Central Bank of Malta

THIRTY-EIGHTH ANNUAL REPORT

AND

STATEMENT OF ACCOUNTS

2005

Address
Pjazza Kastilja
Valletta CMR 01
Malta

Telephone
(+356) 2550 0000

Fax
(+356) 2550 2500

Website
http://www.centralbankmalta.com

E-mail
info@centralbankmalta.com

Printed by
Print It Printing Services
Corradino, Malta

The cut-off date for information published in this Report is 28 February 2006, except where otherwise indicated. The source for data in Tables and Charts is the Central Bank of Malta, unless otherwise indicated.

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

Our Mission

To maintain price stability and to ensure a sound financial system, thereby contributing to sustainable economic development.

We seek to achieve this mission by:

- Pursuing appropriate interest and exchange rate policies
- Maintaining the value of the external reserves
- Safeguarding the integrity of the financial sector
- Promoting and supporting the development of financial markets and efficient payment and settlement systems
- Issuing notes and coins to meet the demands of the public
- Conducting economic analyses and publishing economic and financial statistics
- Advising the Government on economic and financial matters

To achieve the above objectives, the Bank is committed to providing effective support functions through a sound financial control system and appropriate information systems, and through the development of competent and qualified staff.

BOARD OF DIRECTORS*

Michael C. Bonello
Governor

David A. Pullicino
Deputy Governor

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

Executive Management Committee*

Michael C. Bonello
Governor & Chairman

David A. Pullicino
Deputy Governor

Alfred Demarco
Director
Economics and External Relations Division

Godfrey Huber
Director
Finance and Banking Division

René G. Saliba
Director
Financial Markets Division

Herbert Zammit LaFerla
Director
Financial Stability Division

John Agius
Director
Resource Management Division

Audit Committee*

Joseph V. Gatt
Chairman

David A. Pullicino
Member

Charles J. Falzon
Member

Monetary Policy Advisory Council*

Michael C. Bonello
Governor & Chairman

David A. Pullicino
Deputy Governor

Joseph V. Gatt
Director

Philomena Meli
Director

Charles J. Falzon
Director

Alfred Demarco
Director
Economics and External Relations Division

René G. Saliba
Director
Financial Markets Division

Herbert Zammit LaFerla
Director
Financial Stability Division

Investments Policy Committee*

Michael C. Bonello
Governor & Chairman

David A. Pullicino
Deputy Governor

Godfrey Huber
Director
Finance and Banking Division

René G. Saliba
Director
Financial Markets Division

Raymond Filletti
Senior Manager
Financial Control Department

Saviour Briffa
Senior Manager
Reserve Management Department

Stephen Attard
Manager
Middle Office

Mario Bugeja
Manager
Investments and Reserves Office

*As at 30 March 2006

THE BOARD OF DIRECTORS

(Left to right)
Standing: Philomena Meli (Director), Joseph V. Gatt (Director), Charles J. Falzon (Director),
Seated: David A. Pullicino (Deputy Governor), Michael C. Bonello (Governor & Chairman), Bernadette Muscat (Secretary)

Philomena Meli was appointed as Director of the Central Bank of Malta for a period of five years with effect from 21 January 2003. She is an economist and is presently an adviser on trade policy matters in the Economic Policy Division at the Ministry of Finance.

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

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

Organisation Chart*

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

*As at 30 March 2006

LETTER OF TRANSMITTAL

CENTRAL BANK OF MALTA
VALLETTA

30th March 2006

Dear Prime Minister,

In accordance with Article 23(1) of the Central Bank of Malta Act (Cap. 204), I have the honour to transmit a copy of the annual accounts of the Bank, certified by the auditors, for the financial year ended 31st December 2005, a statement of the Bank's investments and a report on the Bank's operations during that year.

Yours sincerely,

Michael C. Bonello
Governor

Contents

ABBREVIATIONS

BIS	Bank for International Settlements
COICOP	Classification of Individual Consumption by Purpose
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ecu	european currency unit
EMU	Economic and Monetary Union
ERM II	exchange rate mechanism II
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
ETC	Employment and Training Corporation
EU	European Union
FI	fungibility issue
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
MIGA	Multilateral Investment Guarantee Agency
MFI	Monetary Financial Institution
MFSA	Malta Financial Services Authority
MSE	Malta Stock Exchange
NACE Rev. 1	Statistical classification of economic activities in the European Community
NECC	National Euro Changeover Committee
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
OECD	Organisation for Economic Co-Operation and Development
OMFI	Other Monetary Financial Institution
OPEC	Organisation of Petroleum Exporting Countries
RPI	Retail Prices Index
UNDP	United Nations Development Programme
WTO	World Trade Organisation

Governor's Statement

The past year witnessed an important milestone in Malta's monetary history with the entry of the Maltese lira into the EU's Exchange Rate Mechanism (ERM II) on 2 May. Preceded by measures to liberalize the economy and to harmonise financial standards and practices with those of the Union, ERM II membership constitutes a further step in a sequence that will culminate in the adoption of the single currency. The latter, in turn, is a central component of a strategy designed to place the economy in a position to exploit more effectively the opportunities of the European single market.

This is, therefore, an opportune moment to take stock of where the economy stands in the evolving process that will eventually lead to full participation in Economic and Monetary Union (EMU). In particular, this is a time to focus on some of the challenges inherent in the achievement of the convergence criteria.

ERM II participation

In anticipation of ERM II membership, three separate though related decisions were taken by the Monetary Authorities. The first concerned the timing of entry into ERM II; the second was the setting of the central parity rate for the Maltese lira within the Mechanism; while the third concerned the choice of an exchange rate strategy.

Underpinning these decisions was the firm conviction that an early adoption of the euro is in Malta's best interest. The economy would benefit from the resulting elimination of exchange rate risk and uncertainty, reduced transaction costs and lower interest rates. As has already been amply documented in the strategy document issued in April 2005, Malta's candidacy for euro area membership is supported by a number of factors, most notably the already close integration with the EU economy, the similarity between the structure of the Maltese economy and that of the euro area and the relatively high degree of synchronicity in the respective business cycles.

The importance of being able to benefit from the greater security afforded by participation in a monetary union with a major international currency was underlined by the continuing unfavourable external environment, exemplified in 2005 by the sharp rise in fuel and commodity prices and the intensification of competition from the emerging economies.

With regard to the first decision, it had been recognised from the outset that the timetable for ERM II membership and eventual adoption of the euro would be determined by the rate of progress in implementing fiscal and structural reforms. The results achieved in both these areas made it feasible for the Maltese lira to enter ERM II just a year after EU membership. This was particularly the case with fiscal consolidation, as the deficit/GDP ratio was halved in 2004 to 5.1%, and was well on track to reach the 3.9% target in 2005. Consequently, the timing of ERM II membership did not imply a hastening of the timetable that was originally drawn up. The decision was taken in conjunction with the European Commission and the European Central Bank (ECB).

At the same time, however, the Bank's support for the Government's decision on ERM II was contingent upon the fiscal targets set out in the Convergence Programme being assiduously pursued and a steady pace of structural reform maintained. In reaffirming its position in this regard, the Bank implicitly rejected the view that adherence to the terms of the nominal convergence criteria within the stated timeframes had ruled out the possibility of a more accommodative fiscal stance aimed at accelerating the pace of economic activity. This for several reasons. In the first place, the expansionary impact of a larger fiscal deficit on Malta's open economy is diluted by a substantial leakage into imports. Moreover, although public spending may provide a short-term boost to the economy, the consequent increase in the public debt would magnify the correction that would be required to address the serious structural imbalances that in part have been responsible for the slow rate of growth in recent years. Finally, failure to honour commitments related to the Stability and Growth Pact would also have unwelcome consequences, including for investor confidence.

The deliberations that preceded the decision on the level at which the Maltese lira would enter ERM II were given a broader focus in the light of an extensive investigation conducted by the Bank of the equilibrium value of the real exchange rate. This study concluded that the Maltese lira was not significantly misaligned from its estimated equilibrium level. As a result, the decision was taken by the Maltese Authorities, and accepted by the relevant EU institutions, for the Maltese lira to enter ERM II at the prevailing exchange rate. The support provided by the study was reinforced by the conviction that nominal exchange rate adjustments are constrained in their ability to provide a lasting solution to structural problems and loss of international competitiveness.

The exchange rate peg of the Maltese lira is a time-tested mechanism that has provided a stable environment for trading and investment decisions and it has also offered a credible anchor for monetary policy. Against the background of three decades of exchange rate and price stability, the Authorities opted for continuity and committed themselves to maintain the Maltese lira at the established central parity rate against the euro for the duration of the ERM II period. While this commitment is underpinned by the Government's ongoing efforts to achieve the objectives of the Convergence Programme, the Central Bank of Malta stands ready to use the monetary policy instruments at its disposal to maintain exchange rate stability.

The decision to keep the lira at the central parity rate and the supportive macroeconomic policy framework evoked a positive response from the financial markets. The downward trend observed in the Bank's net foreign assets in the early part of 2005, which was partly prompted by uncertainty about the exchange rate, was first interrupted and then reversed.

Nominal convergence

Smooth participation in ERM II needs to be accompanied by similar progress in satisfying the other conditions for adopting the euro. In this regard, the past year witnessed a further improvement in the fiscal position and it now appears that the target deficit ratio of 3.9% of GDP is likely to have been bettered. Looking ahead, the Budget for 2006 charts a course which envisages a continuation of this trend, leading to a further reduction to 2.7%, thereby satisfying the relevant Maastricht criterion. The attainment of this target will depend crucially on a rigorous implementation of all the planned measures. Its achievement should also impact positively on the public debt/GDP ratio, which is still above the benchmark limit. After remaining unchanged in 2005 at 76.7%, the ratio is projected by the Government to decline to 70.8% this year, largely as a result of the expected receipt of privatisation proceeds.

Meeting the inflation criterion for adopting the euro constitutes an equally important policy challenge, particularly in the light of the sharp rise in oil prices during 2005. This factor inevitably led to markedly higher domestic energy and fuel costs, and these were duly reflected in consumer price indices. Price levels also appear not to have benefited sufficiently from the liberalized trading environment following EU membership, particularly in the case of some essential commodities. As a result, the HICP index tended to exceed the Maastricht reference value during the year. In these circumstances, containing local costs should be a priority policy objective. A more proactive stance is also called for on the part of the agencies whose responsibility it is to ensure that competition and price transparency prevail.

Real convergence

If the opportunities offered by membership of EMU are to be fully exploited, the ongoing efforts to achieve nominal convergence need to be complemented with supply side reforms that will enable the economy to narrow the existing output gap and to achieve, and sustain, higher rates of growth. While initial estimates suggest that a 2.5% real GDP growth rate was recorded last year, this positive outcome was nevertheless preceded by two consecutive years of contraction. The latter partly reflected the short-term costs of fiscal consolidation. With the effect of this factor expected to ease progressively, and if the incipient recovery in exports observed towards the end of 2005 persists, the economy should continue to register positive growth rates.

A remaining source of uncertainty in this regard is the price of imported oil and its effect on production costs and consumer prices. This factor had a marked impact on GDP growth and on the balance of payments in 2005, contributing to a three-and-a-half percentage-point deterioration in the current account deficit to GDP ratio. In addition, the demand for exports remains sensitive not only to the pressures of international competition, but also to non-economic factors such as international political crises and the possible outbreak of a flu pandemic.

While the forecast recovery over the next few years is welcome, the expected average growth rate – around 2 per cent – is not sufficient to enable the economy to meet simultaneously the challenges of demographic change and faster convergence to EU average income levels. It is estimated that one percentage point of the annual GDP growth rate over the next twenty years will be absorbed by the increase in the dependency ratio associated with population ageing. Consequently, the economy must expand at a faster rate for per capita income to rise.

Looking ahead, since the sizeable output gap is clearly not entirely a cyclical phenomenon, attention must be focused on the structural constraints that are reducing the efficiency of resource deployment in the economy. This, in turn, is impeding private operators from taking advantage of the additional resource capacity that is becoming available as a result of the contraction of the public sector. These constraints are also curtailing the economy's ability to exploit the opportunities of EU membership and to build up the necessary resilience to external shocks.

The constraints on growth that the economy faces are well known. While useful measures were announced in the Budget for 2006 designed to improve resource management and efficiency in the public service, for example, considerations of accountability and sustainability in the management of public resources are still not developed enough. This applies in particular to the areas of social welfare, health and unemployment benefits. There is also a need to further streamline bureaucratic procedures and to reduce government-induced costs for economic operators.

In the wider economy, more remains to be done to render product and labour markets more price-sensitive and flexible. In particular, priority should be given to productivity-enhancing measures. Enchanced efforts must also be made to strengthen the country's scientific and technological base and to further develop and diversify the skills of the labour force.

Success in overcoming the challenges identified above will require a concerted effort to identify concrete solutions that are economically sustainable and socially equitable.

Bank operations

The past year was again one characterised by rapid change as the Bank continued to integrate itself with the European System of Central Banks (ESCB) and developed a closer relationship with the ECB. Prior to ERM II entry the Bank modified its monetary policy stance, raising the central intervention rate by 25 basis points to 3.25% in April. This decision followed a period in which the Bank's net foreign assets declined. In the event, entry into ERM II had a positive influence on financial market sentiment and the Bank's net foreign assets recovered. In consequence, the monetary policy stance was left unchanged during the rest of the year.

In support of its monetary policy, the Bank continued to use open market operations to absorb excess liquidity from the banking system. In mid-September, it cut the term to maturity of its weekly open market operations from fourteen days to seven to improve the management of liquidity in the banking system and to align its operating framework more closely to that of the ECB. At the same time, the margins between the Bank's overnight lending and deposit rates and the central intervention rate were both narrowed to ±100 basis points from ±150 basis points.

In exercising its statutory responsibility to ensure the stability of the financial system, the Bank continued to monitor developments to identify any structural weaknesses, maintaining close contact with the regulator, the Malta Financial Services Authority. In this context, the Maltese authorities, together with their counterparts in the EU, signed a Memorandum of Understanding in May 2005 on co-operation in the management of financial crisis situations between central banks, banking supervisors and ministries of finance.

The Bank also continued to provide a range of banking services to the public sector and to credit and financial institutions in Malta. As the sole issuer of currency, it ensured that the supply of notes and coins was sufficient to meet demand, that currency in circulation was fit for use and that any counterfeits were quickly detected. In matters related to counterfeit euro notes, the Bank worked closely with the ECB.

Following entry into ERM II, preparations for the adoption of the euro were intensified. In June the Steering Committee for the Euro Adoption, on which the Bank is represented by the Governor, was set up to direct the euro changeover process and monitor progress of the necessary preparations at the national level. At the same time, the Government also established the National Euro Changeover Committee (NECC) to formulate and implement a strategic plan for the adoption of the euro and to co-ordinate the changeover process. The Bank is an active participant in the NECC, where it is represented by the Deputy Governor, and has in particular contributed to the preparation of standards and guidelines related to the changeover.

During the year, the Bank continued to deepen its relations with the ECB and the other national central banks which, collectively, make up the ESCB. I attended the quarterly meetings of the General Council of the ECB, while Bank officials participated in the work of the ESCB committees and working groups.

Preparations for Malta's future participation in the euro area also entailed increasing the range of statistical data compiled and transmitted to the ECB. Following the entry of the Maltese lira into ERM II, the Bank also began to report regularly to the ECB on related developments, in particular its foreign exchange operations.

In accordance with Article 105(4) of the Treaty and Article 4 of the Statute of the ESCB, the Bank consulted the ECB on legislative measures within its remit and on measures implementing EU law. In this context, amendments to the Central Bank of Malta Act to transpose and implement EU legislation about specifications of medals and tokens similar to euro coins came into force during 2005.

As the euro changeover will also give rise to added demands on its human resources, the Bank continued to provide extensive training to its staff both in Malta and abroad. This included several short-term secondments with the ECB itself, which also enabled the Bank to obtain a better understanding of the ECB and its workings.

The Bank's internal governance framework was further strengthened during 2005 with the Audit Committee being formally recognised in the Central Bank of Malta Act. The Committee's Charter, meanwhile, was upgraded to adopt recognised international standards and to take into account ESCB policies in this area.

The Bank's profit for the year amounted to Lm10.8 million as against Lm14.9 million in 2004. A detailed explanation of the factors which determined the year's profit outcome may be found in the *Notes to the financial statements*.

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

Michael C. Bonello

Part I

FINANCIAL AND ECONOMIC DEVELOPMENTS

1. The International Environment

The world economy

In 2005 the world economy displayed continued resilience, although in the context of higher energy prices and rising interest rates the global growth rate of 3.3% represented a decline from the historically high rate of 3.8% reached in 2004 (see Table1.1). Moreover, the problem of global imbalances persisted, with the current account deficit of the United States widening further, while Europe, Asia and the oil-exporting countries reported surpluses. The US was again the main driver of world growth, with China emerging as an important contributor. The euro area economy continued to grow at a slow pace, although data for the second half of the year indicate an improvement. Meanwhile, Japan showed increasing signs of economic recovery.

Driven by robust productivity growth and fiscal stimulus, US output grew by 3.5% in 2005, despite disruptions brought about by adverse weather conditions and higher oil prices. However, the US trade deficit reached a record level of over USD800 billion. In the first three quarters of the year, household consumption continued to grow as employment conditions improved. Conversely, in the last quarter, economic expansion slowed down, as consumer spending moderated. The average rate of inflation accelerated to 3.4%, from 2.7% in 2004, as a result of higher energy costs. Meanwhile, unemployment fell to 5.1% in 2005 from 5.5% in the previous year.

The euro area continued to be characterised by relatively slow economic expansion and high unemployment. Higher oil prices exerted a negative impact on demand and consumer confidence and dampened growth in the first half of the year. In the third quarter, economic activity improved as consumption and investment expenditure increased, while net exports grew steadily. In the December quarter, however, economic expansion decelerated, reflecting a weak performance in Germany and France. Consequently, the growth rate declined from 1.8% in 2004 to 1.4%. Consumer price inflation averaged 2.2% over the year, an increase of 0.1 percentage points over 2004, while unemployment fell to 8.6% in 2005 from 8.9% in 2004.

Growth in the United Kingdom slowed sharply, largely because of weaker private consumption, which was reflected in a moderation of house prices. However the decline in the growth rate to 1.8% in 2005, from 3.2% a year earlier, was mainly attributed to a decline in industrial production. Moreover, the current account of the balance of payments remained in substantial deficit. During the second half of the year, annual consumer price inflation rose above the

Table 1.1
INTERNATIONAL ECONOMIC INDICATORS
% change from previous year

	Real GDP			Consumer prices		
	2004	2005	2006[1]	2004	2005	2006[1]
United States	4.2	3.5	3.4	2.7	3.4	2.8
Euro area	1.8	1.4	1.9	2.1	2.2	2.0
United Kingdom	3.2	1.8	2.1	1.3	2.1	2.0
Japan	2.3	2.5	2.2	0.0	-0.2	0.2
World total	3.8	3.3	3.3	2.6	2.7	2.6

[1] Forecasts

Sources: Consensus Forecasts; ESRI, Japan.

government's 2% target, before falling back below the target level to 1.9% in December. Meanwhile, the unemployment rate remained relatively low, although it increased marginally in the latter part of the year to reach 5.1% in the three months to December.

The Japanese economy continued on the path of gradual recovery with output expanding by an estimated 2.5%, led by private domestic demand. Deflation persisted, however, with the consumer price index continuing to fall throughout 2005 to end the year at 0.1%. Reflecting the more buoyant economic conditions the unemployment rate fell to 4.4% from 4.7% in the preceding year.

Interest rates

During 2005, the Federal Reserve continued to tighten its monetary policy stance, raising its target for the federal funds rate by 25 basis points at each of its eight meetings. At the end of the year, the rate stood at 4.25% (see Chart 1.1). The Federal Open Market Committee was expected to maintain its policy firming into the new year to ensure the attainment of both sustainable economic growth and price stability.

In the euro area, the European Central Bank maintained an accommodative policy stance in order to support economic activity. The ECB kept the minimum bid rate on its main refinancing operations unchanged at 2% through most of the year, before raising it by a quarter of a percentage point in December against a backdrop of emerging inflationary pressures.

In the UK, the repo rate remained unchanged at 4.75% in the first seven months of the year. Then in August the Bank of England cut the rate by 25 basis points to 4.5% in response to further evidence of subdued economic growth. During the remainder of the year, the Bank left its monetary policy stance unchanged despite an expected reduction in the rate of inflation.

The Bank of Japan maintained its policy of quantitative monetary easing throughout 2005, injecting excess funds into the banking system in an effort to stabilise the core CPI at above zero per cent. As a result, the Bank of Japan's discount rate remained constant at 0.1%.

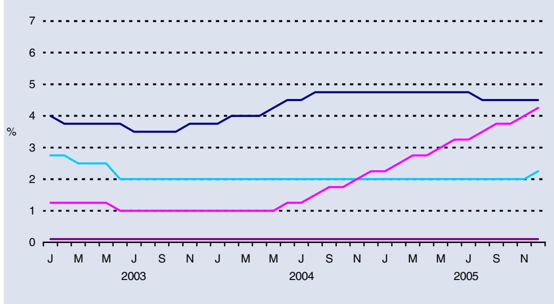
Long-term interest rates in the US declined until June, as prospects of reduced long-term inflation expectations became more firmly anchored (see Chart 1.2). In the second half of the year, ten-year bond yields in the US generally rose before declining again slightly in December. Long-term rates in the euro area and the UK followed a roughly similar pattern, while in Japan they remained low and were relatively stable.

Exchange rates

In 2005, foreign exchange markets were characterised by the strengthening of the US dollar vis-à-vis other major currencies (see Chart 1.3). Over the year, the dollar appreciated by 12.9%, 10.4% and 14.5% against the euro, the pound sterling and the Japanese yen respectively (see Table 1.2). The strong performance of the US economy, together with interest rate differentials, favoured the dollar, despite the continued high level of the US trade deficit.

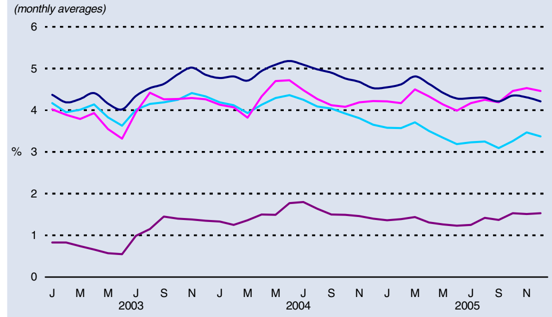
In the early months of the year, the US dollar moved on an upward trend as markets focused on growth

Chart 1.1
OFFICIAL INTEREST RATES
(end of period)



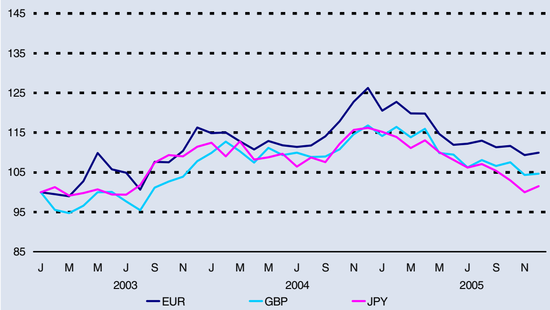
Sources: ECB; Federal Reserve; Bank of England; Bank of Japan.

Chart 1.2
LONG-TERM INTEREST RATES*
(monthly averages)



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

Chart 1.3
EXCHANGE RATE MOVEMENTS OF SELECTED MAJOR CURRENCIES AGAINST THE US DOLLAR
(index of end-of-month rates, Jan. 2003=100)



Source: Reuters.

and interest rate prospects rather than on the widening current account deficit. In the second quarter, continued economic strength in the US relative to Europe and Japan, coupled with political uncertainty in the EU as France and the Netherlands rejected the proposed European Constitution, gave further impetus to the US currency.

