	1	115
Securities and other instruments	**17,906**	9,850	8,056
Total	**18,559**	9,851	8,708

[20] Comprising investments held as a counterpart to the Bank's capital and statutory reserves.

L 15 Capital and reserves

The following table analyses the movement in capital and reserves of the Bank:

	Capital €'000	General reserve fund €'000	Reserves for risks and contingencies €'000	Capital contribution €'000
Balance as at 31 December 2013	20,000	75,505	163,716	55,278
Net issuance of euro coins	-	-	-	5,119
Transfer from profits for the year	-	-	8,757	-
Balance as at 31 December 2014	**20,000**	**75,505**	**172,473**	**60,397**

L 15.1 Capital

In terms of article 19(1) of the Central Bank of Malta Act (Cap. 204), the Bank shall have an authorised capital of €20,000,000. This is fully paid up and is held exclusively by the Government of Malta.

L 15.2 Reserves

(a) General reserve fund

In terms of article 19(2) of the Central Bank of Malta Act (Cap. 204), the Bank shall also maintain a general reserve fund which shall be of not less than €20,000,000 and which shall be available for any purpose as may be determined by the Board of Directors. Whenever amounts are drawn from the general reserve fund, these shall be replaced as may be decided by the Board.

(b) Reserves for risks and contingencies

Reserves for risks and contingencies are maintained in terms of article 22(1) 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 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.

(c) Capital contribution

This reserve represents the capital contribution made by the Government of Malta to the Bank in respect of the agency agreement between the Bank and the Government relating to the issuance of euro coins. The Bank shall act as agent of the Government and shall retain full responsibility for procurement, storage and issuance of euro coins. This reserve represents seigniorage revenue arising from the issue of euro coins. In terms of the agency agreement, the Government has agreed not to withdraw such revenue and retain these amounts in a reserve account held at the Bank. Allocation of revenue to the reserve account shall be deemed as a capital contribution to the Bank by the Government.

Notes to the profit and loss account

1 Net interest income

This item represents the net result of interest income and interest expense.

1.1 Interest income

Interest income includes income on foreign reserve assets and euro-denominated portfolios, as well as interest income on intra-Eurosystem claims and monetary policy instruments.

	2014	2013	Change
	€'000	€'000	€'000
Marketable debt securities			
- In euro	**56,810**	62,443	(5,633)
- In foreign currency	**5,070**	4,467	603
Fixed-term deposits			
- In euro	**4**	11	(7)
- In foreign currency	**39**	14	25
Current accounts and overnight deposits			
- In foreign currency	**7**	7	-
IMF	**37**	36	1
Monetary policy operations			
- Main refinancing operations	**15**	411	(396)
- Longer-term refinancing operations	**351**	1,304	(953)
- Marginal lending facility	**1**	1	-
- Securities acquired under the SMP	**5,529**	7,942	(2,413)
Intra-Eurosystem claims			
- Claims arising from the transfer of foreign reserves	**53**	174	(121)
- Net claims related to the allocation of banknotes within the Eurosystem	**(42)**	106	(148)
- TARGET2 balances	**-**	1,856	(1,856)
Forward foreign exchange contracts	**(164)**	(442)	278
Other interest income	**31**	47	(16)
Total	**67,741**	78,377	(10,636)

1.2 Interest expense

Interest expense arises from interest payable on Government of Malta and other customer accounts, intra-Eurosystem liabilities as well as liabilities to euro area credit institutions related to monetary policy operations.

	2014	2013	Change
	€'000	€'000	€'000
Government accounts			
- In euro	**263**	951	(688)
- In foreign currency	**8**	34	(26)
Other customer accounts			
- In euro	**(44)**	120	(164)
- In foreign currency	**30**	123	(93)
Monetary policy operations			
- Minimum reserves	**393**	1,264	(871)
- Fixed-term deposits	**508**	303	205
Intra-Eurosystem liabilities			
- TARGET2 balances	**1,340**	20	1,320
Other interest expense	**154**	2,160	(2,006)
Total	**2,652**	4,975	(2,323)

2 Net result of financial operations, write-downs and risk provisions

2.1 Realised gains/losses arising from financial operations

This item includes realised gains/losses arising from transactions leading to reductions in foreign currency positions and disposals of financial instruments, mainly debt securities.

	2014	2013	Change
	€'000	€'000	€'000
Net gains/losses on disposal of financial instruments	**14,923**	12,821	2,102
Net gains/losses on foreign currency positions	**1,679**	(65)	1,744
Total	**16,602**	12,756	3,846

2.2 Write-downs on financial assets and positions

This item comprises unrealised revaluation losses arising from the price revaluation of debt securities and the exchange rate revaluation of foreign currency assets and liabilities, including off-balance sheet positions, by comparing the market value at balance sheet date with the average book value.

	2014	2013	Change
	€'000	€'000	€'000
Write-downs on debt securities	**457**	4,461	(4,004)
Write-downs on foreign currency positions	**18**	4,557	(4,539)
Total	**475**	9,018	(8,543)

2.3 Transfer to/from provisions for foreign exchange rate, interest rate, credit and gold price risk

This sub-item consists of movements in provisions (see note L13 'Provisions' in the notes to the balance sheet).