In August the dollar weakened slightly amid signs of an improvement in the European and Japanese economies. Moreover, the devastating effects of the hurricane season in the southern part of the US put further downward pressure on the currency. In September, however, it stabilised against the other major currencies, largely due to the solid performance of the economy together with expectations of further interest rate increases in the US.

Throughout October and November the dollar regained ground, supported by widening interest rate differentials. In December, however, it retreated moderately on account of positive news concerning the euro area economy.

Reflecting the dollar's strength over the year, the euro depreciated continually against the US currency. It also weakened against the pound sterling but appreciated marginally versus the Japanese yen. The euro's decline against sterling was particularly pronounced in the second half of 2005, as market analysts reassessed their expectations regarding the direction of short-term interest rates.

On 21 July, the Chinese yuan was revalued upward by 2% against the US currency, and its peg against the US dollar was replaced by a managed float against a basket of currencies. These changes contributed to the temporary appreciation of the euro against the Japanese yen. Furthermore, the relatively high oil dependency of the Japanese economy exerted further downward pressure on the yen.

Commodities

Oil

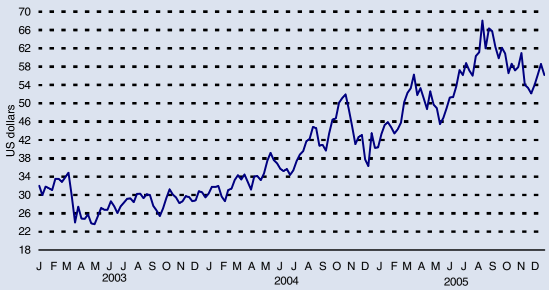
During 2005, oil prices increased sharply, particularly from mid-May to around mid-August (see Chart 1.4).

Table 1.2
EXCHANGE RATES OF SELECTED MAJOR CURRENCIES AGAINST THE US DOLLAR - 2005

	USD/EUR	USD/GBP	JPY/USD
Closing rate on 31.12.04	1.3645	1.9295	102.53
Closing rate on 30.12.05	1.1883	1.7288	117.35
Lowest exchange rate vs the US dollar during the year	1.1674 (17 Nov.)	1.7113 (28 Nov.)	121.31 (05 Dec.)
Highest exchange rate vs the US dollar during the year	1.3475 (03 Jan.)	1.9290 (09 Mar.)	102.15 (17 Jan.)
% appreciation (+)/depreciation (-) of the currency vs the US dollar from closing rate on 31.12.04 to closing rate on 30.12.05	-12.9	-10.4	-14.5

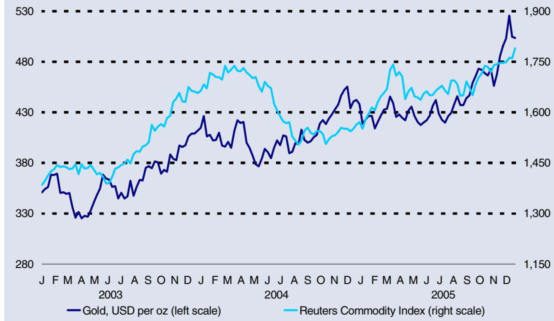
Source: Reuters.

Chart 1.4
OIL (USD/BARREL)*
(end of week)



* Brent Blend.
Source: Reuters.

Chart 1.5
COMMODITY PRICES
(end of week)



Source: Reuters.

On average, the price of oil as measured by Brent crude was 41.3% above the previous year's level, reaching a peak of USD68.06 per barrel on 12 August. Limited spare capacity together with buoyant demand and security concerns were the major factors behind the rise. Moreover, hurricanes in the US during the summer affected the country's oil production and refining capacity and worsened supply conditions. As global oil supply improved in the light of increased oil production, prices receded in the autumn so that by the end of December the price of oil stood at USD56.20 per barrel.

Gold

Gold prices were weak in the early part of the year as a result of reduced political tensions in the Middle East (see Chart 1.5). However, between mid-February and March the price was boosted by indications that the central banks of a number of developing countries were considering a diversification of their foreign currency reserves into other assets, including gold. Between April and July the price of the metal fluctuated, as expectations of a revaluation of the Chinese yuan boosted the demand for gold, whilst the dollar's appreciation pushed the price of the metal to lower levels. Later in the year, higher oil prices and concerns over inflation led to an increase in the price of gold. This upward trend persisted till the end of the year, when the price reached a high of USD527.90 per ounce in mid-December. Over 2005, the price of gold rose by 8.6%, standing at USD503.50 per ounce at the end of December.

Other commodities

During the year, the Reuters Commodity Index[1] followed an upward trend as the prices of both food and industrial raw materials increased (see Chart 1.5). As a result, the index rose by 3.7% over the year.

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

2. Monetary and Financial Developments

The Central Bank of Malta tightened its monetary policy stance during 2005, raising the central intervention rate by 25 basis points to 3.25% in April. Money market interest rates rose in line with official rates. At the longer end, 5- and 10-year government bond yields declined during the year, while yields on 15-year government securities remained unchanged. Corporate bond yields generally moved slightly higher over the year, while the upward trend in equity prices, which began in 2003, gathered pace.

Monetary growth accelerated in 2005 following moderate expansion during the previous two years. This was attributable to a significant rise in the net foreign assets of the banking system and, to a lesser extent, to an increase in domestic credit, primarily in the form of loans to the non-bank private sector.

The monetary base[1]

In 2005 the monetary base (M0) expanded by Lm3.8 million, or 0.6%, compared with 4.6% in the previous year (see Table 2.1).[2] Currency in issue rose by Lm13.6 million, or 2.7%, extending the upward trend observed in recent years. In contrast, bank deposits with the Central Bank of Malta contracted by Lm9.8 million, or 6.7%, mainly because one bank was exempted from holding reserve deposits during the year.

The increase in the monetary base mainly reflected a sizeable expansion in the Bank's foreign assets, which rose by Lm62.4 million. However, growth in M0 was dampened by a reduction in the Bank's net claims on government and by an increase in its other liabilities, as the Bank absorbed more liquidity from the banking system through term deposits.

Table 2.1
THE MONETARY BASE AND ITS SOURCES

Lm millions

			Change	
	2004	2005	Amount	%
Currency in issue	506.4	520.0	13.6	2.7
Bank deposits with the Central Bank of Malta[1]	145.3	135.5	-9.8	-6.7
Monetary base (M0)	**651.7**	**655.5**	**3.8**	**0.6**
Central Bank of Malta assets				
Foreign assets	860.6	923.0	62.4	7.3
Claims on Government	21.3	9.1	-12.2	-57.3
Fixed and other assets	54.3	58.6	4.3	7.9
less:				
Remaining liabilities				
Private sector deposits	5.6	3.7	-1.9	-33.9
Government deposits	115.7	147.4	31.7	27.4
SDR allocations	5.6	5.9	0.3	5.4
Foreign liabilities	0.6	0.0	-0.6	+
Other liabilities	71.6	94.7	23.1	32.3
Capital and reserves	86.0	83.5	-2.5	-2.9

+ indicates a value exceeding +/- 100%

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

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

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

Table 2.2
MONETARY AGGREGATES

Lm millions

	Annual growth rates (%)			Amount outstanding	Change
	2003	2004	2005	2005	2005
NARROW MONEY (M1)	**9.0**	**6.0**	**5.6**	**1,670.1**	**89.1**
Currency in circulation	5.4	5.6	2.7	498.9	12.9
Deposits withdrawable on demand	10.7	6.3	7.0	1,171.2	76.2
INTERMEDIATE MONEY (M2)	**2.4**	**2.4**	**4.2**	**3,041.6**	**123.3**
Narrow money (M1)	9.0	6.0	5.6	1,670.1	89.1
Deposits redeemable at notice up to 3 months	3.0	4.4	4.7	31.4	1.4
Deposits with agreed maturity up to 2 years	-4.1	-1.7	2.5	1,340.1	32.7
BROAD MONEY (M3)[1]	**2.4**	**2.4**	**4.2**	**3,041.6**	**123.3**
of which FCDs	4.0	4.4	13.7	382.0	45.9

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

Monetary aggregates[3]

After having remained stable during 2003 and 2004, monetary growth picked up in 2005, with broad money (M3) expanding by Lm123.3 million, or 4.2% (see Table 2.2). The acceleration took place in the second half of the year when the downward trend in broad money growth that began in 2004 was reversed.

Narrow money (M1), which accounts for just over half of M3, rose by Lm89.1 million in 2005 reflecting mainly an increase in deposits withdrawable on demand, although currency in circulation also contributed. The rise in deposits was mainly driven by households and private non-financial companies, which increased their outstanding Maltese lira balances. Nonetheless, the annual increase in M1 slowed down, falling to 5.6% from 6% in 2004, as currency in circulation expanded less rapidly, possibly because higher deposit rates raised the opportunity cost of holding cash (see Chart 2.1).

The increase in M1 was the main factor driving the growth in intermediate money (M2), which expanded by Lm123.3 million in 2005. The rise in the latter also reflected an increase in deposits with an agreed maturity of up to two years, which picked up after having contracted during the previous two years. These deposits added Lm32.7 million, or 2.5%, primarily due to growth in household deposits denominated in foreign currency.

Chart 2.1
MONETARY AGGREGATES
(% change on previous year)

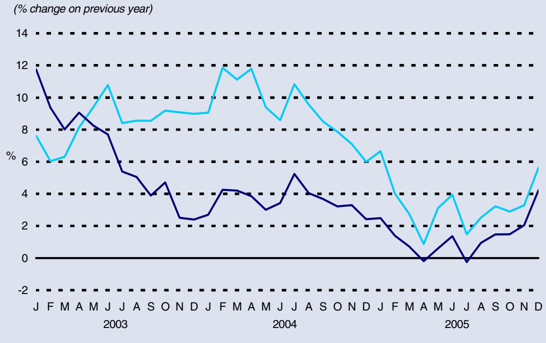
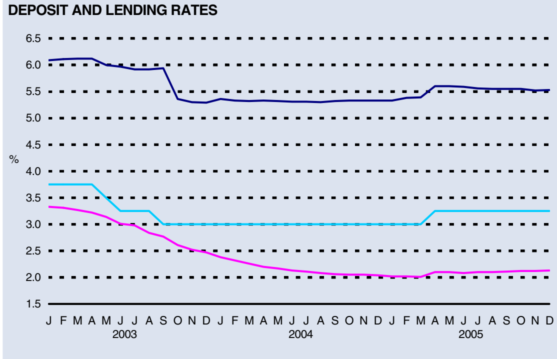


Chart 2.2
DEPOSIT AND LENDING RATES



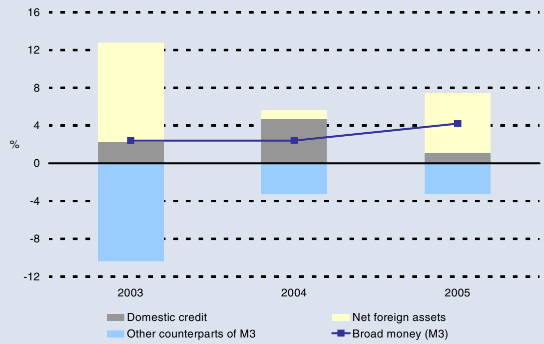
[3] In October 2003 the Central Bank of Malta revised its definitions of the main monetary aggregates and their counterparts to bring them in line with the standards laid down in ECB Regulation 2001/13. Data shown in this chapter for the period before October 2003 are estimates based on these standards. For further information see "Changes in the Compilation of Money and Banking Statistics in Malta", *Central Bank of Malta Quarterly Review* 36:4 (2003), pp. 53-60.

In 2005 banks increased their deposit rates, following the 25 basis point rise in the central intervention rate. Thus, the weighted average interest rate on Maltese lira deposits rose from 2.04% at the end of 2004 to 2.13% (see Chart 2.2). The average deposit rate moved up by nine basis points in April. Whereas average interest rates on savings deposits added almost a quarter of a percentage point over the year as a whole, time deposit rates increased by just 10 basis points and rates on current accounts were practically unchanged. The relatively slow response of deposit rates to the change in the central intervention rate could reflect lags in the adjustment of time deposit rates and excess liquidity in the banking system. At the same time, the weighted average interest rate on bank loans went up by 20 basis points to 5.53%.

Counterparts of monetary growth[4]

The pick-up in monetary growth during 2005 was mainly attributable to more rapid expansion in the net foreign assets of the banking system, which had increased only moderately during the preceding year (see Chart 2.3). Apart from a recovery in the Central Bank of Malta's net holdings, the rise in the latter was boosted by an increase in the share capital of two foreign-owned banks that began operations during the year, which also led to a sizeable increase in the other counterparts of M3. To a lesser extent, monetary growth also reflected a rise in domestic credit that was driven entirely by higher lending to the non-bank private sector.

Chart 2.3
CONTRIBUTIONS TO MONETARY GROWTH



Domestic credit expanded by Lm33.6 million, or 1.3%, during 2005, driven entirely by higher claims on other residents (see Table 2.3). However, the annual rate of credit expansion was significantly below the 5.5% growth of the previous year, reflecting a sizeable reduction in net claims on central government (see Chart 2.4).

Table 2.3
BROAD MONEY AND ITS COUNTERPARTS

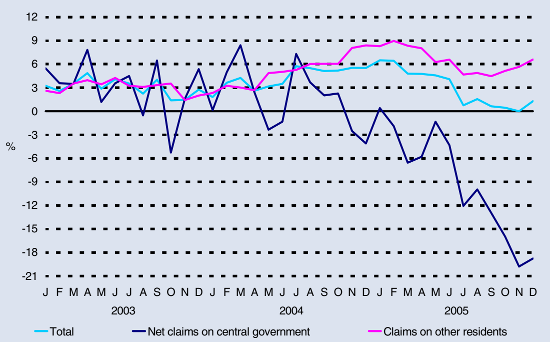
Lm millions

	Annual growth rates (%)			Amount outstanding	Change
	2003	2004	2005	2005	2005
Broad money (M3)	**2.4**	**2.4**	**4.2**	**3,041.6**	**123.3**
Domestic credit	**2.8**	**5.5**	**1.3**	**2,636.7**	**33.6**
Net claims on central Government	5.4	-4.1	-18.8	442.8	-102.4
Claims on other residents	2.0	8.4	6.6	2,194.0	135.9
Net foreign assets	**22.8**	**1.7**	**11.3**	**1,809.7**	**184.0**
Central Bank of Malta	4.3	-5.4	7.2	932.6	62.3
Banks	61.7	11.3	16.1	877.1	121.7
less:					
Other counterparts of M3[1]	**32.0**	**7.7**	**7.2**	**1,404.8**	**94.3**

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

[4] A re-classification exercise on monetary data, going back to October 2003, which resulted in changes in the resident/non-resident status of certain companies, necessitated major revisions to the counterparts of broad money as from that date. This resulted in an increase in the MFIs' net foreign assets and a decrease in domestic credit.

Chart 2.4
DOMESTIC CREDIT
(% change on previous year)



Claims on other residents added Lm135.9 million, or 6.6%, in the year under review. Loans and advances to other residents, which account for more than 95% of such claims, increased by Lm141.3 million, or 7.1%, with demand for bank credit stemming entirely from the private sector (see Table 2.4). On an annual basis, however, growth in claims on other residents, which had picked up in the previous year, slowed down as claims on the non-bank public sector declined.

During 2005, the increase in loans and advances to other residents was mainly driven by lending to households and individuals, mostly for house purchases. In addition, credit to the 'real estate, renting and business activities' sector also increased noticeably, partly driven by loans for real estate development, but also on account of a reclassification from construction. These increases were, however, offset by a drop in loans to the non-bank public sector,

Table 2.4
CLAIMS ON OTHER RESIDENTS[1]

Lm millions

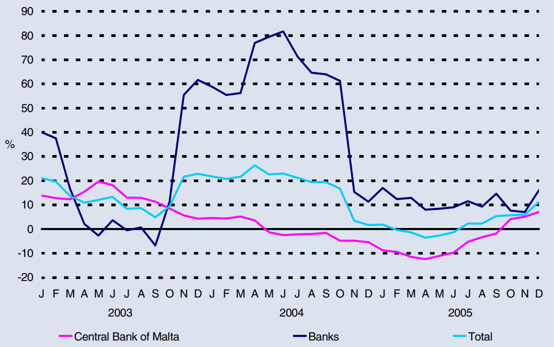
	Annual growth rates (%)			Amount outstanding	Change
	2003	2004	2005	2005	2005
Claims on the non-bank private sector	8.0	7.9	9.0	2,043.7	168.2
of which loans and advances	8.7	7.9	10.0	2,001.6	181.4
Claims on the non-bank public sector	-36.5	14.0	-17.7	149.6	-32.2
of which loans and advances	-39.4	17.4	-25.1	119.2	-40.0
Claims on other general government[2]	-0.6	19.5	-6.1	0.7	0.0
of which loans and advances	-0.6	19.5	-6.1	0.7	0.0
TOTAL CLAIMS	**2.0**	**8.4**	**6.6**	**2,194.0**	**135.9**
of which loans and advances					
Electricity, gas & water supply	N/A	55.9	-35.9	61.1	-34.2
Transport, storage & communication	N/A	-7.3	-1.8	123.2	-2.3
Agriculture & fishing	N/A	7.4	-11.7	8.7	-1.1
Manufacturing	N/A	-6.7	-12.5	106.6	-15.3
Construction	N/A	7.9	-0.7	215.6	-1.4
Hotels & restaurants	N/A	-0.6	-0.8	203.8	-1.7
Wholesale & retail trade; repairs	N/A	0.7	2.2	296.7	6.4
Real estate, renting & business activities	N/A	6.9	52.1	190.7	65.3
Households & individuals	N/A	17.8	16.4	838.9	118.2
Other[3]	N/A	11.8	10.9	76.1	7.5
TOTAL LOANS AND ADVANCES	**2.6**	**8.6**	**7.1**	**2,121.4**	**141.3**

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

[2] In Malta, this refers to the local councils.

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

Chart 2.5
NET FOREIGN ASSETS
(% change on previous year)



which shed Lm40 million, primarily due to the repayment of outstanding balances by a major non-financial corporation that borrowed abroad.

Net claims on central government contracted by Lm102.4 million, or 18.8%, during 2005 on account of an increase in government deposits held with the banking system and a reduction in banks' Treasury bill holdings. The latter reflected changes in the composition of government debt, which shifted away from Treasury bills, largely held by banks, to long-term debt.

The net foreign assets of the banking system rose sharply in 2005, with their annual growth rate rising to 11.3% from 1.7% in the previous year (see Chart 2.5).

The net foreign assets of the Central Bank of Malta rose by Lm62.3 million, or 7.2%, reversing the downward trend observed over the previous year. After declining further during the first four months of 2005, the Bank's holdings stabilised following the entry of the Maltese lira into ERM II in May, which had a positive impact on financial market sentiment, and then followed an upward trend in the second half of 2005. This growth was primarily driven by substantial purchases of foreign currency from the rest of the banking system as well as by an inflow resulting from a foreign currency denominated loan taken by a major non-financial corporation from foreign banks.

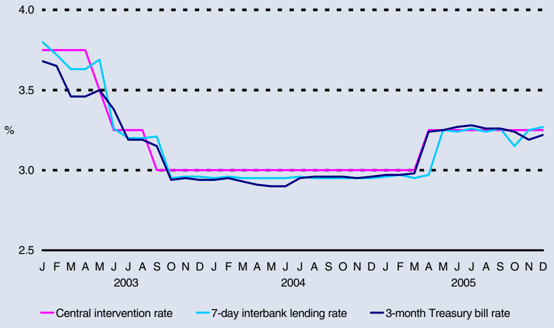
Meanwhile, the net foreign assets of the rest of the banking system grew by Lm121.7 million, or 16.1%, reflecting almost entirely a sizeable increase in the holdings of the international banks. The latter increased by almost Lm120 million, or 55.7%, mostly because the share capital of two new foreign-owned banks was reinvested abroad. In addition, the net foreign assets of the deposit money banks added Lm2.4 million, or 0.5%, during 2005.

The other counterparts of M3 rose by Lm94.3 million, or 7.2%, during the year under review. This mainly reflected the share capital inflow mentioned earlier, which contributed to an expansion of Lm111.9 million in banks' capital and reserves. An increase in deposits excluded from broad money also boosted the banks' non-monetary liabilities, though this factor was offset by the redemption of long-term debt securities that had been issued by one bank.

The money market

Activity in the interbank market continued to expand in 2005, with the value of interbank deals rising from Lm256.3 million in 2004 to Lm368.9 million. The pick-up in activity reflected the asymmetric distribution of liquidity across the banking sector. The maturity structure of interbank loans ranged from one to 131 days, with loans of up to fourteen days being the most popular. Interest rates on one-week and fourteen-day loans increased during 2005, in line with the rise in official interest rates in April, with the former ending the year at 3.27%, 32 basis points above its level at the end of 2004 (see Chart 2.6).[5]

Chart 2.6
MONEY MARKET INTEREST RATES
(end of month)



[5] As no interbank deals in this maturity took place in December 2005, the official fixing rate was used instead.

Table 2.5
ISSUES OF LONG-TERM DEBT SECURITIES[1]

Lm millions

	2003	2004	2005
Government			
Total issues [2]	148.8	144.5	165.0
Redemptions	48.9	44.6	55.0
Net issues	99.9	99.9	110.0
Non-government sector			
Total issues	24.7	10.0	0.0
Redemptions	3.5	0.0	27.3
Net issues	21.2	10.0	-27.3
Total net issues	**121.1**	**109.9**	**82.7**

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

[2] Data exclude stocks that were issued directly to the Foundation for Church Schools. These amounted to Lm66,700 in 2003, Lm1.7 million in 2004 and Lm0.6 million in 2005.

Sources: Central Bank of Malta; The Treasury.

During 2005 the Treasury made less use of short-term debt to finance its operations, issuing Lm462.1 million worth of Treasury bills, compared with Lm608.8 million during the preceding year. Maturing bills, on the other hand, totalled Lm517.2 million during 2005. As a result, the amount of Treasury bills outstanding at the end of the year dropped by Lm55.1 million to Lm190.2 million. Three-month bills accounted for more than half of the total issued, with the rest having maturities ranging between one month and one year. As in previous years, banks participated heavily in Treasury bill auctions, subscribing to over three-fourths of the amount issued, with collective investment schemes and insurance companies taking up most of the remainder. The three-month yield in the primary market moved in tandem with the central intervention rate, rising by 26 basis points to 3.22% at end-December.

Turnover in the secondary market for Treasury bills amounted to Lm144.4 million, up from Lm116.5 million in 2004. Trading involving the Bank rose by Lm61.1 million to Lm115.5 million, and consisted mainly of purchases from collective investment schemes and, to a lesser extent, from insurance companies and credit institutions. The remainder represented trade between the banks and other financial institutions. As in the primary market, secondary market Treasury bill yields rose in line with official interest rates during the year, with the yield on the three-month bill reaching 3.24% by end-December.

The capital market

Net issues of long-term debt securities in the primary market amounted to Lm82.7 million in 2005, somewhat less than in the preceding year when they reached Lm109.9 million. Government issues rose by Lm10.1 million to Lm110 million, as the Government relied more heavily on long-term borrowing to finance the deficit. No securities were issued by the non-government sector (see Table 2.5). On the contrary, the latter redeemed Lm27.3 million worth of bonds during the year, as securities issued by a credit institution matured and others issued by a public non-financial corporation were converted into shares.

The Government resorted to the capital market in March, May and August, issuing six different stocks with a combined value of Lm165 million. Since Lm55 million worth of stocks matured during 2005, net issues of government stocks in the primary market amounted to Lm110 million. Terms to maturity ranged from seven

Table 2.6

SECONDARY MARKET TRADING IN GOVERNMENT STOCKS

Lm millions

	2003	2004	2005
Central Bank of Malta purchases	5.4	13.4	3.9
Central Bank of Malta sales	0.0	7.6	8.8
Other deals[1]	42.9	32.2	53.7
Total	**48.3**	**53.1**	**66.4**

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

Sources: Central Bank of Malta; MSE.

to sixteen years, whereas coupon rates varied from 5% to 5.7%. More than two-thirds of the bonds were sold by auction, with market interest rates determining the price paid by successful bidders. Credit institutions purchased around two-fifths of the total amount issued, while households and collective investment schemes took up most of the remainder.

Turnover in the secondary market for government bonds increased for the third consecutive year, rising from Lm53.1 million in 2004 to Lm66.4 million (see Table 2.6). Transactions involving the Bank accounted for Lm12.7 million of the total value, with purchases and sales amounting to Lm3.9 million and Lm8.8 million, respectively. Participants traded mainly in medium- and long-term securities, with bonds having a term to maturity between five and fifteen years accounting for over half of the total turnover. Yields on 5-year and 10-year government bonds declined by 61 and 31 basis points respectively during the year, reaching 3.65% and 4.39% in December (see Chart 2.7). Meanwhile, the yield on 15-year bonds remained stable in thin trading throughout the year.

Turnover in the secondary market for corporate bonds declined further, falling from Lm8.4 million in 2004 to Lm7.4 million. More than half of this involved just six bonds, or less than a quarter of the market, with the rest being more or less evenly spread among the remaining stocks. Developments in corporate bond yields were mixed, but on average they moved slightly higher over the year.

Turnover in the equity market rose to Lm52 million, from Lm32.2 million in the previous year, with the shares of two major banks accounting for almost two-thirds of total trading. Prices of most shares increased during 2005, leading to a sharp rise in the MSE share index, which climbed by 62.3% to end the year at 4980.7 (see Chart 2.8). Thus, the index extended the recovery which began in 2003, surpassing its previous historical peak by the end of the year.

Chart 2.7
GOVERNMENT BOND YIELDS
(end of month)

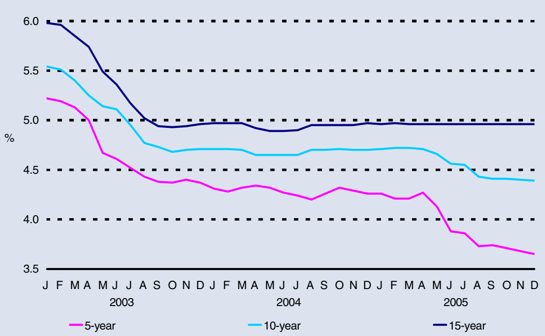


Chart 2.8
MSE SHARE INDEX
(end of month)

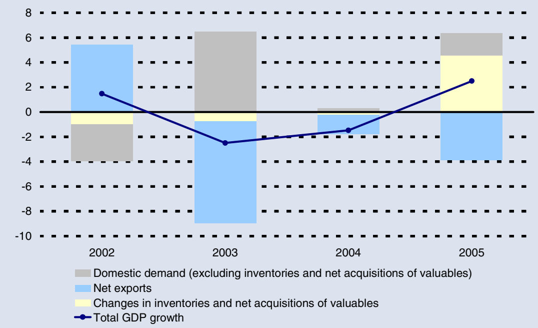
Source: MSE.

3. Output, Prices and Employment[1]

Gross domestic product

Following two years of negative growth, the economy is estimated to have expanded by 2.5% in 2005 (see Table 3.1). Revisions to the method of measuring Financial Intermediation Services Indirectly Measured and a re-allocation of such services to the user sectors mainly contributed to the revisions of the real GDP growth rate to -2.5% for 2003 and -1.5% for 2004. The deterioration in 2003 was attributed to the downturn in external demand while in 2004 it was due to weak growth in domestic demand along with a further decline in net external demand (see Chart 3.1.)

Chart 3.1
CONTRIBUTIONS TO GROWTH
(percentage points)



Source: NSO.

In contrast, the more substantial growth rate in 2005 was underpinned by increased domestic demand in the form of a recovery in private consumption and strong growth in investment. Inventory accumulation, which incorporates the statistical discrepancy, contributed positively to growth for the first time since 2000. On the other hand, the decline in exports of goods and services exacerbated the contractionary effect of the external sector for the third year in a row (see Table 3.2).

Domestic demand

Household private consumption expenditure increased by 1.4% in 2005, following a decline of 1.2% in the previous year. Although the weakness of consumption had continued into the first quarter of 2005, it recovered and strengthened over the remaining three quarters of the year. The higher consumption partly reflected a strong expansion in personal borrowing over the year. In contrast the deceleration in the growth rate of public sector consumption, which has been ongoing since 2002, culminated in a 1.9% reduction in government consumption in 2005, reflecting the process of fiscal consolidation.

Gross fixed capital formation (GFCF) provided a boost to economic activity throughout the year. It expanded at an annual rate of 6.1% after peaking at 12.4% in the second quarter. The increase in GFCF was primarily

Table 3.1
GDP COMPONENT GROWTH RATES

% change

	2002	2003	2004	2005
Household & NPISH final consumption expenditure	-0.3	2.4	-1.2	1.4
Government final consumption expenditure	4.0	3.0	1.8	-1.9
Gross fixed capital formation	-18.7	28.6	3.8	6.1
Exports of goods & services	3.6	-2.1	0.4	-3.9
Imports of goods & services	-2.3	7.0	2.0	0.2
GROSS DOMESTIC PRODUCT	**1.5**	**-2.5**	**-1.5**	**2.5**

Source: NSO.

[1] The cut-off date for information included in this Chapter is 10 March 2006.

Table 3.2
GROSS DOMESTIC PRODUCT

Lm millions

	2001	2002	2003	2004	2005
			(constant 2000 prices)		
Household & NPISH final consumption expenditure	1,115.5	1,112.0	1,139.0	1,125.0	1,140.3
Government final consumption expenditure	328.5	341.6	351.7	358.0	351.4
Gross fixed capital formation	321.3	261.2	335.9	348.6	369.8
Changes in inventories & net acquisitions of valuables	-10.4	-27.5	-40.4	-43.8	32.0
Domestic demand	**1,754.7**	**1,687.2**	**1,786.3**	**1,787.7**	**1,893.4**
Exports of goods & services	1,538.0	1,593.2	1,559.7	1,566.3	1,504.9
Imports of goods & services	1,590.4	1,553.0	1,661.7	1,694.7	1,697.5
Net exports	**-52.4**	**40.2**	**-102.0**	**-128.4**	**-192.6**
GROSS DOMESTIC PRODUCT	**1,702.5**	**1,727.4**	**1,684.3**	**1,659.4**	**1,700.8**
GDP deflator (2000 = 100)	102.1	104.0	108.6	110.3	113.3
			(market prices)		
GROSS DOMESTIC PRODUCT	**1,737.7**	**1,796.8**	**1,829.1**	**1,830.4**	**1,927.1**
Net income received from the rest of the world	11.7	2,558.0	-12.3	-22.9	-54.9
GROSS NATIONAL INCOME	**1,748.8**	**1,799.4**	**1,817.7**	**1,804.2**	**1,869.9**

Source: NSO.

driven by the Government and featured to a large extent the construction of roads partly financed by funds from the EU and the Italian government. Private corporate sector investment in machinery and personal investment related to housing also contributed to the overall increase in the GFCF.

External demand

Almost half of the negative contribution of net external demand occurred in the first three months of 2005. Over the next three quarters of the year, the real (as well as the nominal) external imbalance narrowed considerably.

Table 3.3
NET VALUE ADDED

Lm millions

	2004	2005	Growth rate (%)
TOTAL ECONOMY	**1,291.0**	**1,371.7**	**6.2**
Agriculture	32.2	32.5	1.1
Fishing	3.0	2.6	-14.6
Mining	5.1	5.6	9.9
Manufacturing	222.1	222.6	0.2
Electricity	-2.2	-1.8	-19.6
Constuction	71.2	72.8	2.3
Wholesale & retail trade	178.8	188.6	5.5
Hotels & restaurants	85.4	85.3	-0.1
Transport, storage & communication	109.7	136.0	23.9
Financial intermediation	48.5	65.8	35.6
Real estate, renting & business activities	169.4	179.6	6.0
Public administration	106.1	105.6	-0.4
Education	100.3	102.7	2.4
Health & social work	81.7	83.4	2.0
Other services	79.6	90.3	13.5

Source: NSO.

Adjusted for price changes, exports of goods and services declined by 3.9% in 2005. As the fall in exports in nominal terms was a more modest 1.5%, the sharper decline in real terms was mainly due to a sharp rise in the export deflator, which registered an average increase of 2.5% over the year.

Real import volumes, on the other hand, were essentially unchanged, increasing by only 0.2%, even if in nominal terms import values were up by 3.2%, partly as a result of the surge in the cost of imported oil supplies.

Though the rise in export prices marked the first such annual increase since 2002, the slightly larger increase in import prices contributed to a further marginal erosion in the terms of trade.

Nominal sectoral developments

Sectoral information on net value added shows that various sectors, notably service providers, reported significant nominal gains (see Table 3.3). Double-digit relative gains were registered in financial intermediation and in transport, storage & communication. The wholesale & retail trades reported an increase of 5.5%, while the real estate, renting & business activities sector reported a rise of 6%. Net value added increased by 2.3% in construction while rising by 1.1% in agriculture. In manufacturing and in the hotels & restaurant sector, it remained largely unchanged.

Manufacturing

GDP data show that nominal net value added in the manufacturing sector was virtually unchanged in 2005, rising by a marginal 0.2% during the year. A 2.8% rise in employee compensation across the sector was largely absorbed by a 6.4% reduction in the operating surplus.

The impact of developments in international and domestic markets varied across the sub-sectors of manufacturing, as reported in the NSO's Manufacturing Survey (see Table 3.4). The radio, TV & telecom sub-sector, which is a large producer of electronic components, and accounts for 55% of surveyed exports, continued to be affected in particular by the strong international competition in the market for semi-conductors. It registered a decline of Lm86.6 million, or 18%, in exports, though the deterioration moderated in the closing months of the year. The clothing sub-sector, which continued to face the challenge of competition from lower cost locations, particularly in Asia and North Africa, experienced a fall of Lm8.1 million or 25.1%, following reductions of 31.2% and 13.9% in each of the previous two years.

On the other hand, the exports of all the other sub-sectors of manufacturing rose by a combined Lm24.2 million in 2005. The chemicals sub-sector with its dynamic pharmaceutical segment recorded an increase of Lm8.6 million, or 41.5%, while the textiles sub-sector registered an increase of Lm7 million or 26.9%.

According to the Survey, sales in the domestic market increased by Lm2.3 million, or 1.1% compared with the substantial drop of Lm13.1 million reported in 2004. If sustained, this moderate recovery in local sales would represent a turning point in the process of consolidation following trade liberalization. Performance varied across the sub-sectors. Food manufacturers, whose sales are heavily dependent on domestic demand, reported a reduction in their sales of Lm5.5 million, or 5.7%. Firms in the clothing and the tobacco sub-sectors similarly reported reduced sales, following notable gains in the previous year, while manufacturers of fabricated metal, non-metallic products, and furniture recorded a more buoyant performance.

In terms of investment, the Survey shows a net decline of Lm4.6 million, or 8.7%, compared with 2004. Changes in investment outlays varied among the sub-sectors. For example, the electronics industry recorded an increase of Lm3.5 million or 19.2%.

Employment in manufacturing industry continued to contract, dropping by a further 3.4% during 2005, mainly reflecting lay-offs in the labour-intensive textiles, clothing, leather and plastic & rubber sub-sectors. Manufacturers in the furniture and the chemicals sub-sectors, on the other hand, added to their workforce.

Table 3.4
MANUFACTURING PERFORMANCE - SELECTED INDICATORS[1]

Lm millions

	2003	2004	2005
Total turnover	**1,028.4**	**1,015.5**	**947.3**
Change in exports	**36.6**	**0.3**	**-70.5**
Radio, TV, telecom etc	28.3	-0.9	-86.6
Medical & precision equipment	4.2	8.3	0.6
Printing & publishing	5.4	-0.2	2.6
Textiles	1.3	13.7	7.0
Chemicals	2.1	-8.5	8.6
Clothes	-7.6	-14.7	-8.1
Food & beverages	2.1	-1.2	4.4
Others	0.8	3.8	1.2
Change in local sales	**0.1**	**-13.1**	**2.3**
Food & beverages	3.7	-7.2	-5.5
Tobacco	0.4	3.4	-2.9
Other non-metallic minerals	1.4	0.3	6.0
Printing & publishing	1.1	-0.5	1.5
Furniture	-3.9	-3.9	2.3
Fabricated metal products	1.3	-1.3	3.3
Clothes	-0.3	3.0	-2.6
Others	-3.6	-6.9	0.1
Change in investment	**4.8**	**4.4**	**-4.6**
Radio, TV, telecom etc	0.0	0.6	3.5
Chemicals	0.7	3.5	-4.4
Food & beverages	5.1	-3.4	0.1
Textiles	-1.6	2.7	0.0
Printing & publishing	-0.6	2.6	-2.7
Others	1.1	-1.6	-1.1
Change in employment	-1,360	-427	-673
Change in wages per employee (%)	9.0	2.6	0.8

[1] Based on a survey of representative firms conducted by the NSO.

Source NSO.

The overall decline in the demand for labour was mirrored in the slow growth of average earnings in manufacturing industry, as reported in the Survey. Growth in the average wage per employee decelerated to 0.8% from 2.6% a year earlier. According to the Survey, this slowdown was largely driven by the clothing and the leather sub-sectors, which experienced a substantial fall in wages per employee, while other sub-sectors reported lower increments during the year.

Tourism

The number of tourists departing by air rose by 2.1% in 2005. However, expenditures declined by 1.1%, as the significant growth in spending on non-package holidays was not sufficient to outweigh the fall in other types of tourist expenditure, in particular that on package holidays. There was also a marginal decline in total bed-nights, with the overall average length of stay falling to 9.5 nights from 9.7 nights in 2004. All types of accommodation reported shorter stays except for five-star and two-star hotels.

At the same time, nominal GDP data for 2005 show that the net value added of the hotel and restaurant sector fell by 0.1%, as a 2.0% increase in employee compensation was offset by a 6.6% decline in the operating surplus.

Table 3.5
TOURISM ACTIVITY INDICATORS

	2003	2004	2005	*% change* 2005
Tourist departures by air	**1,089,089**	**1,127,407**	**1,150,769**	**2.1**
UK	471,898	451,997	481,968	6.6
Germany	124,773	134,758	138,127	2.5
Italy	78,366	80,991	78,392	-3.2
France	77,029	86,061	81,779	-5.0
Others	337,023	373,600	370,503	-0.8
Nights stayed (millions)	**11.1**	**11.0**	**10.9**	**-0.4**
Average length of stay (nights)	**10.2**	**9.7**	**9.5**	**-2.4**
Expenditure (Lm millions)	**429.8**	**432.3**	**427.6**	**-1.1**
Package	213.9	219.5	203.7	**-7.2**
Non-package	73.6	69.3	82.5	**19.1**
Other	142.2	143.5	141.4	**-1.5**

Source: NSO.

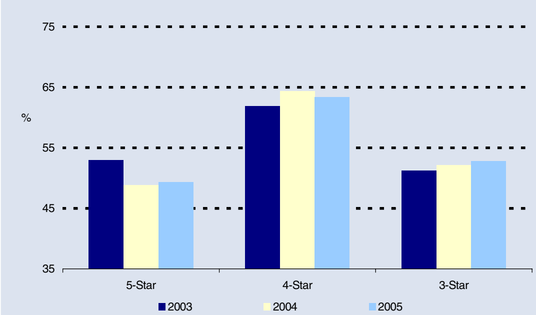
The pick-up in tourist numbers was mainly driven by a strong performance in Malta's core markets. Indeed, in contrast to the previous year, the number of British tourists rose by 6.6%, reflecting the introduction of additional airlines and an increase in the number of flights to Malta. The German market, Malta's second largest source market, also reported positive results, while significant gains were recorded in the Danish and Austrian markets, included in the "others" category in Table 3.5. The performance of other key markets weakened, however, with the Italian and French markets shedding 3.2% and 5%, respectively.

Meanwhile, the accommodation sector underwent substantial expansion and restructuring. As at December 2005, bed stock (both active and dormant) stood at 39,876, 2.3% higher than in 2004, with five-star, four-star and three-star hotels increasing their capacity by 15.2%, 2% and 8.1%, respectively. Moreover, 442 additional beds will be added to the market by March 2006, as one hotel commences operations while another expands its capacity.

In spite of the higher bed stock, the overall average occupancy rate was reported to have increased marginally to 53.8%.[2] Among the accommodation sectors, the highest occupancy rate was recorded at 63.4% by four-star hotels, one percentage point below the previous year's. Occupancy rates in five-star hotels edged above the 2004 level, though this was still below 2003, while rates in three-star hotels rose slightly over the years (see Chart 3.2).

The number of visitors arriving on cruise liners increased considerably in 2005. The slowdown noted in 2004 was completely reversed, with arrivals rising by 9.5% to just over 312,000. Substantial gains were recorded in the French, German and Italian markets. By contrast, the number of passengers from Spain and the UK declined considerably.

Chart 3.2
AVERAGE OCCUPANCY RATES IN MAJOR HOTEL CATEGORIES



Source: NSO.

[2] Data on occupancy are obtained from the NSO's survey on collective accommodation establishments, while nights stayed are obtained from the NSO's departing tourist survey.

Table 3.6
CONSTRUCTION ACTIVITY INDICATORS[1]

	2003	2004	2005
Output (Lm millions)	**130.6**	**137.3**	**144.0**
Private sector	116.3	122.6	129.6
General government	14.3	14.7	14.4
Net value added (Lm millions)	**67.5**	**71.2**	**72.8**
Share of value added in GDP (%)	3.7	3.9	3.8
Total employment	**11,327**	**10,548**	**10,670**
Private employment	**7,354**	**7,475**	**7,731**
Share of private employment in gainfully occupied (%)	5.3	5.4	5.6

[1]Employment data for 2003 and 2004 are averages for the respective years, while those for 2005 are averages for the first nine months of the year.

Source: NSO.

Construction

Turnover in the construction industry rose by Lm6.7 million, or 4.9%, in 2005 (see Table 3.6). This acceleration was fuelled by a 5.7% increase in private sector activity, the highest growth rate of the last three years. In fact, this was reflected in a surge in the number of dwelling permits issued, particularly covering the redevelopment of old units into new smaller units, mainly apartments (see Table 3.7). A number of hotel projects also contributed to the increase. In addition, private sector activity was boosted by government spending on the construction and upgrade of the road network, mainly financed by the Fifth Italian Financial Protocol, and work on the Mater Dei hospital.

The faster tempo of construction activity increased the industry's demand for labour and buoyed employment incomes. ETC data show that private firms in the sector added 256 full-time jobs during the first nine months of 2005, compared with an increase of 121 jobs in 2004.

As reported in the National Accounts for 2005, the net value contributed by the construction sector was 2.3% higher than in 2004. Total employee compensation was up by 4.2%, while operating surplus declined by 1.3%. Labour Force Survey (LFS) statistics for the first three quarters show a 3.5% increase in per-employee income in the construction industry, compared with a 2.6% increase across all sectors, possibly reflecting a relative labour shortage in the sector.

The labour market

According to the LFS, the labour force expanded during the first three quarters of 2005, as a result of

Table 3.7
APPROVED DWELLING PERMITS BY TYPE

	2001	2002	2003	2004	2005
Apartments	2,657	3,420	4,548	5,265	7,539
Maisonettes	774	910	1,085	966	1,058
Terraced houses	203	135	414	353	363
Other	546	1,016	81	123	121
Total	**4,180**	**5,481**	**6,128**	**6,707**	**9,081**

Source:Malta Environment & Planning Authority.

Table 3.8
LABOUR MARKET INDICATORS BASED ON THE LFS[1]

	2003 Jan. - Dec.	2004 Jan. - Dec.	2005 Jan. - Sep.
Labour force	159,913	159,339	160,294
Employed	147,815	147,871	148,601
By type of employment			
Full-time	134,271	135,007	134,586
Full-time with reduced hours	2,856	1,580	1,452
Part-time	10,688	11,283	12,563
By economic sector			
Private sector	98,354	98,868	100,322
Public sector	49,461	49,003	48,279
Unemployed	12,098	11,469	11,693
Unemployment rate (%)	7.6	7.1	7.3
Average gross annual salary (Lm)	5,054	5,053	5,187
Growth in average gross annual salary (%)	1.1	0.0	2.6

[1] Figures are based on annual averages, except for 2005 figures, which are averages for the first three quarters.
Source: NSO.

higher numbers of both employed and unemployed persons.[3] Growth in private sector employment was partly offset by reductions in the public sector. While part-time employment increased, full-time jobs and employment on reduced hours declined (see Table 3.8).

The unemployment rate rose to 7.3% on average, 0.2 percentage points higher than in the previous year. Among the unemployed population, there were increases in the 25 – 34 age category and in those over 45 years. Survey results also showed a significant rise in short-term unemployment.

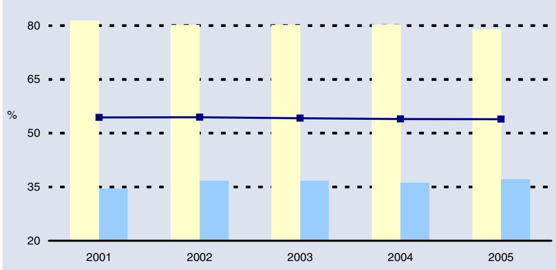
LFS data for 2005 showed that the average gross annual salary increased by 2.6% to Lm5,187. Average wage growth was flat in the previous year.

Other key LFS indicators were relatively stable. The overall employment rate, which measures the proportion of the working-age population in employment, was virtually unchanged at 53.9%. Similarly, the activity rate, which tracks the labour force as a proportion of the working-age population, was constant at 58.2, as a reduction of 1.4 percentage points in the male activity rate was offset by a similar rise in the female rate (see Chart 3.3).

Meanwhile, according to the ETC's administrative records, the labour supply contracted marginally as the number of unemployed declined, offsetting a moderate rise in the gainfully occupied population. As a result, the unemployment rate dropped to 5.2% from 5.7% in the previous year (see Table 3.9).

The ETC data indicate that full-time employment in

Chart 3.3
ACTIVITY AND EMPLOYMENT RATES*



* The activity rate and employment rate represent the labour force and the number of employed, respectively, as a share of the working age population.
Source: NSO.

[3] The analysis of LFS and ETC results is based on annual averages of the respective aggregates, whilst figures for 2005 are averages over the first three quarters. As from 2004 the LFS was compiled on an ongoing basis rather than during a specific week and hence results for the last two years may not be strictly comparable with those for 2003.

Table 3.9
LABOUR MARKET INDICATORS BASED ON ETC DATA [1]

	2003 Jan. - Dec.	2004 Jan. - Dec.	2005 Jan. - Sept.
Labour supply	**145,650**	**145,545**	**145,432**
Gainfully occupied	**137,833**	**137,290**	**137,914**
Registered unemployed	**7,817**	**8,255**	**7,518**
Unemployment rate (%)	**5.4**	**5.7**	**5.2**
Public sector	**47,446**	**46,748**	**45,682**
Public majority	7,147	6,257	5,636
Government departments	32,038	31,842	31,351
Independent statutory bodies	8,261	8,649	8,695
Private sector	**90,387**	**90,542**	**92,232**
Private direct production	**34,098**	**33,207**	**33,166**
Manufacturing	24,175	23,144	22,847
Private market services	**55,583**	**56,687**	**58,452**
Wholesale & retail	20,323	20,690	20,897
Hotels & catering establishments	8,199	8,084	8,010
Transport, storage & communication	5,678	5,851	6,400
Banks & financial institutions	4,585	4,564	4,572
Real estate, renting & business activities	8,103	8,492	9,231
Other services	8,695	9,006	9,343
Temporary employed	**706**	**648**	**614**
Part-time employees	**33,270**	**35,973**	**39,436**
Part-time as a primary job [2]	18,259	20,078	22,044
Part-time holding a full-time job	15,011	15,895	17,393

[1] Figures are based on annual averages, except for 2005 figures, which are averages for the first three quarters.