3 Net income/expense from fees and commissions

Fees and commissions receivable mainly arise from banking services provided by the Bank. Fees and commissions payable include correspondent account charges, handling fees on cheques drawn on the Bank and TARGET2 connection and participation fees.

4 Income from equity shares and participating interests

During 2014 the Bank received €55,300 (2013: €382,434) representing its relative share of the ECB's distributable remaining profits for 2013 in proportion to the Bank's subscribed capital key (see note 4 'Capital key' in the general notes to the financial statements).

Also included under this caption is the amount of €778,508 (2013: €1,250,399) due to the Bank with respect to the ECB's 2014 interim profit distribution (see note 7 'ECB profit distribution' in the general notes to the financial statements).

Income from equity shares and participating interest also reflects the increase/decrease in the relative share of the Bank in the net equity of the ECB as at 31 December 2014 due to the ECB's capital key changes (see note A9.1 'Participating interest in the ECB' in the notes to the balance sheet).

5 Net result of pooling of monetary income

This item contains the net result of pooling of monetary income for 2014 amounting to an income of €2,353,762 as compared to an expense of €761,238 in 2013.

The amount of each Eurosystem NCB's monetary income is determined by measuring the actual annual income that is derived from the earmarkable assets held against the liability base. The liability base consists mainly of the following items: banknotes in circulation; liabilities to euro area credit institutions related to monetary policy operations denominated in euro; net intra-Eurosystem liabilities resulting from TARGET2 transactions; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is to be deducted from the monetary income to be pooled.

The earmarkable assets consist mainly of the following items: lending to euro area credit institutions related to monetary policy operations denominated in euro; securities held for monetary policy purposes; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET2 transactions; net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem; and a limited amount of each NCB's gold holdings in proportion to each NCB's capital key. Gold is considered to generate no income.

Where the value of an NCB's earmarkable assets exceeds or falls short of the value of the liability base, the difference shall be offset by applying to the value of the difference the latest applicable marginal rate for the Eurosystem main refinancing operations.

The monetary income pooled by the Eurosystem is allocated among NCBs according to the subscribed ECB capital key. The pooling and reallocation of monetary income to NCBs leads to certain net reallocation effects. One reason is that the yields earned on certain earmarkable assets and the interest expense paid on certain liability base items may differ to a varying degree among the Eurosystem NCBs. In addition, usually each

Eurosystem NCB's share of earmarkable assets and liability base deviates from its share in the subscribed capital of the ECB. The net result arising from the calculation of monetary income is a receipt (as opposed to a payment in 2013) by the Bank which is the difference between the net monetary income pooled amounting to €7,461,688 (2013: €15,906,678) and the amount redistributed of €9,210,696 (2013: €15,133,248). A net income of €604,735 (2013: €12,192) was received in relation to previous years' adjustment.

6 Other income

Other income includes an amount of €4,000,000 (2013: €4,000,000), reflecting the recognition of income in respect of the balance of unredeemed Maltese lira fifth series currency notes, which as at 31 December 2014 amounted to the equivalent of €41,089,805 (2013: €42,770,324). These currency notes will still be exchangeable at the Bank until 31 January 2018. The value of unredeemed currency notes, after deducting therefrom the amount of currency notes which are expected to be redeemed until that date, is apportioned as income in the profit and loss account over the remaining period until 31 January 2018. This accounting treatment is in accordance with the provisions of article 62(3) of the Central Bank of Malta Act (Cap. 204) (see note 3(l) 'Demonetised Maltese lira currency notes' in the general notes to the financial statements). This item also includes income from numismatic issues of coins.

7 Staff costs

Staff costs include salaries and other ancillary costs.

	2014	2013	Change
	€'000	€'000	€'000
Staff salaries	**8,760**	8,437	323
Other staff costs	**936**	837	99
Training, welfare and other related expenditure	**824**	681	143
Total	**10,520**	9,955	565

The full-time equivalent average number of staff employed by the Bank during the year was as follows:

	2014	2013	Change
	Number	Number	Number
Governors	**3**	2	1
Director general	**1**	1	-
Divisional directors	**5**	5	-
Heads and executives	**99**	103	(4)
Supervisory and clerical staff	**186**	176	10
Non-clerical staff	**35**	34	1
Total	**329**	321	8

8 Administrative expenses

This item consists of operating expenditure incurred by the Bank.

Administrative expenses of €5,687,318 (2013: €5,072,879) 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, inclusive of VAT, for the current financial year amounted to €62,000 (2013: €78,500).

Compensation to the members of the Board of Directors for the financial year under review amounted to €222,664 (2013: €160,195). The Governor is entitled to such benefits as the use of a leased motor vehicle, health insurance cover and refund of certain other expenses. The Deputy Governors and other members of the Board of Directors are entitled to health insurance cover and the refund of certain other expenses.

9 Depreciation of tangible and intangible fixed assets

Depreciation of buildings, equipment, computer hardware and software was charged to the Bank's profit and loss account according to the depreciation rates disclosed in note 3(m) 'Tangible and intangible fixed assets' in the general notes to the financial statements.