[2] Persons whose only employment consists of part-time activity are not counted with the gainfully occupied population or with the labour supply.

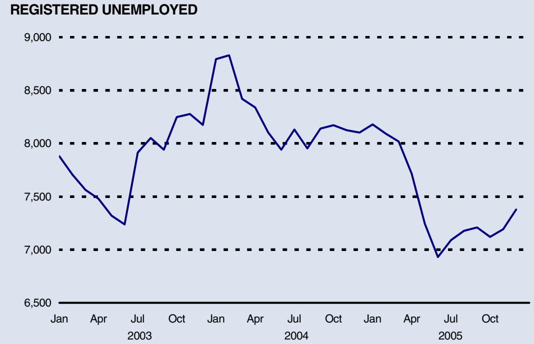
Source: NSO.

the private and public sectors followed broadly the same patterns of recent years in 2005. Public sector employment fell by 2.3%, a sharper decline than in 2004, reflecting the ongoing reforms in the public sector, involving privatisation, voluntary retirement schemes and restrictions on non-essential recruitment in government departments.

On the other hand, private sector employment expanded by 1.9%.[4] Increases were recorded in the number of full-time jobs in transport, storage & communication, in the real estate, renting & business activities sector and in the "other services" category. At the same time, manufacturing employment declined.

Part-time employment continued to expand robustly during 2005, reflecting a structural shift in the labour force. The two categories of part-time employees –

Chart 3.4
REGISTERED UNEMPLOYED



Source: NSO.

[4] The increase included the shift to private sector employment that resulted from the privatisation of the Malta Freeport Terminal in October 2004.

Table 3.10
REGISTERED UNEMPLOYED[1]

	2003	2004	2005
Skilled	6,063	6,388	6,347
Unskilled	1,753	1,866	1,099
Total	**7,817**	**8,255**	**7,446**
by duration			
Under 20 weeks	3,381	3,558	3,133
21 to 52 weeks	1,521	1,871	1,498
53 weeks and over	2,915	2,825	2,815
by age			
Under 30 years	3,391	3,458	3,118
30 to 49 years	3,302	3,464	3,107
50 years and over	1,124	1,333	1,222
Placements to vacancies ratio (%)	45.0	47.5	56.0

[1] Figures are annual averages.
Source: NSO; ETC.

those with only part-time employment and those whose part-time activity was their secondary occupation – each increased by about 9.5%.

ETC records indicated that the average number of persons registering as unemployed in 2005 fell to 7,446, from 8,255 a year earlier. The placement ratio, which measures the proportion of vacancies advertised through the ETC that were filled by unemployed persons, increased to 56%. Furthermore, a number of previously unemployed persons moved into part-time jobs or into training schemes, while others were removed from the register for working illegally or for refusing employment or training. During the year the smallest number of registrants, 6,930, was recorded in June, the lowest figure since June 2003 (see Chart 3.4).

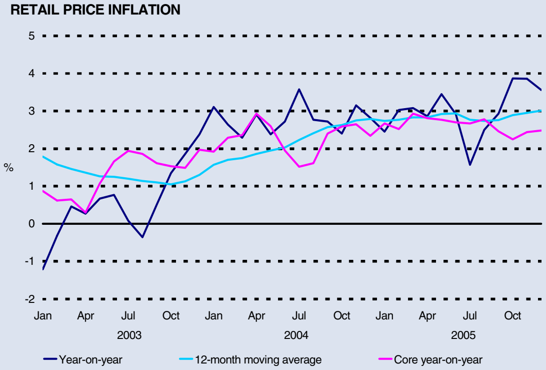
Of the reduction in the number of unemployed, 95% were in the unskilled category, reflecting the reclassification of registrants and the provision of training schemes by the ETC. In terms of duration, persons registering for less than a year accounted for nearly the entire drop in registered unemployment. Meanwhile, age distribution statistics indicate that 42% of job seekers were less than 30 years old, while those over 50 accounted for 16% of the total (see Table 3.10).

Prices and wages

Retail prices

The 12-month moving average inflation rate based on the Retail Prices Index, which is the official measure of inflation, increased to 3.0% over the year to December 2005 from 2.8% a year earlier. Meanwhile, on a year-on-year basis, the RPI rose to 3.6% from 2.8% (see Chart 3.5). Core inflation, as measured by the Central Bank of Malta index, edged up to 2.5% in 2005 from 2.3% a year earlier.[5]

Chart 3.5
RETAIL PRICE INFLATION



Sources: Central Bank of Malta estimates; NSO.

[5] This measure of inflation reflects changes in those sub-indices that show persistent price increases over the years. One-off fluctuations or temporary shocks do not affect core inflation to the same extent as the standard inflation measures. The water & electricity and the fuel sub-indices, which were two main contributors to headline inflation in 2005, carry a zero weight in the core inflation measure.

Table 3.11
RPI 12-MONTH MOVING AVERAGE INFLATION

	% change		Contributions to inflation[1]	
	2004	2005	2004	2005
Food	0.2	1.8	0.1	0.4
Beverages & tobacco	9.2	2.4	0.6	0.2
Clothing & footwear	-2.5	-0.5	-0.2	0.0
Housing	3.8	5.0	0.3	0.4
Water, electricity, gas & fuels	1.3	23.0	0.0	0.5
Household equipment & house maintenance cost	2.2	2.1	0.2	0.2
Transport & communications	4.0	3.8	0.9	0.9
Personal care & health	5.1	3.6	0.3	0.2
Recreation & culture	1.2	1.1	0.1	0.1
Other goods & services	8.0	3.0	0.5	0.2
RPI	**2.8**	**3.0**	**2.8**	**3.0**

[1]Components are expressed in percentage points and add up to the number at the bottom of the column. Figures may not add up exactly due to rounding.
Source: NSO.

Two components of the RPI showed a substantial rise during the year, reflecting the direct impact of the higher price of imported oil. These were the water, electricity, gas & fuels sub-index and the transport & communications sub-index. The former rose by 23% on a 12-month moving average basis and contributed half a percentage point to the total rate (see Table 3.11). A primary factor behind the rise was the electricity and water surcharge introduced at 17% in January 2005 and raised to 55% in November. The transport & communications sub-index registered a 3.8% increase, adding 0.9 percentage points to overall inflation. The fuel component, which makes up 16% of this sub-index, reflected higher prices of diesel and of unleaded and leaded petrol, which on a 12-month moving average basis were up by 24%, 9.8% and 9%, respectively, during 2005.

The food sub-index, which rose by 1.8%, contributed 0.4 percentage points to total inflation. The increases were mainly in the prices of meat, dairy products and vegetables. In contrast, the beverages & tobacco sub-index rose by 2.4% in 2005, a considerably slower rate than in previous years.

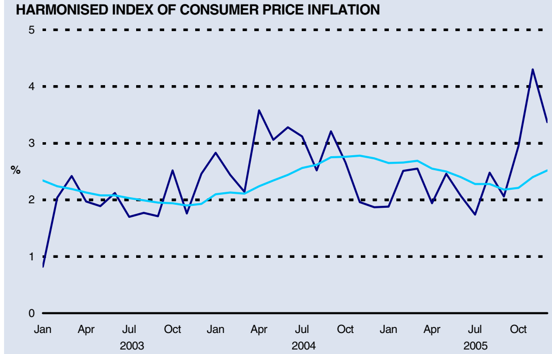
The housing sub-index registered an average increase of 5%, mainly on account of higher prices for electrical equipment. This sub-index contributed 0.4 percentage points to overall inflation.

Harmonised Index of Consumer Prices[6]

In December 2005, HICP inflation, measured on a 12-month moving average basis, edged down to 2.5% from 2.7% a year earlier (see Chart 3.6). In contrast, the year-on-year rate went up to 3.4% from 1.9% in 2004.

Mirroring the RPI counterpart of this index, the 12-month moving-average rate of change in the HICP was mainly driven by housing, water, electricity, gas & other fuels, up 9.3%, and transport, up 3.5%. With a combined weight of nearly 22% in the HICP, the two

Chart 3.6
HARMONISED INDEX OF CONSUMER PRICE INFLATION



Source: NSO.

[6] The HICP, which is published on a monthly basis and measured on the basis of standards developed by Eurostat, is used to compare inflation rates across the EU.

Table 3.12
HICP 12-MONTH MOVING AVERAGE INFLATION

	% change		Contributions to inflation [1]	
	2004	2005	2004	2005
Food & non-alcoholic beverages	-0.2	1.7	0.0	0.3
Alcoholic beverages & tobacco	13.0	1.8	0.6	0.1
Clothing & footwear	-2.5	-0.5	-0.2	0.0
Housing, water, electricity, gas & other fuels	2.8	9.3	0.2	0.7
Furniture, household equipment & routine maintenance	2.8	2.4	0.3	0.2
Health	6.9	5.5	0.2	0.2
Transport	4.0	3.5	0.6	0.5
Communications	10.2	10.0	0.2	0.2
Recreation & culture	0.2	1.9	0.0	0.2
Education	3.0	1.6	0.0	0.0
Restaurants & hotels	2.6	0.0	0.5	0.0
Miscellaneous goods & services	5.8	3.0	0.3	0.2
HICP	**2.7**	**2.5**	**2.7**	**2.5**

[1]Components are expressed in percentage points and add up to the number at the bottom of the column. Figures may not add up exactly due to rounding.
Source: NSO.

categories accounted for nearly a half of the total inflation rate (see Table 3.12). In contrast, prices of alcoholic beverages & tobacco decelerated sharply from 2004.

A contributor to the 0.2 percentage point decline in the overall HICP rate of inflation between 2004 and 2005 (in contrast to the mild acceleration in the RPI) was the absence of an increase in the restaurant and hotels sub-index, which has a smaller impact on the RPI.[7] Lower accommodation prices contributed to a zero change in this sub-index between 2004 and 2005.

Wages

Central Bank of Malta estimates, compiled from collective agreements, suggest that the rate of wage

Table 3.13
ESTIMATED CHANGE IN AVERAGE WAGES[1]

%

	2003	2004	2005
Unskilled	3.1	5.3	2.9
Skilled	3.0	3.3	2.8
Clerical	2.9	2.8	3.5
Administrative[2]	3.8	2.6	2.2
Average for all categories	**3.1**	**3.8**	**3.0**
Excluding civil service employees	**3.0**	**3.9**	**3.2**

[1] The Table shows Central Bank of Malta estimates based on data drawn from officially registered collective agreements. The average wage for each labour category was computed as a weighted mean of the average minimum wage and the average maximum wage.

[2] Refers to middle management and professionals, as the wages of the top managerial grades are not covered by collective agreements.
Sources: Central Bank of Malta estimates; Department of Employment & Industrial Relations; Ministry of Finance.

[7] Unlike the RPI, the HICP takes into account not only expenditure by resident private households but also expenditure by institutional households and foreigners. The separate inclusion of the restaurants and hotels component in the HICP basket recognises the contribution of the tourism sector to the economy.

inflation in 2005 was 3.0% for all categories and 3.2% excluding government employment (see Table 3.13). The equivalent rates for 2004 were 3.8% and 3.9%, respectively. Across all categories, average wage increases in 2005 ranged from 2.2% for administrative workers to 3.5% for clerical workers.[8] Wage growth was slower than in 2004 for all categories except the clerical. These figures include only unionised employees covered by collective agreements. Since such employment constitutes just under half of the gainfully occupied population, such estimates may not be representative of developments in the overall economy.[9]

Meanwhile, the LFS, which tracks the change in remuneration across the entire employment market, reported wage growth of 2.6%, as mentioned earlier.[10] In comparison, price inflation in 2005 was 3%.

Unit labour costs, defined as the cost of labour compensation per unit of real output, is a widely used measure of competitiveness. Employment income per worker rose by 1.9% during the first three quarters of 2005 from the same period a year earlier, whereas productivity (measured by real output per person in employment) increased by 1.2%. Thus, unit labour costs grew by 0.8%, offsetting the decline registered in 2004.

Residential property prices

While property prices may have a significant impact on household wealth, with implications for private consumption, they may also have an impact on inflation since movements in asset prices may be a prelude to an upward movement in consumer prices.

As indicated in Chart 3.7, residential property prices

Chart 3.7
RESIDENTIAL PROPERTY PRICE INDEX
2004Q1=100

resumed their upward trend in 2005, rising by an average of 10.4%, after having slowed down in the latter half of 2004.[11] The increase can partly be explained by developments in the market for finished flats, which account for around two-fifths of the index. This category was heavily influenced by the inclusion of a number of luxury units that came onto the market. However, the sharpest rise in prices was registered in the terraced houses category. Prices of all other categories of property also increased during the year, except those of town houses, which dropped marginally.

A number of factors contributed to the general rise in house prices, such as the continuing shift in preferences towards investment in property on account of the relatively low yields on financial investments. The drive for home ownership in view of the small size of the rental market is another important factor.

Short-term outlook

Malta's small size is often a source of volatility in macroeconomic indicators and renders it vulnerable to external shocks. The latter may be large enough to cause significant deviations from the expected outcome. The economic transformation which the

[8] An updated figure for 2004 shows wage inflation up to 5.3% among unskilled workers, as reported in Table 3.13. A number of collective agreements recorded at the end of 2004, mostly in the banking sector and in the transport, storage & communication categories, were the reason for the update.

[9] The exercise covers around 41,500 private and public sector employees and approximately 25,500 civil servants. Together these comprise around 48% of the gainfully occupied population. The estimates exclude overtime pay, production bonuses and all other allowances or income in kind, but include the cost-of-living adjustment.

[10] The period in consideration for 2005 is January – September.

[11] Trends in property prices are measured using the Bank's own index. The methodology of the index was revised in 2004 and fine-tuned in 2005. The latter involved an adjustment to the categories so that luxury units are no longer identified as a separate type of property but are allocated to their related category. The median Fisher index chained on a quarterly basis is being used as a measure of central tendency, in order to diminish the impact of extreme values. The Bank's method of measuring house prices is expected to be reviewed further with the aim of developing a hedonic index, which will capture the impact of differences in the quality of dwellings on prices.

country has been undertaking in recent years, moreover, is characterised by restructuring in the commercial and industrial sectors, higher foreign direct investment in specific sectors and the closing down of some labour intensive industries. Against this background the Bank has analysed past and current developments in Malta and abroad to project the expected economic performance in 2006.

Assumptions for the forecast

The Bank's macroeconomic forecasts for 2006 are based on the previous year's performance and are contingent on developments in Malta's main trading partners and the projected conduct of fiscal policy.

In particular, foreign demand is assumed to accelerate slightly in line with the anticipated cyclical upturn abroad. On the other hand, foreign inflation is assumed to decelerate in view of limited second round effects from the recent hike in oil prices. The latter are assumed to stabilise around the level attained in the last quarter of 2005, implying a further increase on an annual basis.

The projections also embody information contained in the latest Convergence Programme regarding the fiscal policy targets for 2006, and in particular, the Government's aim to narrow the fiscal deficit further. The effective exchange rate, in turn, is assumed to remain unchanged from the average recorded during the last quarter of 2005. Similarly official interest rates in Malta are assumed constant at their current level.

The Bank's forecast

Economic growth in 2006 is expected to be slightly lower than in 2005, with the increase in real GDP estimated at between 1.7% and 2.3%. Some factors which contributed significantly to growth in 2005, such as additions to inventories and public investment, are not anticipated to provide the same stimulus in 2006 (see Table 3.14). Projections for 2006 are characterised by slower growth in household consumption and a further decline in government consumption. Moreover, investment growth is expected to decelerate on account of a decline in the rate of expansion of public sector projects. However, the external sector is likely to mitigate the effect of the latter factor as exports are projected to recover and to grow faster than imports.

Among the domestic expenditure components of GDP, private consumption is expected to bear part of the brunt of economic restructuring, with growth projected

Table 3.14
OUTLOOK FOR SELECTED ECONOMIC INDICATORS

%

	2004	2005	2006
	Actual		Estimate
GDP growth at constant prices	**(1.5)**	**2.5**	**1.7 - 2.3**
Growth in GDP components at constant prices			
Private consumption expenditure	(1.2)	1.4	0.3 - 0.9
Government consumption expenditure	1.8	(1.9)	(0.0) - (0.6)
Gross fixed capital formation	3.8	6.1	1.3 - 1.9
Inventories (% of GDP)	(2.6)	1.9	1.9
Exports of goods and services	0.4	(3.9)	1.9 - 2.5
Imports of goods and services	2.0	0.2	0.3 - 0.9
External goods and services balance (% of GDP)	(7.2)	(10.5)	(9.7) - (10.3)
General government balance (% of GDP)	(5.1)	(3.9)	(2.6) - (3.0)
Inflation rate	3.3	3.0	2.8 - 3.2
Unemployment rate	7.2	7.3	7.2 - 7.5

Note: Figures in parenthesis are negative.

to range between 0.3% and 0.9%. This reflects mainly restrained growth in disposable incomes, forecast to be less than projected inflation. Such a scenario is driven by the agreed-upon public sector wage rate, which is expected to rise by around 1.5% in 2006, the ongoing competitive wage pressures facing the private sector, and the possible downside risks to employment.

As a result of the fiscal consolidation programme, government consumption is estimated to decline further by up to 0.6%. This retrenchment hinges on the planned downsizing of public employment, as retirees are not fully replaced, coupled with limited growth in the nominal non-wage component of government consumption.

Investment growth, in turn, is projected to range between 1.3% and 1.9%. Although private sector investment is expected to accelerate from 2005 levels, this is likely to be offset to some extent by the smaller boost provided by the public sector. The latter had increased strongly in 2005 as a result of numerous transport-related projects funded by the EU and Italy. On the other hand, the stronger private sector investment forecast is based on expectations that export-oriented firms will increase their capacity in the light of an anticipated growth in external demand, as well as the continuing restructuring process.

An upswing in exports is projected, with growth in the range of 1.9% to 2.5%. This follows a generally more positive outlook among export oriented firms, driven by the cyclical recovery in foreign markets. The expansion of the pharmaceutical sector, in particular, is expected to contribute positively to overall exports. The trend of scaling down operations in labour intensive sectors is, however, expected to limit the strength of the recovery in exports. On the other hand, earnings by the tourism sector are expected to improve further in line with the overall growth in the industry worldwide. Additional bed capacity in the higher accommodation range, and also increased reliance on internet bookings, which tend to generate a higher achieved room rate, should also contribute positively.

Imports are also forecast to rise, albeit at a slower pace than exports, up between 0.3% and 0.9%. Imports are seen to increase in view of the higher demand stemming from exports and investment, which categories generally entail a relatively high import content.

The positive contribution to growth stemming from net exports is expected to narrow the external goods and services deficit to between 9.7% and 10.3% of GDP. The extent of the improvement is contained in view of possible unfavourable developments in the country's terms of trade. Export prices are likely to drop under the pressure of globalisation and rapid technological developments, while high oil prices may prevent average import prices from falling.

Against this background, inflation, as measured by the Retail Price Index, is expected to remain stable in the region of 2.8% to 3.2%, fuelled by the recent adjustment in utility prices to cover the hike in international oil prices. Unemployment is also expected to remain stable or move slightly higher, ranging from 7.2% to 7.5%. Job losses induced by economic restructuring are expected to be in the main compensated for through job creation in expanding sectors. At the same time, the fiscal deficit is expected to narrow further, to 3% of GDP or less in 2006, in line with the Government's medium term fiscal strategy.

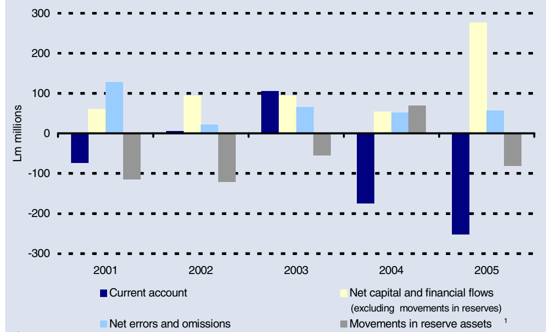
The recovery in exports may be stronger than projected if export oriented firms prove more successful in their penetration of export markets. This could also induce a positive spill-over effect on investment. Consumption may also be stronger than anticipated despite the moderate pace of disposable income growth, such that the impact on savings could be stronger than anticipated. All these factors may have a positive impact on GDP growth, thus pushing the output gap closer to zero. However, downside risks also exist, and are primarily related to movements in international oil prices, where a further bout of price increases could reverse the current projection of accelerating economic activity and a deceleration in inflation in Malta's main trading partners.

4. The Balance of Payments and the Maltese Lira[1]

The balance of payments

Provisional data on the balance of payments show that the current account deficit continued to widen in 2005 as a result of a larger merchandise trade gap and higher net outflows on the income account. After excluding movements in reserves, net inflows on the capital and financial account increased considerably and exceeded the current account imbalance. Net errors and omissions remained positive, while reserve assets rose significantly, reversing the decline recorded in the previous year.

Chart 4.1
BALANCE OF PAYMENTS TRENDS



[1] A negative movement indicates an increase in reserve assets.
Source: NSO.

The current account

In 2005 the current account deficit widened for the second consecutive year, expanding by Lm77.2 million, or 44%, to Lm252.5 million (see Chart 4.1). This reflected a larger merchandise trade gap and higher net investment income outflows that outweighed a positive shift on the transfers account and a larger surplus on

Table 4.1
EXTERNAL BALANCES[1]

Lm millions

	2004		2005	
	credit	debit	credit	debit
Current account balance		**175.3**		**252.5**
Goods and services	1,393.4	1,521.5	1,367.8	1,574.2
Goods balance		291.1		384.5
Goods	918.6	1,209.7	866.0	1,250.5
Services balance	163.1		178.0	
Services	474.8	311.7	501.8	323.8
Transport	120.7	132.2	125.8	134.6
Travel	269.1	88.0	274.1	92.9
Other services	85.0	91.5	101.9	96.3
Income (net)		21.5		49.9
Current transfers (net)		25.7	3.8	
Capital and financial account balance[2]	**54.4**		**276.5**	
Capital account balance	28.8		62.4	
Financial account balance	25.6		214.1	
Direct investment	149.0		250.4	
Portfolio investment		571.5		1,028.8
Financial derivatives	0.9			15.7
Other investment	447.2		1,008.1	
Movements in reserves[3]	**69.3**			**80.6**
Net errors and omissions	**51.6**		**56.6**	

[1] Provisional.
[2] Excludes movements in official reserves.
[3] Excludes revaluation adjustments.
Source: NSO.

[1] This analysis is based on data available up to 9 March 2006.

services. The deterioration was mostly driven by developments during the first half of the year.

***Merchandise trade*[2]**

Official balance of payments data show that the merchandise trade deficit widened by Lm93.4 million to Lm384.5 million during the year. Exports declined by Lm52.6 million and imports rose by Lm40.8 million.

On the basis of Customs data, the merchandise trade gap increased by Lm91.1 million, or 22.1%, on a year earlier (see Table 4.2). This was driven entirely by a drop in exports, which was only partly offset by a decline in imports.[3]

During the year, exports contracted by Lm101.8 million, or 11.3%, with sales of machinery and transport equipment, which includes semi-conductors, dropping by Lm64.4 million and accounting for most of the decline. This category of exports fell for most of the year, before picking up slightly in November and December. In addition, exports of mineral fuels and lubricants shed Lm29.6 million as a state-owned oil-bunkering firm ceased its import and re-export operations mid-way through 2004. To a lesser extent, foreign sales of miscellaneous manufactured articles, which include clothing and footwear, continued with their downward trend. At the same time, exports of beverages and food declined, with the latter due to lower sales of fish, which had risen sharply in December 2004. By contrast, foreign sales of chemicals and of semi-manufactured goods increased.

The Lm10.7 million, or 0.8%, decline in imports reflected lower purchases of industrial supplies and capital goods (see Table 4.2). The former dropped by Lm37.6 million, or 6%, reflecting lower purchases of semi-finished goods. The reduction in imports of electrical machinery and equipment, a key element of industrial supplies, was considerably less than the drop in exports in the same category, which suggests an accumulation of inventories. Although imports of capital goods also fell, thus contributing to the overall decline, this was mainly due to a base effect arising from a surge in imports of yachts in 2004 in connection

Table 4.2
MERCHANDISE TRADE[1]
(based on Customs data) *Lm millions*

	2003	2004	2005[2]	% change 2004	% change 2005
Imports	**1,281.3**	**1,315.4**	**1,304.7**	**2.7**	**-0.8**
Consumer goods	311.1	344.2	353.2	10.6	2.6
Industrial supplies	657.6	622.6	585.0	-5.3	-6.0
Capital goods & others	210.7	241.5	223.3	14.6	-7.5
Fuel & lubricants	101.9	107.1	143.2	5.1	33.7
Exports	**928.3**	**903.8**	**802.0**	**-2.6**	**-11.3**
Trade deficit	**353.0**	**411.6**	**502.7**	**16.6**	**22.1**

[1] These data are taken from NSO News Release No. 23/2006 published on 9 February 2006.

[2] Provisional

Source: NSO.

[2] Merchandise trade figures are compiled by the NSO from Customs data, which are recorded on a cost, insurance and freight basis. These data are then adjusted in the compilation of the balance of payments to cater for differences in coverage, valuation and timing. In addition, insurance and freight are allocated to the services account. As a result, the goods balance shown in Table 4.1 does not tally with the merchandise trade balance shown in Table 4.2.

[3] The discrepancy between the balance of payments data and the Customs data regarding imports is mainly attributable to imports of yachts under a temporary registration scheme in 2004. These were recorded in the Customs data but had no impact on the balance of payments figures. The balance of payments data on exports also include ship repair and shipbuilding carried out in Malta, which are not captured in the Customs data.

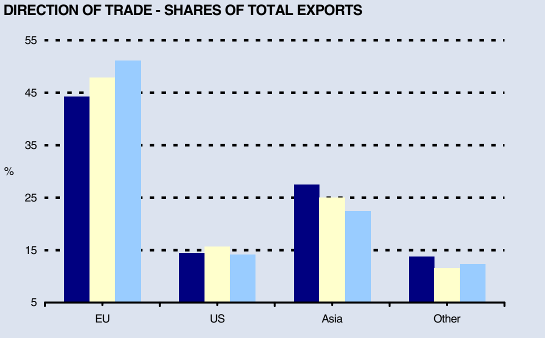
with the temporary registration scheme in effect during the first quarter of that year .

Reflecting the higher international price of oil, payments for imported fuel rose markedly, despite the reduction in oil purchases for re-export. Fuel imports were up by Lm36.1 million, or 33.7%. Imports of consumer goods continued to increase in the first full year of complete trade liberalisation, driven by purchases of durable goods and, to a lesser extent, of food & beverages. Their annual growth rate slowed down, however, dropping to 2.6% from 10.6% in the previous year.

Although exports to the EU fell during 2005, they accounted for a larger proportion of Maltese trade, as exports to the US and Asia contracted much more sharply. As a share of the total, foreign sales to the EU rose by 3 percentage points, from 47.8% to 51.1% (see Chart 4.2). Conversely, the proportion of exports to the US decreased to 14.1% after having risen during the previous year, while the share of exports to Asia fell for the second consecutive year, to 22.4%. The proportion of exports to other countries increased by just under one percentage point.

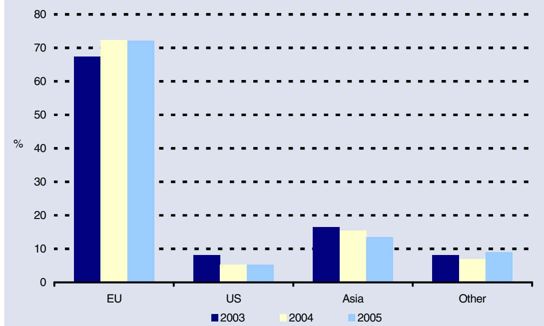
The EU accounted for 72.2% of Maltese imports, with this share remaining largely unchanged on a year earlier after having increased steadily since 2000. At the same time, the decline in imports from the US was stemmed, with their share in the total remaining stable at just over 5%. Whereas the proportion of imports from Asia continued to decrease, that of imports from other countries grew from 6.9% to 9.0%, driven by the sharp rise in the value of fuel imports from Africa (see Chart 4.3).

Chart 4.2
DIRECTION OF TRADE - SHARES OF TOTAL EXPORTS



Source: NSO.

Chart 4.3
DIRECTION OF TRADE - SHARES OF TOTAL IMPORTS



Source: NSO.

Services

After having contracted during 2004, the surplus on services widened by Lm14.9 million, or 9.2%, to Lm178 million (see Table 4.1). This was mostly driven by the other services component, which shifted from a deficit of Lm6.5 million to a surplus of Lm5.6 million. In turn, this mainly reflected a doubling in net income from miscellaneous business, professional and technical services, a rise in net inflows on telecommunications and lower net outflows on insurance. Higher net receipts, of Lm2.7 million, from transport activities also contributed. Net income from travel remained virtually unchanged, as the growth in receipts, which went up by 1.8%, was almost wholly offset by higher payments.

Income and transfers

Net outflows on the income account were more than twice their 2004 value, reaching Lm49.9 million. Net outflows of investment income accounted for the entire rise, adding Lm32 million as a result of higher profits registered by companies with non-resident participation. Dividends rose by Lm58.6 million, driven by credit institutions and the electronics sector, and outweighing a drop in reinvested earnings. The resultant outflow was only partly offset by an Lm18.5 million increase in net interest receipts from abroad.

Meanwhile, the balance on the current transfers account swung from a deficit of Lm25.7 million to a surplus of Lm3.8 million. This was mainly due to a significant contraction in net private transfers abroad. The balance on government transfers also turned positive, despite Malta's contribution to the EU budget, reflecting corporate tax receipts.

The capital and financial account

Excluding movements in reserves, the surplus on the capital and financial account was up substantially during 2005, rising by Lm222.1 million over the previous year to Lm276.5 million.

Net inflows on the capital account totalled Lm62.4 million, Lm33.6 million more than in 2004, reflecting higher official transfers from the EU and Italy. Net inflows on the financial account made the major contribution, increasing by Lm188.5 million to Lm214.1 million. The monetary sector dominates flows on the individual components of the financial account. In particular, large flows are generated by banks that deal almost entirely with non-residents. As banks normally channel inflows on the other investment account into portfolio investment abroad, their net impact on the financial account overall is much smaller.

Net inflows on the other investment account rose by Lm560.9 million as banks increased their liabilities to non-residents in the form of loans and currency & deposits. In addition, a public non-financial corporation borrowed abroad and the non-bank sector drew down on holdings of currency and deposits abroad. These movements overshadowed a rise in foreign lending by banks and higher payments relating to trade credits by the non-bank sector. Meanwhile, net direct investment inflows were up strongly, rising by Lm101.4 million, mostly on account of the establishment of a foreign-owned bank, though payments received by resident firms from their foreign parents to settle outstanding debts also contributed.

Conversely, net portfolio outflows were up markedly, rising from Lm571.5 million in 2004 to Lm1,028.8 million. The additional outflows mainly consisted of net investments in foreign bonds and notes by the banking sector. At the same time, the financial derivatives item swung from a surplus of Lm0.9 million in 2004 to a negative balance of Lm15.7 million in 2005, reflecting the operations of the banking sector.

Errors and omissions, which amounted to Lm56.6 million, continued to be positive, implying an overestimation of the current account deficit or an underestimated capital and financial account balance or both.

Against this backdrop, the official reserves were up significantly, rising by Lm80.6 million after having decreased in the previous year.

The Maltese lira and indicators of external competitiveness

The Maltese lira

The entry of the Maltese lira into ERM II on 2 May 2005 was the key development regarding the exchange rate during the year. The lira joined ERM II at a central parity rate of Lm0.4293 to the euro, abandoning the previous currency basket in which the euro already had a 70% share. The Maltese Authorities made a unilateral commitment to maintain the exchange rate of the lira unchanged against the euro in ERM II. Therefore, movements of the Maltese lira in 2005 reflected international foreign exchange market developments, with the lira following the basket currencies until end-April and tracking the euro thereafter.

During 2005 the lira gained 1.2% against the euro. The entire appreciation took place during the first four months of the year. The lira subsequently remained unchanged against the European currency at the established central parity rate. Meanwhile, in terms of the US dollar, the Maltese lira lost 12.2% as the dollar strengthened against all the other major currencies. During the first half of 2005, the domestic unit also lost ground against the pound sterling, against which it reached a low for the year in June. Although it recovered during the second half of the year, over the year as a whole it fell by 1.5% against the UK Currency. In contrast, the Maltese lira rose by 0.7% against the Japanese yen (see Table 4.3).

On an average basis, during 2005 the lira was down by 0.5% against the euro. On this basis, the wide exchange rate fluctuations against the US dollar in 2004 and 2005 largely evened out, with the lira depreciating by just 0.3% during the year reviewed.

Table 4.3
EXCHANGE RATES OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES FOR 2005

	EUR[1]	USD	GBP	JPY
Average for 2004	0.4279	2.9061	1.5853	314.2
Average for 2005	0.4299	2.8960	1.5910	318.3
% appreciation (+)/depreciation (-) of the MTL against the respective currency	-0.5	-0.3	0.4	1.3
Closing rate on 31.12.2004	0.4343	3.1393	1.6252	321.7
Closing rate on 30.12.2005	0.4293	2.7570	1.6012	324.0
% appreciation (+)/depreciation (-) of the MTL against the respective currency	1.2	-12.2	-1.5	0.7
High for the MTL during the year	0.4291	3.1049	1.6301	334.2
	(29 Apr.)	(03 Jan.)	(04 Jan.)	(12 Dec.)
Low for the MTL during the year	0.4342	2.7185	1.5436	305.0
	(4 Jan.)	(17 Nov.)	(24 Jun.)	(23 Jun.)

[1] As from 1 April 2005, the Central Bank of Malta started to quote the Maltese lira against the euro exclusively in terms of units of Maltese lira per euro. As a result, an increase in the MTL/EUR exchange rate implies a depreciation of the Maltese lira against the euro and vice-versa. The other currencies are quoted per one Maltese lira.

Conversely, over the same period, the local unit gained 1.3% against the Japanese yen and rose by 0.4% against sterling (see Table 4.3).

Effective exchange rates

The Maltese lira depreciated in nominal effective terms during 2005, reversing the slight appreciation registered during the previous year (see Chart 4.5). Between end-December 2004 and the end of 2005, the Nominal Effective Exchange Rate (NEER) of the Maltese lira shed 1.2%. The drop reflected the depreciation of the currency against the US dollar during this period.

At the same time, however, the lira appreciated marginally in real effective terms. The Real Effective Exchange Rate (REER) rose by 0.2% after having added 1.3% during 2004. The rise in the REER reflected price differentials, as inflation in Malta exceeded that recorded in its main trading partners and competitors, offsetting the impact of the nominal effective depreciation of the lira.

Chart 4.4
EXCHANGE RATE MOVEMENTS OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES
(index of end-of-month rates, end-1999 = 100)

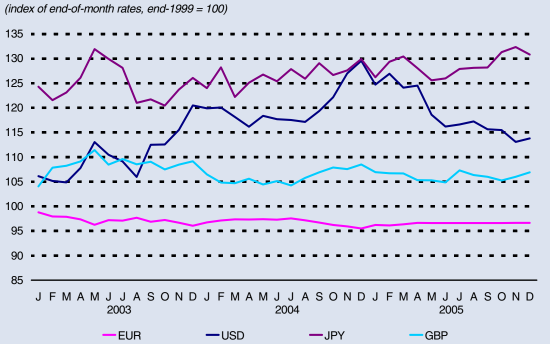
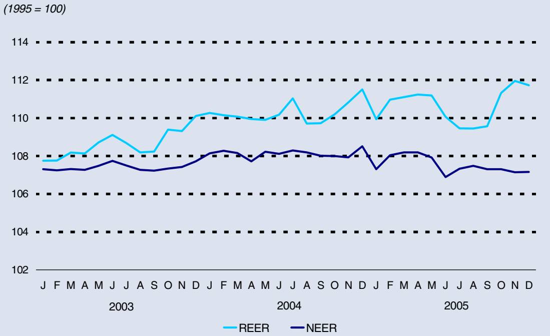


Chart 4.5
REAL AND NOMINAL EFFECTIVE EXCHANGE RATE INDICES FOR THE MALTESE LIRA
(1995 = 100)



5. Government Finance

According to the latest Update of Malta's Convergence Programme,[1] the general government deficit as a percentage of GDP fell from 5.1% at end-2004 to 3.9% in 2005, mirroring developments in the Consolidated Fund.[2] The deficit to GDP ratio is expected to continue narrowing between 2006 and 2008, while government debt is also expected to fall as a proportion of GDP.

General government[3]

The general government deficit continued to fall during 2005, narrowing to 3.9% of GDP from 5.1% a year earlier (see Table 5.1). This was due to growth in revenue, driven by tax and non-tax receipts, which exceeded the increase in expenditure. The primary balance, which is computed by stripping out interest payments from expenditure, shifted into a small surplus of 0.3% of GDP, from a deficit of 1.0% in 2004. These developments took place despite a relatively subdued economic performance, as shown by the cyclically adjusted budget deficit, which also contracted, to 2.6% of GDP.[4] Over the same period, general government debt as a proportion of GDP remained unchanged at 76.7%.

In 2006 the deficit to GDP ratio is expected to fall further, contracting by 1.2 percentage points to 2.7%, with revenue continuing to grow faster than expenditure, buoyed by significant one-off receipts from the sale of land. It is projected to continue declining, falling to 1.2% of GDP by 2008. This hinges particularly on a lower level of capital expenditure as the new state hospital reaches completion. In addition, the correction of the fiscal imbalance is also based on recurrent expenditure restraint, greater efficiency in tax collection and increased receipts generated by economic growth. The debt-to-GDP ratio is also anticipated to decrease significantly, from 76.7% in 2005 to 70.8% in 2006, driven by privatisation receipts, before falling to 67.3% in 2008.

Table 5.1
UPDATED CONVERGENCE PROGRAMME: KEY FISCAL INDICATORS

% of GDP

	2004	2005	2006	2007	2008
Total revenue	43.6	45.7	45.9	42.7	40.9
Total expenditure	48.8	49.6	48.6	44.9	42.1
Interest payments	4.1	4.1	4.0	3.8	3.7
Budget balance	-5.1	-3.9	-2.7	-2.3	-1.2
Primary balance	-1.0	0.3	1.4	1.5	2.4
Cyclically adjusted budget balance	-4.3	-2.6	-1.0	-0.3	0.6
Gross debt	76.7	76.7	70.8	68.9	67.3

Source: Update of Convergence Programme 2005-2008, Ministry of Finance.

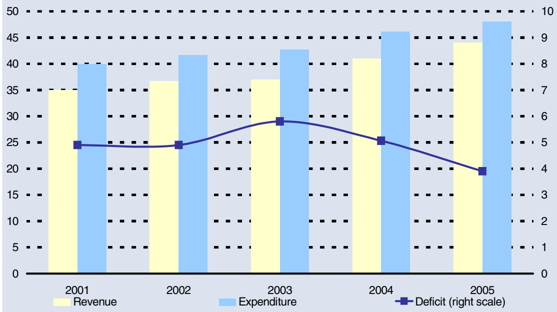
[1] As a Member State of the European Union, Malta is required to submit Convergence Programmes to the European Commision in line with the provisions of the Stability and Growth Pact. The Programme presents the Government's macroeconomic policy objectives and includes medium-term projections for key economic variables and a detailed explanation of the Government's medium-term budgetary objectives.

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

[3] The analysis in this section is based entirely on the data contained in the latest Update of Malta's Convergence Programme. In the remainder of this Chapter, GDP data are taken from NSO News Release No. 47/2006 published on 10 March 2006.

[4] When the economy is growing below potential, this would have an adverse effect on the budget, and vice-versa. The cyclically adjusted balance attempts to account for these cyclical effects on the deficit. Thus, according to the data provided in the Programme, since economic growth in Malta was below potential, the cyclically-adjusted deficit in 2005 was smaller than the unadjusted shortfall.

Chart 5.1
FISCAL INDICATORS
(% of GDP)



Note: Figures refer to the Consolidated Fund.
Sources: Ministry of Finance ; National Statistics Office.

Consolidated Fund performance in 2005[5]

The deficit on the Consolidated Fund narrowed for the second consecutive year during 2005, dropping by Lm18 million to Lm76 million, or 3.9% of GDP (see Chart 5.1). Meanwhile, the primary deficit contracted by Lm23.5 million from its 2004 level. Revenue grew by 13.3% over the previous year, surpassing the 9.7% growth in expenditure. As a result, the revenue-to-GDP ratio rose from 41.0% in 2004 to 44.1%, while the expenditure-to-GDP ratio also increased, reaching 48.0%.

Revenue

In 2005 revenue continued to expand at a rapid pace, rising by Lm99.5 million, or 13.3%. Growth in revenue was mainly driven by foreign grants, which accounted for half of the annual increase and, to a lesser extent, by higher yields from Value Added Tax (VAT) and temporary measures.

Non-tax receipts, which advanced by Lm63.1 million, accounted for three-fifths of the overall rise in revenue. Grants from the EU more than doubled in the first full year of membership. Together with official funds from Italy, grants went up by Lm52.8 million and accounted for most of the increase in non-tax revenue. These were boosted by licence fees relating to telecommunications, fees collected under the

Table 5.2
GOVERNMENT BUDGETARY OPERATIONS[1]

Lm millions

	2003	2004	2005	2003	2004 % change	2005
Revenue	**676.4**	**749.8**	**849.3**	**2.6**	**10.8**	**13.3**
Direct tax [2]	330.9	337.6	352.0	6.4	2.0	4.2
Indirect tax	274.6	301.2	323.2	4.3	9.7	7.3
Grants	2.5	30.3	83.1	-7.4	+	+
Other non-tax revenue	68.4	80.7	91.0	-16.9	18.0	12.8
Expenditure	**781.9**	**843.8**	**925.3**	**4.6**	**7.9**	**9.7**
Recurrent expenditure [2]	677.9	739.2	780.2	4.4	9.0	5.6
of which interest payments	63.0	69.6	75.1	-1.3	10.4	7.9
Capital expenditure	104.0	104.6	145.1	6.4	0.6	38.7
Primary balance [3]	-42.4	-24.4	-0.9	-	-	-
Balance on Consolidated Fund	**-105.4**	**-93.9**	**-76.0**	**-**	**-**	**-**

+ indicates a value exceeding +/- 100%

[1] Data for 2005 are the revised estimates, as shown in the *Financial Estimates 2006* and the *Budget Speech 2006* published in October 2005

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

[3] Total revenue less total expenditure excluding interest payments

Source: Ministry of Finance.

[5] This analysis is based on information contained in the Financial Estimates 2006 and the Budget Speech 2006. The Consolidated Fund captures most of the transactions of central government on a cash basis.

Investment Registration Scheme and, to a lesser extent, eco-contributions.[6] Non-tax revenue also rose as a result of capital gains on the sale of Malta Government Stocks. However, a drop in Central Bank of Malta profits transferred to Government contributed negatively to non-tax revenue.

Indirect tax revenue went up by Lm22.0 million, stemming from VAT, which yielded an additional Lm27.3 million. It was estimated that close to half of this increase reflected temporary factors that had curtailed growth in the previous year.[7] More buoyant economic activity and, to a lesser extent, the collection of arrears following the amnesty scheme launched by the Government, also contributed.[8] Customs and Excise yielded Lm3.2 million more than in 2004, mainly due to higher receipts from duties on cigarettes, petroleum and mobile telephony. In contrast, intakes from levies on imported goods fell as a result of the removal of levies on EU products upon accession in May 2004. On the other hand, revenue from licences, taxes and fines contracted by Lm8.4 million due to the non-recurrence of a licence payment related to the privatisation of public lottery operations in 2004.

Direct tax revenue advanced by Lm14.3 million, with income tax being the main contributor. This rose by Lm13.4 million, mainly reflecting a strong intake from capital gains tax, although higher income from employment also contributed. The latter also led to a modest rise in revenue from social security contributions.

Expenditure

In 2005 expenditure expanded by Lm81.5 million, or 9.7%, reflecting increased outlays on infrastructure coupled with additional expenditure on social security benefits and contributions to the EU's own resources. Recurrent outlays went up by Lm41.0 million, mainly reflecting higher spending on programmes and operations, which advanced by Lm35.3 million, or 9.0%.[9] Expenditure on social security benefits, mostly retirement pensions, and contributions to the EU's own resources, added Lm13.5 million and Lm8.0 million, respectively, and accounted for most of the rise. The increase in spending on programmes and operations was contained by new policies regarding the procurement of pharmaceuticals and was also dampened by the non-recurrence of payments effected in 2004 as compensation for the increase in the standard VAT rate in that year.

The government wage bill increased by only Lm2.5 million in view of tighter control on recruitment coupled with a better deployment of employees. Interest payments, however, expanded by Lm5.5 million, reflecting increased levels of debt outstanding.

Capital expenditure continued to expand in 2005, advancing by Lm40.5 million over the previous year's level. Higher outlays were mostly attributable to the new state hospital and roads, with the latter being co-financed by grants from Italy. Acquisition of new equipment for the Armed Forces of Malta and payments for the purchase of land by the Government also contributed. However, growth in capital spending was dampened by a base effect as a result of the purchase by Government of premises for Malta's Permanent Representation in Brussels in 2004.

Government debt and financing operations

During 2005, the increase in gross government debt was smaller than the deficit on the Consolidated Fund, as the further sale of shares by Government in Malta

[6] As from 2005 fees of office include receipts from television licences that were previously collected and retained by the Public Broadcasting Services. In addition, network licences related to mobile telephony amounted to Lm5 million. Meanwhile, the Investment Registration Scheme was reactivated between 22 April and 30 June 2005. The Scheme allowed Maltese residents who held undeclared investments abroad to regularise their position by declaring them and paying a one-time fee. This scheme yielded approximately Lm6 million in 2005.

[7] It is estimated that the change in timing of payment for VAT from the import to the retail stage, introduced in 2004, cost Government some Lm15 million in foregone revenues. This was partly offset by one-off revenue, amounting to Lm3.2 million, derived from the registration of yachts at a reduced VAT rate.

[8] Under this scheme, individuals who cleared their outstanding tax balances, together with the accrued interest, by 30 September 2005 had their penalties waived.

[9] Includes programmes & initiatives and operational & maintenance expenditure.

Table 5.3
GOVERNMENT DEBT AND FINANCING OPERATIONS

Lm millions

	2003	2004	2005
CONSOLIDATED FUND BALANCE	**-105.4**	**-93.9**	**-76.0**
Contributions to sinking funds (foreign)[1]	-5.9	-7.2	-7.0
Contributions to sinking funds (local)[1]	-6.4	-5.2	-5.5
Sinking funds of converted loans	2.1	8.9	4.0
Proceeds from sale of assets	0.0	0.0	18.0
Borrowing requirement	115.6	97.4	66.5
Changes in			
Gross Government debt [2]	**209.4**	**93.8**	**50.8**
Malta Government stocks[3]	100.4	100.0	110.6
Treasury bills[3]	39.7	13.1	-55.1
Local loans	41.8	-15.2	-1.4
Foreign loans	27.5	-4.0	-3.3

[1] Negative figures indicate an application of funds.

[2] The change in gross Government debt is not necessarily equal to the public sector borrowing requirement due to changes in Government deposits and differences in definitions used.