10 Banknote production services

This item includes expenditure relating to the procurement and transportation of euro banknotes and other ancillary costs. Accrued expenditure also reflects the expected costs attributable to the consumption of banknotes issued.

Other notes

(a) Off-balance sheet instruments

At 31 December 2014, the Bank had outstanding foreign exchange forward and swap contracts which relate to the forward purchases of €419,200,000 (2013: €342,950,000) against the sale of other currencies (principally the US dollar), the forward sale of €38,200,000 (2013: €500,000) against the purchase of other currencies, and the net forward sale of SDR34,100,000 (2013: SDR44,640,000) against the euro.

At the balance sheet date, the Bank had outstanding interest rate future contracts linked to German government securities (long position with a notional amount of €24,439,800; short positions with a notional amount of €109,888,750) and US treasury notes (long position with a notional amount of US$29,007,188; short positions with a notional amount of US$54,652,345).

(b) Contingent liabilities and commitments

	2014	2013	Change
	€'000	€'000	€'000
Contingent liabilities			
Guarantees and letters of credit	**218**	218	-
Financial commitments			
Repayment of foreign loans on behalf of the Government	**-**	30	(30)
Total	**218**	248	(30)

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.

Financial commitments represent foreign loans received by the Bank on behalf of the Government of Malta under Financial Conventions and repayable in due course from funds to be made available by the Government.

The Bank also has commitments in respect of tangible/intangible fixed assets which extend beyond the balance sheet date. Capital commitments, which amount to €18,780,020 (2013: €20,985,100), are expected to be incurred up to 2017 and relate mainly to the building of an extension and investment in IT infrastructure.

(c) Transactions with Government

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 L5 'Liabilities to other euro residents denominated in euro' and L7 'Liabilities to euro area residents denominated in foreign currency' to the balance sheet. 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 net interest on deposits as disclosed in note 1.2 'Interest expense' to the profit and loss account. 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. The principal outstanding transactions as at the balance sheet dates are reflected in note (b) ‘Contingent liabilities and commitments’ above.

(d) Market maker in Malta Government securities and Treasury bills

The Bank acts as market maker in Malta 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 note A11.3 ‘Other financial assets’ to the balance sheet). Income earned by the Bank from these assets amounting to €10,890,189 (2013: €11,533,232) is included in note 1.1 ‘Interest income’ to the profit and loss account.

(e) Demonetised Maltese lira currency notes

Maltese lira currency notes were replaced by euro banknotes when Malta became part of the euro area on 1 January 2008. Consequently, Maltese lira currency notes remained legal tender until 31 January 2008 but will continue to be redeemed at the conversion rate of the Maltese lira for the euro of 0.4293 and without charge until 31 January 2018.

During 2014, demonetised Maltese lira currency notes presented for redemption amounted to €1,680,519 (2013: €1,865,853). At 31 December 2014, the value of unpresented demonetised currency notes amounted to €41,089,805 (2013: €42,770,324).

(f) Investment securities pledged as collateral

As at 31 December 2014, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of US$95,000,000 or approximately €78,000,000 (2013: US$95,000,000 or approximately €69,000,000). No amounts were borrowed under these facilities at the balance sheet dates.

(g) Assets held in custody

As at 31 December 2014, assets held in custody by the Bank in terms of the Insurance Business Act (Cap. 403) amounted to the equivalent of €29,224,491 (2013: €28,368,792).

(h) Management of funds belonging to the Investor and Depositor Compensation Schemes

In 2003, the Bank was appointed investment manager in respect of funds belonging to the Investor and Depositor Compensation Schemes. The Bank manages these funds on a discretionary basis in accordance with the investment parameters set by the Management Committees of the respective Schemes. As at 31 December 2014, the Investor and Depositor Compensation Schemes had deposits of €241,758 (2013: €54,429) and €49,212 (2013: €866,577) respectively, with the Bank.

(i) Statement of the Bank’s investments

The statement of the Bank’s investments is disclosed in accordance with the requirements of article 21 (2) (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.

Statement of the Bank's Investments as at 31 December 2014

	EUR €'000	GBP €'000	USD €'000	Total €'000
Cash and balances with banks				**38,849**
Gold balances				**4,547**
Placements with banks by exposure country:				
France	-	12,839	-	**12,839**
Securities by issuer category:				
Government	1,310,423	-	17,665	**1,328,088**
Insurance	14,266	-	-	**14,266**
Monetary financial institutions	1,230,689	-	333,108	**1,563,797**
Other financial institutions	234,112	-	54,580	**288,692**
Non-financial institutions	21,287	-	897	**22,184**
Supranational	9,595	-	13,963	**23,558**
	2,820,372	**-**	**420,213**	**3,240,585**
Claims on the International Monetary Fund				**154,542**
Participating interest in the European Central Bank				**15,859**
Transfer of foreign reserves to the European Central Bank				**37,552**
Fixed income investment funds				**306,227**
Other foreign currency assets				**21,068**
Total investments				**3,832,068**