[3] The figures exclude government debt held by Government Sinking Funds

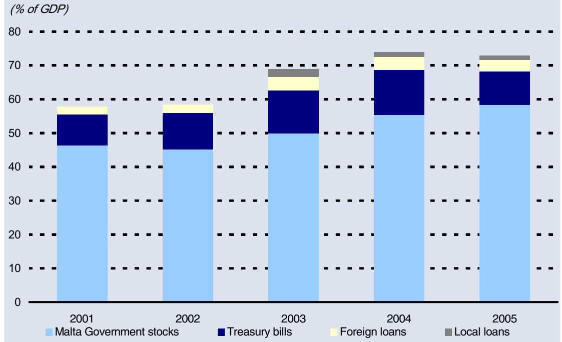
Sources: Central Bank of Malta; Ministry of Finance.

International Airport reduced the borrowing requirement by Lm18.0 million (see Table 5.3). Thus, over the year, gross government debt went up by Lm50.8 million to Lm1,404.2 million, or 72.9% of GDP (see Chart 5.2).[10]

The increase in debt outstanding took the form of medium- to long-term Malta Government Stocks (MGS), which rose by Lm110.6 million. This resulted in a shift in the structure of the debt away from short-term borrowing, with Treasury bills outstanding contracting by Lm55.1 million. Meanwhile, both foreign borrowing and borrowing from local banks declined. The former decreased by a modest Lm1.3 million following repayments that took place in 2005. Similarly, the outstanding value of foreign loans also fell due to repayments and, to a lesser extent, favourable revaluation effects.

Consequently, MGS outstanding at year end amounted to Lm1,123.5 million, or 80% of government debt, while Treasury bills totalled Lm190 million, or 13.5%. Local and foreign loans, which stood at Lm25.3 million and Lm65.2 million, respectively, accounted for the remainder.

Chart 5.2
GROSS GOVERNMENT DEBT
(% of GDP)



Source: Central Bank of Malta.

[10] Data on government debt refer to central government excluding extra-budgetary units. The figures exclude government debt held by Government Sinking Funds. The debt ratio differs from that given in the Update of the Convergence Programme, reflecting more recent figures on the stock of debt outstanding and the latest GDP data.

6. Financial Stability Analysis

During 2005 the Maltese economy improved in an environment of low interest rates. In this scenario, credit institutions maintained a strong financial position, holding capital in excess of the minimum regulatory requirements and registering higher profits. This improved performance mainly resulted from higher net interest income. The non-bank financial sector also reported a strong capital position. Developments in the household sector were characterised by strong growth in borrowing for housing purposes as property prices continued to rise substantially. This notwithstanding, developments in the housing market on their own do not appear to be a major cause for concern for the Maltese financial system. Therefore, the overall medium-term outlook from a financial stability perspective remains positive, although certain areas warrant closer attention.

Regulatory and structural developments

The entry into force of various legislative and regulatory provisions together with structural changes in the system characterised the financial sector during 2005.

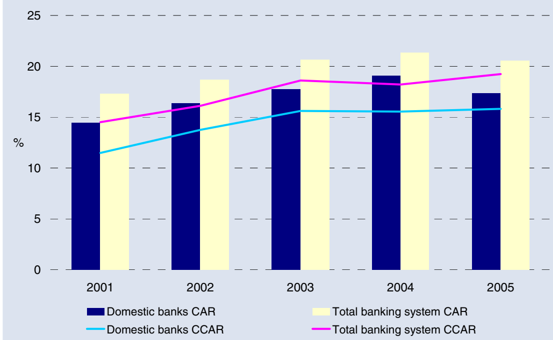
The MFSA continued to strengthen the regulatory framework through the issue of new and revised directives. A number of regulations governing the financial sector entered into force during the year. Foremost among these were the *European Passport Rights for Insurance Intermediaries Regulations,* transposing European Union Directive 2002/92/EC of 9 December 2002, the *Companies Act (The Prospectus) Regulations* and the *Investment Services Act (Investment Advertisement and Prospectus Exemption) (Amendment) Regulations,* further transposing the relevant provisions of EU Prospectus Directive 2003/71/EC of November 2003. The Listing Authority approved a number of amendments to its listing rules, which came into force in the course of the year.

During 2005, the MFSA revised the *Code of Good Corporate Governance*, which was adopted by issuers of listed securities in 2001. In November, the MFSA issued a consultative document on a new *Code* to be adopted by public interest companies, which include institutions authorised to carry out business under the relevant financial laws, non-listed public companies and 'large' private companies.

The main structural changes to the domestic financial system were related to the issue of new licences. Three new credit institutions were authorised to carry out the business of banking under the Banking Act, while two non-bank financial institutions were authorised under the Financial Institutions Act, mainly to undertake credit and money-broking activities. On the other hand, two non-bank financial institutions and one stockbroking firm voluntarily surrendered their licences. In the insurance sector, four principals were licensed, while one ceased operations. Furthermore, four new institutions were authorised to carry on the business of affiliated insurance in specified classes of general insurance. In the investment services sector, eleven schemes offering professional investor funds (PIFs), which target qualified or experienced investors, were licensed to start operations during the year.

Developments in EU financial regulation are expected to continue to impact on the financial system in Malta. Following the implementation of most of the Financial Services Action Plan, the EU Commission issued a White Paper on Financial Services Policy for 2005-2010, outlining proposals for the further integration of European financial markets. More specifically, the proposals cover the provision of mortgage credit to the retail sector and consumer protection. The Paper also addresses the regulatory and supervisory structure within the EU, clarifying in particular the division of responsibilities between home and host countries. During 2005, the European Parliament accepted the European Commission's proposal for a new Capital Requirements Directive (CRD), which is to be implemented in 2007. The effect of this Directive on individual domestic credit institutions will depend largely on whether they adopt the advanced approaches for the allocation of capital. Under the new CRD, credit institutions that lend predominantly to small and medium sized enterprises (SMEs) or to retail customers will require a lower capital allocation. On the other hand, all credit institutions will have to allocate additional capital to cover operational risks.

Chart 6.1
CAPITAL ADEQUACY



Financial sector

The banking sector

Although the overall capital adequacy ratio (CAR) of the banking system declined during 2005, it remained strong and well above the statutory requirement. This robust position was mainly due to internal capital accumulation attributable to the banks' positive financial results in recent years.

After having risen steadily over the previous three years, the CAR of the entire banking sector fell by almost one percentage point to 20.6% in 2005 (see Chart 6.1). Robust credit growth led to a faster increase in the banks' risk-weighted assets compared to their own funds, resulting in the weakening of the ratio. In the case of the domestic banks, the capital ratio dropped to 17.3% compared to 19.1% a year earlier.[1] Apart from growth in their risk-weighted assets, the fall in the domestic banks' CAR reflected a drop in their own funds that resulted from the transfer of distributable reserves and other adjustments. While the domestic banks' core capital adequacy ratio (CCAR) remained stable, the CCAR of the entire banking system continued on its upward trend, rising by one percentage point to 19.2%. Univariate stress testing confirms the strong shock-absorbing capacity of the banking sector.

The operating profits of the banking system went up by 22.2% during 2005, mainly driven by higher net interest income. In turn, the latter was largely underpinned by wider interest rate spreads and credit growth. Higher commission income and cost containment also contributed positively towards the banks' performance. The cost-to-income ratio thus continued its trend decline (see Chart 6.2).

While the return-on-equity (ROE) for the banking system rose to 14.6% during 2005 from 13.9% a year

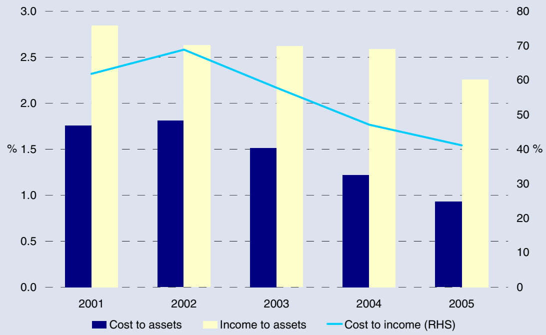
Table 6.1
FINANCIAL SOUNDNESS INDICATORS

%

	2001	2002	2003	2004	2005
Regulatory capital to risk-weighted assets (CAR)	17.32	18.68	20.65	21.35	20.58
Regulatory Tier 1 capital to risk-weighted assets (CCAR)	14.50	16.12	18.60	18.21	19.24
Non-performing loans net of provisions to capital	70.88	53.73	38.43	30.59	19.84
Non-performing loans to total gross loans	11.30	9.72	8.06	6.56	3.92
Return on assets (ROA)	0.83	0.75	0.99	1.32	1.24
Return on equity (ROE)	12.41	8.91	10.19	13.90	14.61
Interest margin to gross income	65.86	71.15	70.91	45.42	48.74
Non-interest expenses to gross income	61.82	68.86	57.77	47.08	41.11
Liquid assets to total assets	27.10	24.48	24.38	24.25	21.59
Liquid assets to short-term liabilities	59.15	54.65	55.77	45.52	57.90

[1] Credit institutions that transact predominantly with residents are referred to as domestic banks in this chapter.

Chart 6.2
PROFITABILITY



earlier, the return-on-assets (ROA) fell slightly, to 1.2%, over the year (see Table 6.1).

The total assets of the banking system rose by 30.5% to Lm11.7 billion, largely due to higher lending and increased holdings of investment securities. The latter rose by 32.8% as banks sought higher-yielding investment opportunities. The lending portfolio of the entire banking system increased by 27.2% to Lm4.7 billion during 2005, largely reflecting an increase in lending to non-residents. At the same time, the lending portfolio of the domestic banks rose by 6.4% to Lm2.5 billion as at end-December 2005.[2] For the past four years, bank lending continued to grow at a relatively modest rate but still faster than deposits. This notwithstanding, the funding gap as at December 2005 remained adequate.

Asset quality within the banking sector continued on its positive trend, with non-performing loans as a proportion of the loan portfolio dropping from 6.6% in 2004 to 3.9% during 2005. The corresponding ratio reported by the domestic banks also decreased, from 10.5% to 7.4%, through the additional write-off of bad debts and an improvement in underlying asset quality (see Chart 6.3). The improvement was attributable to the household sector and most of the corporate sector. As a result, the domestic banks' exposure to credit risk has diminished, although concerns remain on the concentration of bank lending in specific economic sectors and the still high level of non-performing loans.

The overall improvement in the credit risk environment continued to be reflected in a marked reduction in provisions for loan losses. These dropped by Lm10.9 million to Lm59 million by the end of the year, as a Lm15 million contraction in specific provisions was partly offset by a Lm4 million increase in general provisions. Nevertheless, the coverage ratio rose by three percentage points to 28.9%, reflecting the reduction in non-performing loans referred to earlier (see Chart 6.4).[3] The overall level of non-performing loans and the concentration of the credit portfolio towards specific economic sectors could, however, raise concerns about the longer-term sustainability of the lower loan loss provisions.

The non-bank financial sector

Links between the banks and the non-bank financial sector are manifested largely through cross-sectoral equity holdings.

Despite the closure of an insurance principal, the

Chart 6.3
NON-PERFORMING LOANS

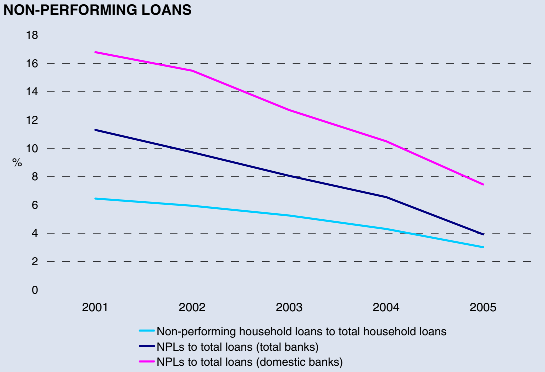
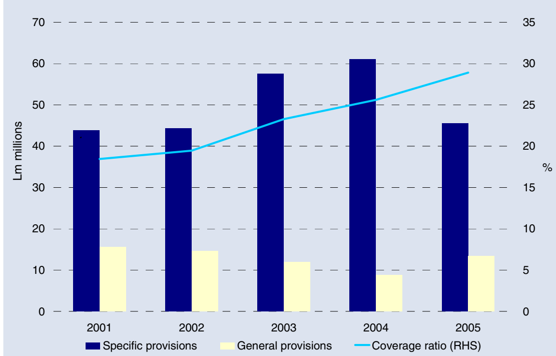


Chart 6.4
PROVISIONS



2 These data exclude interbank loans.
3 The coverage ratio is defined as the ratio between total provisions and non-performing loans.

balance sheet total of the insurance sector expanded by 24.5% during 2005 resulting mainly from increased technical reserves counterbalanced by a larger portfolio holding of Malta Government securities and quoted equity of non-associate companies.[4] Profitability within this sector improved, mainly due to cost containment, as premium income remained stable. Results of stress testing exercises indicate a strong shock-absorption capacity.

As at end-December 2005, the majority of the fourteen locally-based Collective Investments Schemes (CISs) were open-ended. Total assets amounted to approximately Lm574 million, an increase of 33% compared to the previous year. Malta Government securities accounted for most of the assets held by locally-based CISs, with equities of domestic credit institutions and foreign securities also being significant. On the other hand, the net asset value of PIFs, which generate high volume business activities, exceeded Lm1.2 billion by the end of 2005.

The thirteen financial institutions licensed by the MFSA under the Financial Institutions Act registered a marginal decrease in total assets, to Lm9 million, by the end of 2005.[5] During the year, the profitability of this sector declined as non-interest income contracted while wages and salaries rose. Nevertheless, as these institutions are small and undertake a limited range of activities, they do not pose any financial stability concerns.

The non-financial sector

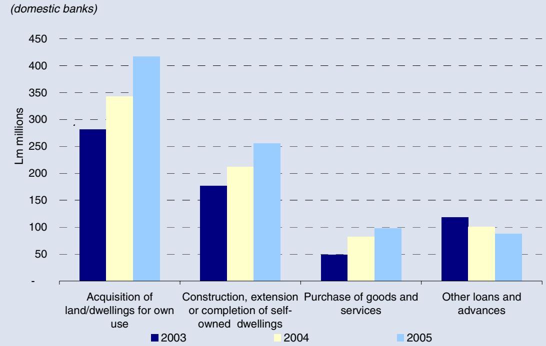
The household sector

Households' net wealth increased during 2005, despite additional borrowing from banks. Household debt expansion slowed down, but it still grew by a strong 13.4%, driven mainly by an increase in mortgage loans (see Chart 6.5).[6] Buoyant property prices and the relatively low interest rate environment boosted lending directed towards the real estate market. However, although credit standards remained basically unchanged during 2005, more conservative loan-to-value ratios for house purchases may have contributed to the slowdown in borrowing by households.[7]

The expanding demand for dwellings, partly fuelled by the search for yield, pushed up house prices, as explained in Chapter 3 of this Report. The rapid growth of household debt, coupled with lower estimated disposable incomes, raised the debt burden to 71.8% in 2005 compared with 63.3% a year earlier.[8] The rise in the debt burden may put pressure on the household sector, especially in the event of substantial increases in interest rates, since the majority of loans carry a variable rate of interest. According to the information submitted in the latest Bank Lending Survey, further increases in property lending are expected in 2006, with an increased concentration in the 80% to 90% loan-to-value ratio bracket, with the proportion of lending at higher loan-to-value ratios falling. Consumer lending remained basically unchanged during 2005, following a 10.3% surge in 2004.

From a financial stability perspective, if mortgage lending continues to expand, the probability of costly adjustments in the future would increase. This

Chart 6.5
HOUSEHOLD BORROWING
(domestic banks)



[4] Data cover eight insurance principals conducting business directly in Malta.
[5] Nine financial institutions mainly trade in foreign exchange; three others conduct lending activities, with the remaining company being involved in money broking.
[6] Mortgage loans consist of loans directed towards the acquisition of land/dwellings for own use and those directed towards the construction, extension or completion of self-owned dwellings.
[7] These data are derived from the Bank Lending Survey conducted with domestic banks by the Central Bank of Malta.
[8] The household debt burden is defined as gross household debt in relation to disposable income.

notwithstanding, the default rate by borrowers for the purchase of property has traditionally been very low and remains on a decreasing trend. In addition, although the default rate on other categories of household loans is generally higher, this fell during 2005.

The corporate sector[9]

The net indebtedness of the corporate sector to the banking system fell by 1.1% during 2005, as an acceleration in corporate deposits outweighed a marginal increase in corporate loans. Corporate deposits increased by 7.9% to Lm447 million, with the fastest growth taking place in deposits denominated in foreign currency. However, nearly two-thirds of corporate deposits are still held in Maltese lira. The economic recovery contributed to a 25% decrease in non-performing loans to the corporate sector as the quality of loans granted to the wholesale & retail and the real estate, renting & business activities sectors improved. This reduced credit risk significantly, although rising oil prices may pose significant risks to the profitability and liquidity of the corporate sector, especially small and medium-sized enterprises.

Market infrastructure

Total market capitalisation on the MSE rose to Lm2.9 billion in 2005 from Lm2.2 billion a year earlier, mainly driven by higher equity prices, whose capitalisation reached Lm1.5 billion. The MSE share index rose by a substantial 62.3% to 4980.7, compared to the 44.4% growth recorded in 2004. This was largely the result of an increase in bank share prices, which mainly reflected the significant profits recorded in 2005 as well as other factors such as bonus issues and splitting of shares. The commencement in 2006 of activity in the Off-Exchange market is expected to increase market accessibility. From a financial stability perspective, the main concern relates to the lack of liquidity in the domestic capital market. This is especially true of the market for corporate bonds, which during the year experienced lower turnover in both value and volume terms.

During 2005, the MSE became an active participant in MaRIS, the domestic real-time gross settlement system, bringing the number of participants to seven. MaRIS contributes to a significant reduction in credit risk but requires higher liquidity positions so that gross settlement can be effected on a daily basis.

Risk outlook

The economic recovery during 2005 contributed to an improved financial environment. The Bank's short- to medium-term financial stability outlook, which focuses on downside risks to the baseline economic scenario rather than the most likely outcome, is favourable. However, certain areas warrant attention. A slowdown in economic activity, inflationary pressures or increased unemployment are seen as the major macroeconomic threats to the stability of the system. The rapid growth of household debt, rising house prices and the relatively subdued performance of the corporate sector pose some downside risks.

On the other hand, the high profitability registered by the banking sector, its robust capital position and improving asset quality are viewed positively. Moreover, results of univariate stress testing carried out in respect of exceptional but plausible events show that, even in adverse scenarios, credit institutions are able to withstand adverse economic and financial developments.

[9] Corporate data refer to resident companies with exposures to banks operating on the domestic market.

Part II

BANK POLICIES,

OPERATIONS AND ACTIVITIES

1. The Conduct of Monetary Policy

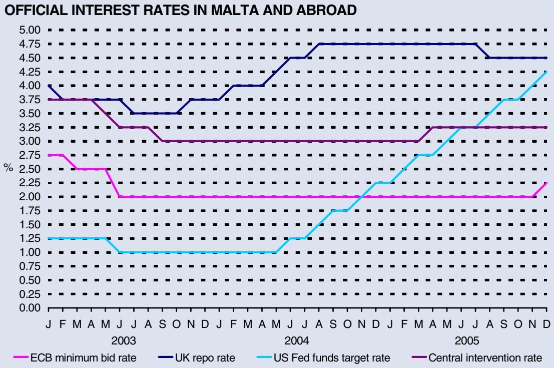
The Central Bank of Malta is responsible for the conduct of monetary policy, with the primary objective of maintaining price stability. Responsibility for exchange rate policy is shared with the Government. In a major development in this area, on 2 May 2005 the Maltese lira entered ERM II at a central parity rate of MTL/EUR 0.4293. Prior to entry into ERM II, the Maltese lira was pegged to a basket of three low-inflation currencies, namely, the euro, the pound sterling and the US dollar. In order to retain the same stability and benefits of a fixed exchange rate regime enjoyed in the past, the Maltese authorities committed themselves to maintain the exchange rate of the lira unchanged against the euro at the central parity rate.

Entry into ERM II did not affect the Bank's responsibility to set its own monetary policy, and as long as Malta remains outside the euro area, the Bank will continue to determine official interest rates in Malta. Consequently, the Monetary Policy Advisory Council meets monthly to analyse both domestic and international economic and financial developments and advise the Governor on monetary policy matters. The Governor, however, is solely responsible for taking decisions on monetary policy and, in particular, for setting the central intervention rate.

In April 2005, prior to ERM II entry, the Bank raised the central intervention rate by 25 basis points to 3.25% (see Chart 1.1). The decision to tighten the monetary policy stance followed a decline in the Bank's net foreign assets that reflected the liberalisation of trade, a higher fuel import bill and increased capital outflows that were being compounded by strong growth in credit to the personal sector. However, entry into ERM II had a positive impact on financial market sentiment and the Bank's external reserves first stabilised and then recovered. Thus, the Bank's net foreign assets, expressed as a proportion of the monetary base, declined until May and moved upwards thereafter, moderating during the last quarter of the year (see Chart 1.2). Meanwhile, the statutory ratio between the external reserves and the Bank's currency and deposit liabilities dropped to 103.9% in May and stabilised in the last two quarters, ending the year at 107.4%.

The increase in the central intervention rate in April resulted in a corresponding rise in domestic money market rates. The rise in the latter, coupled with a broadly stable three-month euro rate, offset higher short-term interest rates on the pound sterling and the US dollar and led to a widening in the three-month premium on the Maltese lira. This went up from 38 basis points at the end of December 2004 to 58 basis

Chart 1.1
OFFICIAL INTEREST RATES IN MALTA AND ABROAD



Sources: Central Bank of Malta; Reuters.

Chart 1.2
TRENDS IN THE CENTRAL BANK OF MALTA'S NET FOREIGN ASSETS

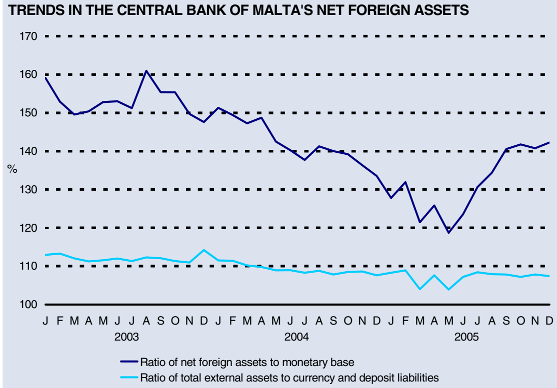
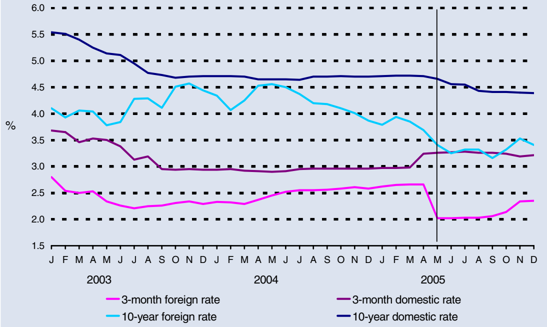


Chart 1.3
DOMESTIC AND FOREIGN MARKET INTEREST RATES



Sources: Central Bank of Malta; ECB.

points in April (see Chart 1.3).[1] The premium widened sharply to 124 basis points following ERM II entry, as sterling and the US dollar, both of which offered relatively high rates, dropped out of the relevant comparator. However, during the second half of the year money market rates in the euro area rose consistently, so that the short-term premium on the lira narrowed, ending the year at 87 basis points. Similarly, the ten-year premium on the Maltese lira also rose during the first half of the year. From 83 basis points at end-2004, this premium widened to 102 basis points in April and increased further following ERM II entry, peaking at 131 basis points in June. It contracted thereafter, reaching 98 basis points at end-December.

External reserves management

According to the Central Bank of Malta Act, the Bank is obliged to hold external reserves equivalent to not less than 60% of its currency and deposit liabilities. The reserves, which play a key role in supporting the exchange rate in ERM II, are mainly composed of bank deposits and investment grade securities issued by non-residents.[2] In managing its portfolio, the Bank seeks, in order of priority, to ensure adequate liquidity to meet domestic demand, to safeguard the value of its foreign assets and to maximise return within the established risk parameters. The parameters for the management of the Bank's reserves are set by the Investment Policy Committee (IPC), within the broad framework approved by the Board of Directors with regard to eligible investment instruments and counterparties. The IPC, which is chaired by the Governor and includes the Deputy Governor and selected senior officials of the Bank, meets on a monthly basis.

In the light of the above reserve management objectives, the Bank operates a prudent risk management framework aimed to provide proper safeguards against credit, foreign exchange and other market risks. The Bank monitors credit risk that may arise from dealings with foreign financial institutions and bond issuers. Through the use of extensive quantitative and qualitative techniques, it also ensures that market risk exposures are kept within the levels prescribed by the IPC.

The Bank computes and publishes daily spot and forward exchange rates for the Maltese lira against major currencies. Until the end of April, all spot transactions by the Bank with the credit institutions were denominated in euro, US dollar and sterling. However, with effect from May 2, when Malta joined ERM II, the Bank started dealing with credit institutions solely in euro. In addition, the Bank stopped dealing with financial institutions and narrowed its spreads on foreign exchange transactions. One forward contract was undertaken prior to ERM II entry.

In 2005 the Bank continued to be a net seller of foreign currency to credit institutions in the spot foreign exchange market. Foreign currency sales to them totalled Lm97.5 million, while purchases amounted to Lm85.9 million. Whereas before ERM II entry the Bank effected net sales of Lm76.9 million, in the ERM II period the Bank was a net buyer to the tune of Lm65.3 million. In addition to these spot transactions, the Bank opened Lm41.5 million worth of swap contracts with credit institutions, all of which matured before the end of the year.

---

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

[2] See the 'Financial Statements' section in this *Report* for more details.

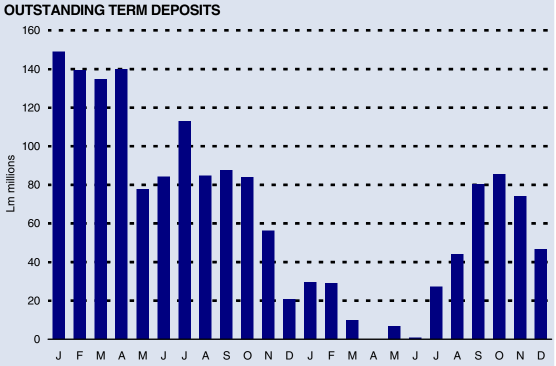
Transactions in the foreign exchange market, excluding deals by the Bank with credit and financial institutions, amounted to Lm2.9 billion, marginally below the level recorded in 2004. Meanwhile, trading in the local foreign exchange interbank market increased significantly during the year, particularly following Malta's entry into ERM II, with a total of 152 interbank foreign exchange transactions, amounting to Lm133.1 million, being recorded. This was considerably above the 64 transactions, worth Lm17.3 million, which took place in 2004.

The Bank collects daily data related to foreign exchange transactions against the Maltese lira. The analysis and evaluation of developments in the local foreign exchange market has acquired greater importance following the entry of the Maltese lira into ERM II. Since joining ERM II, moreover, the Bank also participates in a daily teleconference with the ECB regarding developments in foreign exchange markets in the countries that are members of the Mechanism.

Open market operations

The Bank engages in open market operations to ensure that the level of liquidity in the banking system and, hence, short-term interest rates, remain compatible with its monetary policy stance. Interventions in the money market are mainly conducted by means of weekly term deposit or reverse repo auctions. Reflecting an overall excess of liquidity during 2005, the Bank absorbed a total of Lm1.6 billion through term deposit auctions, Lm1.1 billion less than the amount absorbed the previous year. As a result, outstanding term deposits at the end of 2005 stood at Lm46.8 million (see Chart 1.4). Following the increase in the central intervention rate in April, the weighted average rate of interest paid on term deposits rose from 2.95% to 3.2%, and remained at that level until the end of the year.

Chart 1.4
OUTSTANDING TERM DEPOSITS



In spite of the generally high level of liquidity prevailing through most of the year, the period between March and July was characterised by temporary liquidity shortages, reflecting mainly a drop in the Bank's net foreign assets, which was, however, subsequently reversed. Consequently, during these five months the Bank injected Lm79.6 million into the banking system through reverse repo auctions, with the weighted average interest rate ranging from 3% to 3.28%.

As from 15 September 2005, the Bank reduced the term to maturity of its weekly open market operations from 14 days to seven days, to enhance liquidity management in the banking system and to align its operational framework more closely with that of the ECB.

Standing facilities

Standing facilities, which comprise overnight deposit and lending facilities, are used by central banks to inject or absorb liquidity on an overnight basis. The Bank offers a marginal lending facility, which consists of an overnight loan facility secured by a pledge of collateral. This facility was only used once during 2005, however, and the amount borrowed was marginal when compared to the previous year. The Bank also offers an overnight deposit facility. Credit institutions placed overnight deposits worth Lm233 million during 2005, an increase of Lm146.1 million in comparison to 2004.

On 15 September, the margin between the overnight lending rate and the central intervention rate was narrowed from 150 basis points to 100 basis points. Similarly, the margin between the central intervention rate and the overnight deposit rate was reduced from 150 basis points to 100 basis points. Consequently, while the marginal lending rate was brought down from 4.75% to 4.25%, the overnight deposit rate was increased from 1.75% to 2.25%.

During 2005, the Bank assessed developments in the ECB's collateral management framework to be able to align its framework with that of the ECB.

Reserve requirements

In terms of the Central Bank of Malta Act, the Bank may require credit institutions to maintain a certain minimum amount of reserve deposits with it. According to the relevant Directive, the Bank may exempt credit institutions from maintaining minimum reserves on a non-discriminatory basis. Following a review in terms of the Directive, as of 15 October an additional bank was exempted from holding required reserves, as the Bank judged that the imposition of the reserve requirement would not serve to meet its monetary policy objectives. Four credit institutions continued to be subject to the reserve deposit requirement.

In 2005 the reserve requirement ratio was left unchanged at 4% of the institutions' specified liabilities. Credit institutions are, however, allowed a certain degree of flexibility in the way they manage their liquidity, as balances in these accounts can vary as long as the requirement is met on average during the maintenance period.[3] In line with the rise in the central intervention rate the Bank, in April, increased the remuneration rate applied to reserve requirements by 25 basis points, from 2.75% to 3%.

Money and capital markets

The Bank continued to provide market-making facilities for government securities throughout 2005. It quoted daily bid prices and yields for all listed Malta Government Stocks (MGS) as well as daily buying and selling rates for Treasury bills.

In being ready to trade in such securities, the Bank contributes to the liquidity of the market. Nonetheless, in line with the Central Bank of Malta Act, the Bank does not participate in the primary market for government securities and does not provide any other form of financing to the Government. The Bank does, however, collect and analyse data on Government debt and contributes to the formulation of the Government's debt management strategy, particularly in view of the adoption of the euro. The Bank also quotes the International Securities Market Association (ISMA) redemption yields of all MGS on a daily basis.

In the secondary market for Treasury bills, the Bank quotes rates for both retail and wholesale amounts on the basis of average weighted yields emanating from the weekly Treasury bill primary market auctions, taking into account the central intervention rate for deals under one month.

Meanwhile, the Financial Markets Committee (FMC), which provides a forum for the regular exchange of views and information between the Bank and credit institutions on market-related issues, met ten times during 2005. The issues discussed included the currency arrangement that was to be adopted upon joining ERM II and preparatory work relating to the adoption of the euro. The Committee also discussed developments in the primary and secondary markets for Malta Government securities as well as issues related to the foreign exchange market.

3 This runs from the fifteenth day of each month to the fourteenth day of the following month.

Box 1: Preparing for the Euro Changeover

When Malta joined the EU in May 2004 it automatically joined the Economic and Monetary Union with the status of a Member State with a derogation. This means that Malta will eventually have to adopt the euro as its national currency. To be eligible for adopting the euro, Malta must fulfil the convergence criteria laid down in the Maastricht Treaty. Apart from meeting the criteria on public finance, interest rates and inflation, the Maltese lira must have participated in ERM II for at least two years. The lira, in fact, entered ERM II in May so that January 2008 is the earliest possible date for the adoption of the euro.

Since entry into ERM II, preparations for the adoption of the euro have been stepped up. After consultations with the Bank, the Government set up the structure to co-ordinate preparations for the euro changeover. In June a Steering Committee for the Euro Adoption (SCEA) was established to direct the changeover process and monitor progress of the necessary preparations at the national level. The Committee is chaired by the Parliamentary Secretary within the Ministry of Finance and includes the Governor, the Head of the Civil Service and the Chairperson of the National Euro Changeover Committee (NECC) as members. At the same time, the Government also established the NECC, which is responsible for formulating and implementing a strategic plan for the adoption of the euro and co-ordinating all matters related to the changeover. A number of sectoral committees were also set up within the NECC to focus on various aspects of the implementation strategy, covering the relevant areas of the economy and including a wide range of stake-holders. The Bank is an active participant in the NECC and has contributed to the preparation of national standards and guidelines on various matters related to the changeover, advising the NECC on matters within its competence. The work of the NECC is monitored by the Steering Committee.

The Bank chairs the Financial Sectoral Committee of the NECC, which also includes representatives from the Government, the MFSA, the NSO and credit and financial institutions. Bank officials also participate in a number of technical forums within the NECC structures, covering matters such as training and the migration of information systems to the euro. In addition, the Bank participates in meetings of the Malta Bankers' Association Euro Adoption Sub-committee, which seeks to reach common positions on practical issues related to the euro changeover and banking services. At a technical level, the channels for co-ordination of euro-related preparations were also strengthened through the Bank's participation in other financial sector structures, including the Financial Markets Committee, the Malta Clearing House and the Payment Systems User Group. More generally, EU matters relevant to the financial sector were also discussed in the context of the EU Committee for Banks, which continued to meet once a month.

From a broader EU perspective, the Bank participates in the Public Administration Network (PAN II) Committee, which is composed of government and central bank officials from Member States who exchange information and experiences on practical aspects related to the euro changeover. The Bank entered a twinning programme with the central banks and finance ministries of Ireland and Cyprus to draw on the Irish experience in formulating an effective communications strategy on the euro. The programme was partly financed by the European Commission.

2. Financial Stability

One of the Bank's statutory responsibilities is to ensure financial stability in Malta. In this regard, it monitors regularly the soundness of the financial system, including the domestic payment and securities settlement systems. The Bank's assessment of the workings of the financial system is shared with other relevant authorities, which are responsible for introducing corrective measures when deemed necessary.

A regular analysis of the performance of credit institutions and non-bank financial institutions is undertaken by the Bank and is the main area it focuses on when monitoring the soundness of the financial system. However, the Bank also investigates developments in the non-financial sector, primarily to assess whether weaknesses in this sector may have a negative impact on the financial sector as a whole. Furthermore, stress-test exercises are carried out to evaluate the strength of credit institutions in the event of exceptional but plausible adverse developments. These tests are applied in respect of credit and market risks. The Bank discusses its findings with the Malta Financial Services Authority (MFSA) in terms of the Memorandum of Understanding (MoU) signed between the two institutions in 2003. Twice a year the Bank publishes a summary of its assessments.

During 2005 the Bank continued to develop its analytical tools for the timely identification of problems related to the banks' credit risk through models that project likely changes in non-performing loans. It also initiated a project to develop further its stress-testing analysis on a macro basis by incorporating broader economic and financial indicators.

In following developments in the EU, the Bank continued to study the possible impact that certain EU directives and proposals could have on financial stability in Malta. Foremost among these were the Capital Requirements Directive and the EU Commission's White Paper on Financial Services Policy for 2005 - 2010.

In the course of the year the Bank continued to develop its on-going work on crisis management. To this effect, the Governor, the Chairman of the MFSA and the Minister of Finance, together with their counterparts in the European Union signed a Memorandum of Understanding on co-operation in the management of financial crisis situations between central banks, banking supervisors and ministries of finance. During 2006 the Bank will establish the necessary framework to meet the additional obligations arising from adherence to this MoU, which came into effect in July, and the ones signed in 2004.

During the year the Bank again participated actively in the ESCB's Banking Supervision Committee (BSC) and the associated working groups. In this respect, the Bank undertook a number of surveys of the banking system on behalf of the BSC and participated in a number of task forces addressing specific topics. Together with the MFSA, the Bank also participated in the meetings of the Committee of European Banking Supervisors.

The Bank also continued to be actively involved in the initiative of the IMF to compile financial soundness indicators that form the basis of the Fund's Financial Sector Assessment Programme. It also initiated a study, with the participation of other small island states, to assess particular financial stability issues affecting small islands.

3. Banking and Currency Operations

The Central Bank of Malta continued to provide banking services to the public sector and to credit and financial institutions in Malta. In addition, as the sole issuer of the domestic currency, it ensured that the supply of notes and coins was at all times sufficient to meet the needs of the public, that the currency in circulation was fit for use and that any counterfeits were quickly detected.

Banker to the public sector

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

In 2005 the banking sector negotiated 1.2 million cheques drawn on the Bank by Government departments, 13.7% less than in the previous year. However, the value of these cheques increased by 0.8% to Lm345.3 million. The main factor behind the reduced volume remains the growing use of the direct credit system. The number of direct credit payments increased from 1.4 million in 2004 to 1.5 million in 2005, while their value rose from Lm281 million to Lm299 million. Government salaries, which account for over half the value of such payments, declined marginally. In contrast, direct payments of social security benefits - including pensions - and of dividends on Malta Government Stocks increased, broadly mirroring developments in government expenditure overall.

The foreign exchange services provided by the Bank include the use of documentary letters of credit, inward and outward bills for collection, transfers, guarantees, and the sale and purchase of foreign exchange and travellers' cheques. The bulk of cross-border foreign exchange transactions are carried out through SWIFT transfers. In 2005 the value of foreign exchange receipts processed by the Bank on behalf of the Government and public corporations rose to Lm74.8 million, from Lm67 million in the preceding year. On the other hand, foreign exchange payments fell to Lm100.8 million, from Lm112.8 million in 2004.[1]

The Bank continued to advise the Government and public non-financial corporations on their external financing needs and was also responsible for effecting payments in connection with the Government's external debt servicing. In 2005 capital payments amounted to Lm3.3 million, down from Lm3.8 million a year earlier. Interest payments on outstanding foreign loans fell to Lm2.9 million, from Lm3.5 million in 2004. A further Lm6.9 million was transferred to sinking funds earmarked for foreign debt servicing.

The Bank also administered and maintained accounts in connection with the banking arrangement between Malta and Libya. Although this arrangement was still in force at the beginning of 2005, no activity was registered and the underlying agreement was officially terminated in April by mutual consent of the respective parties.

Banker to the banking system

As banker to the rest of the banking system, the Bank continued to provide credit institutions with deposit facilities.[2] These institutions maintain balances at the Bank to comply with statutory reserve requirements, to settle interbank transactions and to carry out daily operations in the domestic financial markets. The Bank also kept settlement accounts for the MSE, enabling brokers to settle trades in listed securities.

As investment manager for the Investor Compensation

[1] The Bank continued to manage the Foreign Pension Subsidy Scheme on behalf of the Government. The amount paid under this scheme dropped to Lm7,778 in 2005 from Lm10,215 in the previous year.

[2] The Bank also offers deposit facilities to some financial institutions, particularly foreign exchange bureaux.

Scheme and the Depositor Compensation Scheme, the Bank provided financial, accounting and other related support services to them.[3] As the designated custodian of assets under the Insurance Business Act of 1998, the Bank also held in its name, on behalf of insurance companies, certain specified assets backing funds guaranteed by the latter.

Payment and securities settlement systems

The Bank plays a central role in the management of the local payment and settlement system. It is responsible for the operation of the Malta Real-Time Interbank Settlement System (MaRIS) and the associated settlement and payment finality. In this regard, the Bank has full responsibility and control over the day-to-day business operations of the settlement accounts. During 2005, there were 45,825 interbank payments processed by MaRIS for a total value of Lm11.7 billion. Compared with 2004, the volume and value of the interbank payments processed by MaRIS dropped by 5% and 9%, respectively, mainly reflecting a reduction in the amount of liquidity absorbed by the Bank through open market operations.

The Bank continued to oversee the payment and securities settlement systems. As part of its oversight responsibilities, it assessed MaRIS against the Core Principles for Systemically Important Payment Systems issued by the BIS. In this regard, an oversight report on MaRIS was published on a monthly basis. In July 2005, the MSE became a participant in MaRIS and started sending payment instructions automatically. Further discussions were also under way for the Exchange to develop a delivery versus payment securities system.

The Bank also continued to manage the Malta Clearing House, through which most cheques issued in Malta are settled. The number of cheques cleared decreased slightly, from 6.6 million in 2004 to 6.4 million in 2005. On the other hand, the value of these cheques increased by 5% to Lm2.8 billion. The daily average number and value of cheques processed during the year amounted to 25,717 and Lm11.3 million, respectively.

Within an EU context, the Bank participated actively in discussions related to the development of new channels for effecting payments in euro. It also monitored closely euro area developments related to the introduction of the next generation of payment system that is expected to supersede TARGET. In this regard plans were being drawn up to enable the domestic financial sector to establish a link with the new system once Malta adopts the euro.[4] In addition, the Bank kept abreast of progress achieved in the development and implementation of the Single European Payments Area (SEPA). This is expected to increase the efficiency of payments in the euro area through the adoption of a single standard for credit transfers, direct debits and payment cards.

Currency operations

During 2005 the Bank continued to service the local currency needs of the banking sector. It took in currency notes and coins surplus to requirements and issued them in line with the demand from the banks. It also carried out a regular examination of notes and coins to ensure that a high quality standard was maintained. The Bank began to prepare a strategy for the possible introduction of euro notes and coins from January 2008.

Circulation of banknotes and coins

The stock of currency notes and coins issued and outstanding at the end of 2005 stood at Lm520 million, up by 2.7% over the end of the previous year (see Table 3.1). On a year-on-year basis, growth in currency in circulation slowed down, so that by the end of 2005 the share of notes and coins in broad money dipped to 17.1%, from 17.4% at the end of 2004.

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

[4] TARGET is the payment system that the Eurosystem uses for the settlement of central bank operations, large-value euro interbank transfers as well as other euro payments.

Table 3.1

CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE BANK IN 2005

Lm thousands

	Notes and coins			
	Issued	Paid-in	Net issue	Issued and outstanding[1]
January	23,642	30,417	-6,775	499,630
February	25,108	22,751	2,357	501,987
March	25,354	22,293	3,061	505,048
April	26,935	24,907	2,028	507,076
May	30,352	26,807	3,545	510,621
June	34,141	27,756	6,385	517,006
July	31,756	30,925	831	517,837
August	33,409	33,078	331	518,168
September	31,189	31,052	137	518,305
October	29,846	31,402	-1,556	516,749
November	28,755	29,166	-411	516,338
December	33,727	30,021	3,706	520,044
2005	**354,214**	**340,575**	**13,639**	**520,044**
2004	342,016	320,985	21,031	506,405

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

Throughout 2005 movements in the amount of currency in issue moved closely in line with the usual seasonal pattern. In January, currency in issue fell by Lm6.8 million reflecting the disposal of excess holdings accumulated by credit institutions during the festive period. Conversely, there was a rise of Lm3.7 million in December, reflecting the seasonal demand over Christmas. Strong demand was registered in June coinciding with the beginning of the peak tourist season.

At year end, the value of notes in issue amounted to Lm499.9 million, an increase of Lm12.8 million from the previous year's level. Their composition remained relatively unchanged, with the Lm10 note remaining the most widely used denomination, accounting for 69.7% of the total value of notes in issue. Its share in the total increased slightly at the expense of the Lm20 note, which remained the second most commonly used currency note in terms of value (see Chart 3.1).

The value of the outstanding stock of coins rose by Lm0.9 million during the year under review, with the increase spread more or less evenly across all denominations. The shares of the various denominations in the total thus remained broadly unchanged, with the Lm1 coin still the most important by value, followed by the 50c coin (see Chart 3.2).

Chart 3.1
COMPOSITION OF CURRENCY NOTES ISSUED AND OUTSTANDING AS AT END-2005

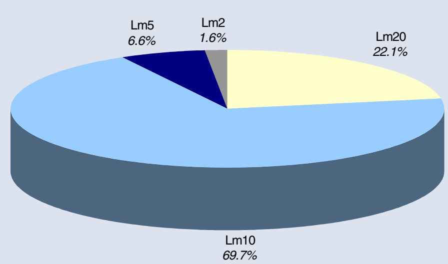
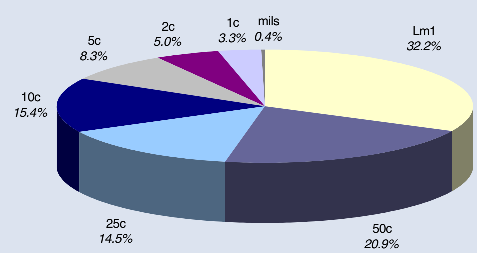


Chart 3.2
COMPOSITION OF COINS ISSUED AND OUTSTANDING AS AT END-2005



As part of the preparations for the introduction of the euro, during 2005 the Bank estimated the amounts of euro notes and coins that would be required in each denomination to satisfy future demand in Malta. In addition, preparatory work was carried out ahead of the public consultation on the designs for the national side of the Maltese euro coins held early in 2006.

Commemorative coins

On 15 June the Bank announced the issue of a new decimal coin set dated 2005. The set consists of the seven current Maltese coins of the Second Series and a 2mils coin of the First Series. The coins were struck at the Royal Mint of the UK, with a minting limit of 17,500 sets. The designs on the obverse and reverse sides of the coins remained unchanged.

Anti-counterfeit measures

The Bank continued to examine cases of counterfeit currency throughout 2005, analysing local and foreign banknotes suspected not to be genuine. In matters related to counterfeit euro notes, the Bank worked closely with the ECB, and staff members participated in a number of ECB working groups specialising in this area. The Bank's Currency Surveillance Unit continued to function as the National Counterfeit Centre, National Analysis Centre and Coin National Analysis Centre in accordance with ECB requirements.

4. Internal Management

Administration

Board of Directors

The Board of Directors is responsible for the policy and general administration of the Bank, except for matters relating to monetary policy where responsibility lies solely with the Governor.

At the end of 2005, the Board of Governors was composed of Michael C Bonello, Governor and Chairman, David A Pullicino, Deputy Governor, and Joseph V Gatt, Philomena Meli and Charles J Falzon as non-executive Directors. Bernardette Muscat served as Secretary to the Board. Over the year, the Board met twelve times.

Audit Committee

The Audit Committee was formally established in 2001. In 2005 amendments to the Central Bank of Malta Act gave legal recognition to the Committee and laid down its functions, which are to assist the Board of Directors in fulfilling its responsibilities in matters related to the internal and external audit process; risk management and internal control; and the financial reporting process. In terms of the changes to the Act and to better reflect international practices, the Board approved a new Audit Committee Charter comprising the Committee's updated terms of reference. The Committee was made up of Joseph V Gatt, as Chairman, Charles J Falzon and David A Pullicino.

During the year the Committee discussed the annual internal audit plan, internal control and risk management issues. It also discussed a new Guidance Note on the appointment and evaluation of external auditors, and held meetings with the latter to discuss the Bank's financial statements and the statutory audit, on which it gave its recommendations to the Board.

Management

The Executive Management Committee (EMC) is responsible for advising the Governor and Deputy Governor on policy matters concerning the management of the Bank and plays an important role in the daily administration of the Bank. The Committee is composed of the Governor as Chairman, the Deputy Governor, and the five Directors responsible for the five divisions of the Bank.

In the context of further integration within the ESCB, the Bank's ESCB Briefing Committee, which is chaired by the Governor and includes senior officials representing the Bank on the ESCB's twelve committees, continued to co-ordinate ESCB-related work.

Governor's official activities in Malta

During 2005 the Governor continued to sit on the Board of Governors of the MFSA and to participate as a member in meetings of the Malta Council for Economic and Social Development (MCESD).

As part of the preparations for ERM II entry, the Governor delivered a number of presentations on the institutional framework governing Economic and Monetary Union (EMU) and on the economic and practical requirements for successful participation in ERM II and the euro area. Presentations were attended by officials and members of staff of the Bank, members of the House of Representatives, the MCESD, the media and representatives of various sectors of the economy.

The Governor addressed various events organised by constituted bodies and professional organisations. These included the Malta Business Bureau, the Institute of Financial Services (Malta) and the Malta Hotels & Restaurants Association. The subjects covered included Malta's membership of the EU, growth and macroeconomic stability, globalisation, and the implications of the adoption of the euro. The Governor also addressed the Commonwealth Business

Forum held in November and gave various interviews to the local press.

Governor's official activities overseas

The Governor attended the four meetings of the General Council of the ECB held during the year. The Governor also accompanied the Minister of Finance to the informal ECOFIN meetings that were held in Luxembourg and the UK. In September he accompanied the Parliamentary Secretary at the Ministry of Finance to the Annual Meetings of the IMF and the World Bank. The Governor took part in a colloquium organised by the ECB in April in honour of Tommaso Padoa-Schioppa, who retired from the Executive Board, and attended the Annual General Meeting of the BIS in June.

In June the Governor also delivered a presentation on the promotion of growth through economic and financial stability during a seminar that was organised by the MFSA in London.

The Governor also gave interviews to the foreign media on a number of occasions.

Economic analysis and research

Bank staff carry out an on-going analysis of economic and financial developments in Malta and abroad as part of the monetary policy process. A wide range of data is assessed, including the results of surveys of business perceptions that are undertaken specifically for the Bank. The Bank publishes its analysis in its *Quarterly Review* and in the *Annual Report*.

During 2005 Bank staff prepared background material as part of the preparations for entry into ERM II. In particular, the Bank concluded a research project on the estimation of the equilibrium exchange rate for Malta, the strategy for Malta's participation in EMU and the eventual adoption of the euro. Together with external contributors, staff also analysed developments in house prices in Malta. Other reports and forecasts were also prepared at the request of the IMF, the ECB and the European Commission.

During the year under review, the Bank continued to provide forecasts of the main macroeconomic variables for the Maltese economy by means of its econometric model, which is based on quarterly data. Modifications to this model were undertaken to incorporate the impact of international oil prices on the economy. The Bank also prepared forecasts of key fiscal variables for Malta as part of the work carried out in this area by the ESCB.

Statistics

To enable it to carry out its tasks and to fulfil its national and international obligations, the Bank continued to compile, disseminate and publish a wide variety of economic and financial statistics.

The Bank continued to co-operate closely with other domestic agencies involved in the collection of statistics, particularly the NSO and the MFSA. The Technical Committee on Financial Statistics, which includes representatives of the NSO, the MFSA, the Malta Bankers Association, the MSE and credit and financial institutions, also met regularly during the year to co-ordinate the transition to new reporting systems and enhance existing ones.

The Bank continued to fulfil its statistical reporting obligations vis-à-vis the ECB. Consequently, in the course of the year the Bank strengthened its information management systems so as to improve the efficiency, security and quality of data exchanges with the ESCB. Meanwhile, Bank officials regularly participated in the work of ESCB committees and working groups as well as the EU's Committee on Monetary, Financial and Balance of Payments Statistics.

In preparation for Malta's future participation in the euro area, towards the end of 2005 the Bank started transmitting all monetary stock statistics as stipulated by the relevant ECB Regulation. For the first time, the Bank also compiled monetary flow statistics to be submitted to the ECB in early 2006. In addition, preparatory work was undertaken to implement ECB requirements concerning statistics on interest rates applied by MFIs to deposits and loans.

In the area of balance of payments statistics, the direct reporting data collection system continued to be extended to all sectors of the economy. The new reporting requirements were discussed with investment services providers, collective investment schemes, the MFSA and associations representing the financial sector. In June, experts from the ECB visited the Bank to discuss technical issues related to the compilation and reporting of statistics on the balance of payments and international investment position. Preparatory work was undertaken to begin publishing a monthly balance of payments statement in line with ECB requirements.

Work on the compilation of Malta's financial accounts in line with the ECB Guideline continued to gain momentum. Discussions with the NSO continued with the aim of compiling full financial accounts for Malta, including the non-financial sector.

The Bank, in conjunction with the NSO and the Ministry of Finance, continued to participate in the *ad hoc* Action Group on Government Finance Statistics (GFS). This group was set up to improve standards in the compilation of government finance statistics and to compile government deficit and debt data that are submitted to Eurostat twice yearly in terms of the Excessive Deficit Procedure. During 2005 the Bank revised the methods it uses to compile property prices in Malta.

The Bank regularly provided the IMF with data used in its surveillance of its members' economic policies and continued to meet the requirements set by the Fund's General Data Dissemination System (GDDS). Bank staff worked closely with an IMF mission that visited Malta between June and July to prepare a Report on the Observance of Standards and Codes (ROSC) data module that assessed the quality of Malta's macroeconomic statistics.

Administration of External Transactions Act

The Bank continued to collect, compile and disseminate statistical information on external transactions as required by the provisions of the External Transactions Act. In 2005 the Bank assisted the Ministry of Finance in launching a third Investment Registration Scheme, which allowed Maltese residents holding assets outside Malta in breach of exchange control or income tax rules to regularise their position. The Scheme commenced on 22 April and was terminated on 30 June 2005. In October one of the remaining restrictions on capital movements, that dealing with contracts of long-term insurance between residents and non-resident insurance undertakings operating outside the European Economic Area, was lifted.

Legal issues

The Bank was involved in the drafting of various pieces of legislation. In many cases, legislation was amended to incorporate EU financial directives and regulations into Maltese law. On 5 July 2005, amendments to the Central Bank of Malta Act came into force in order to transpose and implement Council Regulations (EC) No 2182/2004 and 2183/2004 concerning specifications of medals and tokens similar to euro coins. The amendments also introduced a specific reference to the Bank's Audit Committee and its role. In addition, the Bank amended its Directive No 5 to enhance the gathering of statistical information from credit institutions. In line with the requirements of Article 105 of the EC Treaty, the ECB was consulted on these legislative provisions.

In September 2005, the Interest Rate (Financial Transactions) Order was issued to lift restrictions on interest rates and the compounding of interest on various categories of obligations concluded within a regulated market to attract certain financial business to Malta. The Bank assisted in the drafting of legislation on pricing in euro. Contributions were made to the Mutual Evaluation Questionnaire on the third round evaluation of Malta by the MONEYVAL Committee of the Council of Europe on measures against money laundering and the financing of terrorism. The evaluation was undertaken in November.

A Working Group composed of officials from the Bank and the MFSA proposed further amendments to the Financial Collateral Arrangements Regulations 2004 to bring them in line with EU Directive 2002/47/EC. The Bank also cooperated with external legal advisors in the preparation of legal opinions on the enforceability of Master Agreements under Maltese law.

Data protection

The Data Protection Officer notified the Data Protection Commissioner of new processes introduced by the Bank during the year.

Human resources

As at end-2005, the Bank employed 306 full-time staff. A further sixteen staff members were employed on a part-time basis. Over the year, the Bank recruited twelve Economic Officers, one Junior Programmer, one Systems Operator and six clerks. At the same time, twelve employees resigned while one opted for voluntary severance. Another employee retired upon reaching retirement age.

As in previous years, the Bank offered temporary employment to six university students during the summer period. The Bank also participated in a Traineeship Scheme administered by the Swatar Training Centre and offered temporary work experience to three students attending IT courses at the Centre.

During the year the Bank commissioned an external consultancy firm to conduct a job benchmarking exercise, comparing jobs at the Bank with similar jobs in other central banks.

The Employee Assistance Programme launched in 1999 with the help of Caritas Malta was renewed in 2005. Moreover, the Bank entered into a one-year agreement with the Richmond Foundation, which provides rehabilitation and support services for persons with work-related health difficulties.

Training and development

The Bank continued to provide extensive training to staff members both through in-house training and through external courses organised by both local and foreign institutions (see Table 4.1).

Table 4.1

STAFF TRAINING

Type of Training	No. of Courses/Seminars	No. of participants
In-house	33	952
External		
Local	75	133
Overseas	40	43

As indicated in the Table, a large number of employees participated in external seminars and courses organised in Malta and abroad on a wide range of topics of interest to the Bank and on general management issues. Meanwhile, in-house courses during 2005 covered a variety of areas, including management and supervisory development, IT, economics and health and safety. In particular, the Bank organised a training programme on leadership development for managers and their deputies. Towards the end of the year, two five-session programmes were organised by an external consultant to familiarise staff with the structure, performance and challenges of the Maltese economy and the necessary policy orientations to meet them. All employees attended two divisional workshops, held in January and November, to examine the Bank's performance during the previous year and to identify the main challenges and prepare work plans for the year ahead.

During the year under review, the Bank again provided staff with development opportunities through short-term assignments with the ECB. In this way, staff members obtained valuable exposure to different work practices, thus enhancing their career prospects both at the Bank and with the ECB.

Academic and professional courses

In 2005 an economist was offered a one-year scholarship under the Bank's Development Scheme to read for a Masters Degree in Econometrics and Economics at the University of York. This Scheme encourages staff to pursue postgraduate courses at reputable foreign universities in areas relevant to the Bank's core functions. During the year under review, the first employee who had benefited from this scheme successfully completed the MSc in Economics at University College London.

Table 4.2
ACADEMIC AND PROFESSIONAL COURSES

	Number of employees	
Type of programme	Programmes completed	Programmes being pursued
Postgraduate courses	10	16[(1)]
Honours first degree courses	18	26
Post-graduate diploma courses	1	0
Diploma courses	4	7

[(1)] Includes one staff member on the Bank's development scheme and two on unpaid leave, all following full-time courses.

An increasing number of employees continued to make use of the Bank's study scheme, and several staff members completed their programmes during the year (see Table 4.2). Thirty-three staff members successfully completed academic and professional courses. By the end of 2005, three employees were following full-time courses, while 46 were following approved courses of study on a part-time basis.

Gender equality and discrimination

The Bank continued to give due importance to gender equality. During the year, members of the Bank's working group on the promotion of equality attended seminars organised by the National Commission for the Promotion of Equality for Men and Women (NCPE).

Women make up 38% of the Bank's full-time staff complement. They constitute 18% of the executive grade, slightly more than half of clerical employees and 10% of the staff in non-clerical grades. Furthermore, 45% of staff members involved in self-development programmes on a part-time basis were female. Women accounted for 35% of the participants in the Bank's internal courses; 33% of those attending local external courses and 37% of those following courses overseas.

Premises

During 2005, works on the Bank's service yards were carried out mainly to protect the bastions from water corrosion. In addition, alternative communication links were set up between the Bank's two premises to enhance communication in line with the Bank's business continuity plan.

Works were also carried out to create more space for the Bank's archives. Furthermore, older documents were scanned to increase storage space while facilitating access to them.

Furthermore, the Bank, in collaboration with the Valletta Local Council, carried out works in the area of St James Cavalier to make the environment safer for pedestrians.

Information technology

The process of upgrading the core applications of the computerised systems that support the Bank's operations was completed during 2005. The Reuters and the Library systems were also upgraded to the latest versions. Furthermore, all applications developed internally were rewritten or upgraded to ensure the use of a common development platform.

Throughout the year, the Bank participated in the ECB's IT Committee and Working Groups to familiarise IT staff with applications that need to be introduced to integrate the Bank's network with that of the Eurosystem, particularly in view of Malta's eventual adoption of the euro.

Internal audit

During the year, the Bank's Internal Audit Office continued to provide an independent assurance and consulting function to senior management, the Audit

Committee and the Board of Directors. The Office introduced a new manual comprehensively describing the mandatory internal audit procedures and the methodologies, practices and code of conduct to be followed by internal auditors. This manual adopts recognised international standards and complements the policies incorporated in the Audit Manual of the Internal Auditors Committee of the ESCB.

The Office conducted twenty-five risk based audits during the year in order to examine, evaluate and report on the adequacy of systems of internal controls, risk management and governance processes. These audits covered information security systems, financial issues, ERM II, reserve management, statistical information and market operations. Six of these audits were conducted on behalf of the ESCB. Several follow-up audits were undertaken to ensure the implementation of recommendations. The Bank also participated actively in the ESCB's Internal Auditors Committee and its Statistics Audit Task Force.

Risk assessment

During 2005 the Bank continued to identify, assess and manage a wide range of risks that are inherent to its operations. To this end, the Bank continued to review its internal policies and procedures and to develop a comprehensive risk management framework. In this regard, a Risk Matrix Database is being developed.

In the area of business continuity planning, the Bank ensured that critical business processes were covered by an operational Business Continuity Plan. Several tests were carried out to ensure that the Bank would remain operative even under adverse conditions. The Bank is also implementing an information security framework based on international standards. In this respect, the Board approved the Bank's Information Security Standard, which will be complemented by specific standards and policies on information sensitive assets. At the ESCB level, the Bank has actively contributed to initiatives relating to the establishment and implementation of a risk management framework.

Information and public relations

The Bank continued to communicate information about its activities and to maintain relations with the public and domestic and international institutions through regular press releases, its publications and its website. The Bank published its *Annual Report* and *Quarterly Review*, a weekly money market report and a monthly release on monetary developments.

In April the Bank, in conjunction with the Government, published a document on Malta's strategy for adopting the euro. Subsequently, the Bank introduced a section dealing with ERM II and the euro on its website. As part of its information campaign regarding the euro, the Bank collaborated with the European Commission to set up the Euro Coin Genesis Exhibition in Malta in July. This Exhibition, which illustrates how the common and the national sides of the euro coins were chosen, was inaugurated by the Governor and the European Commissioner for Economic and Monetary Affairs, Joaquín Almunia.

In January, the Prime Minister and Minister of Finance, Lawrence Gonzi, paid an official visit to the Bank.

Library

The Bank's library continued to be an important source of information in the fields of economics, banking and finance. Apart from servicing the needs of the Bank's staff, the library also met requests by other public and private sector bodies and the general public.

During the course of the year, the library upgraded its electronic cataloguing system. It also continued to acquire new books, periodicals and specialised publications related to the Bank's functions and operations. The library also continued to serve as depository for publications issued by international organisations, such as the IMF, the World Bank Group and the EBRD.

Cultural and educational activities

In November, the Governor inaugurated a permanent exhibition of coins used in Malta from Punic times to the early British era. A significant number of coins were received on loan from private collectors and were included, with the Bank's own collection, in the exhibition. To date, the exhibition consists of around 230 coins.

In March, a former Governor of the Bank, John Earland, donated a sum of money to create a fund to finance the award of an annual prize for studies related to financial markets. The first prize was awarded to the top Maltese candidate who sat for the examinations leading to the Certificate for Financial Advisors of the Institute of Financial Services.

During the year the Bank also sponsored a number of other philanthropic and cultural activities and continued to host educational visits for groups of local and foreign students.

5. Relations with International Institutions

During the year, the Central Bank of Malta continued to maintain an active relationship with international financial institutions, the ECB and the EU Commission. As a member of the General Council of the ECB the Governor participated regularly in the Council's meetings. Meanwhile, the Deputy Governor represented the Bank on the EU's Economic and Financial Committee (EFC). The Governor also continued to fulfil his role as Governor for Malta at the IMF and Alternate Governor at the EBRD.

With regard to relations with the World Bank Group, the Bank continued to co-operate with the Ministry of Finance on issues affecting Malta's membership of the IBRD and the MIGA and, following Malta's membership of this institution in June, the International Finance Corporation (IFC).

Although the Bank is not a member of the BIS, it participated, as in previous years, in seminars organised by the latter on matters related to financial stability and supervision. The Bank also monitored developments on the revised framework on bank capital adequacy, known as Basel II, proposed by the Basel Committee on Banking Supervision.

European System of Central Banks

The Bank continued to strengthen its relations with the ECB and the other twenty-four national central banks (NCBs) of the EU, which, collectively, form the ESCB. Besides the Governor's attendance at the quarterly meetings of the General Council, Bank officials continued to participate in ESCB committees and working groups. Following the entry of the Maltese lira into ERM II, the Bank also started to report regularly on developments related to ERM II to the ECB.

In 2005 the Bank hosted an 'out-of-Frankfurt' meeting of the Security Working Group of the ESCB Banknote Committee and an ESCB workshop on the implications of euro area membership for foreign reserve management by NCBs.

Reflecting its obligations as a member of the ESCB, the Bank consulted the ECB on measures implementing new EU Directives and Regulations and other legislative amendments within the remit of the Bank. It also notified such changes to other European institutions.

As in past years, the Bank's staff continued to benefit from short-term attachments and technical training in various areas of specialisation offered by the ECB and the ESCB. These included economic modelling and forecasting, business continuity management, financial risk assessment, liquidity and reserves management and the development of a glossary of financial terms. In June experts from the ECB visited the Bank to discuss technical issues related to the compilation and reporting of statistics on the balance of payments and international investment position.

Meanwhile, the Bank continued to invest in its infrastructure to bring its operating systems and reporting further in line with those recommended by the ESCB. In this regard, the Bank's monetary policy operational framework was reviewed, particularly the interest rate structure on standing facilities and the auction tenor. It also established new procedures for the detection, reporting and management of counterfeit notes in accordance with ESCB best practices. Furthermore, the Bank participated in the development of new channels for effecting payments in euro and took steps to conform further to international and EU standards in the area of statistics.

During the year, the Bank participated in a number of tests which were conducted by ECB experts on its information and communication systems, particularly those used for the direct transmission of statistical data to the ECB and the conduct of exchange rate intervention.

As part of its efforts to align further its translation capacity with ESCB requirements, the Bank worked with the ECB and linguistic experts on a glossary of Maltese economic and financial terms.

The Bank also continued to implement preparatory tasks related to the adoption of the euro in accordance with its changeover plan.

European Commission

A major development during the year was the entry of the Maltese lira into ERM II on 2 May. The decision to join the Mechanism was taken jointly by the Prime Minister and Minister of Finance and the Governor of the Central Bank of Malta, euro area ministers, the President of the ECB and the ministers and the central bank governors of Denmark, Estonia, Lithuania, and Slovenia, at the request of the Maltese authorities. This decision followed a series of discussions with officials from the European Commission, the ECB and the EFC on the state of preparedness of the Maltese economy for participation in the Mechanism.

As in 2004, the Deputy Governor and other senior officials of the Bank also participated in meetings of the EFC and its sub-committees when these discussed issues relevant to central banking or falling within central banks' expertise. During the year the Governor also attended two informal meetings of the EU Council of Ministers responsible for economic and financial affairs (ECOFIN).

The Bank also followed closely the debate on reform of the Stability and Growth Pact (SGP) and the assessments of the fiscal situation and the Convergence and Stability Programmes of the Member States that were carried out by the European Commission and the ECOFIN Council. As in past years, the Bank contributed to the update of Malta's Convergence Programme, which was prepared by the Ministry of Finance.

Senior officials of the Bank continued to attend meetings and conferences organised by the European Anti-Fraud Office of the European Commission (OLAF), including meetings of the Counterfeit Coin Experts Group (CCEG). The Bank also hosted a meeting of the Committee of European Securities Regulators (CESR) in Malta.

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

International Monetary Fund

As the institution representing Malta at the IMF, the Bank voted, in consultation with the Ministry of Finance, on a number of resolutions proposed by the Fund's Executive Board.

The Fund's holdings of Maltese currency and Malta's reserve position in the Fund remained unchanged from the levels reported at the end of 2004, at SDR61.7 million (around Lm32.0 million) and SDR40.3 million (around Lm20.9 million), respectively. Malta's SDR holdings, however, increased by SDR1.3 million to SDR32.1 million in 2005. The increase reflected purchases of SDR as a result of Malta's participation in the SDR Department as well as net interest earned on cumulative holdings.

Between April and May, an Article IV Consultation Mission visited Malta to discuss the latest economic developments and Malta's proposed strategy for participation in ERM II. During the visit, discussions were held with the Prime Minister, the Parliamentary Secretary in the Ministry of Finance and the Governor. The Mission also met representatives of financial institutions, the private sector and trade unions. The 2005 Article IV Staff Report for Malta was published in October.

The Bank also co-operated with the IMF and other Maltese authorities with statistical responsibilities to ensure compliance with the General Data Dissemination System (GDDS) and progress towards meeting the Special Data Dissemination Standard (SDDS). In this context, an IMF Mission visited Malta during the year to assess Malta's macroeconomic statistics against the SDDS.

In December the Bank gave its consent to the legal amendments proposed by the Executive Board of the Fund to allow the implementation of the newly established Exogenous Shocks Facility (ESF) and the Multilateral Debt Relief Initiative (MDRI).

World Bank Group

A major development in Malta's relations with the World Bank Group was the Government's decision to apply for membership of the IFC. The IFC is the World Bank affiliate that finances private sector projects in developing countries. The IFC Board approved Malta's membership in June. The Bank worked closely with the Ministry of Finance in completing the membership procedures. Prior to the membership date it effected a payment of USD1.6 million (around Lm0.6 million) on behalf of the Government in respect of Malta's shareholding in this institution. Malta became the 178th member of the IFC and holds 0.07% of its share capital.

The Bank also continued to monitor relevant developments in the World Bank and its affiliates, particularly those pertaining to Resolutions proposed by the Executive Boards of these institutions. In this regard, it liaised closely with the Ministry of Finance.

European Bank for Reconstruction and Development

The Bank continued to collaborate with the Ministry of Finance on issues related to Malta's membership in the EBRD. Together with the Ministry of Finance, the Bank examined a number of project proposals that were notified by the Office of the Executive Director representing Malta's constituency, which also includes Austria, Bosnia and Herzegovina, Cyprus, Israel and Kazakhstan.

In January a constituency meeting was organised by this Office. The meeting, which was hosted in Vienna by the Austrian Federal Ministry of Finance, discussed a number of issues of interest to constituency members as well as the EBRD's preliminary financial results.

During the year the Bank paid EUR28,750 (around Lm12,446) in respect of Malta's contribution to the general capital increase of the EBRD. The capital increase had been approved in 1996.

During the year, the House of Representatives ratified amendments to the Agreement establishing the European Bank for Reconstruction and Development providing for the acceptance of Mongolia as a country of operation of the EBRD.

Other

In November, the Governor of the Bank of Latvia, Mr Ilmars Rimsevics, visited the Bank. During this visit a short exchange of views was held on the two banks' experience with ESCB membership and preparations for the introduction of the euro.

As in previous years, the Bank participated in a number of seminars and conferences that were organised by non-EU central banks, international financial institutions and companies that supply business solutions to the financial industry.

During the year a senior official of the Bank participated in the 16th and 17th Plenary meetings of the Council of Europe Select Committee of Experts on the evaluation of Anti-Money Laundering Measures (MONEYVAL), forming part of the Malta Delegation to the Committee.

ECONOMIC & FINANCIAL POLICY CALENDAR 2005

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

2 February: ***European Commission assesses Malta's updated Convergence Programme***

The European Commission presents its assessment of Malta's updated Convergence Programme which was submitted in December 2004. It notes that the Maltese Government is on track to bring its deficit below the 3% reference value in 2006. The Commission recognises the particular characteristics of the Maltese economy when assessing risks to the outlook, but states that the prudent underlying macro-economic scenario, the nature of the announced measures aimed at reducing the deficit, as well as budgetary projections set up in the Programme make the consolidation path broadly possible.

4 February – 12 March: The following regulations and amendments to existing regulations related to the financial services industry are issued through legal notices:-

4 February: ***Regulations governing the distance selling of retail financial services, through Legal Notice 36.***

11 February: ***Regulations governing the transparency of financial relations between the State and Public Undertakings, through Legal Notice 45.***

These regulations stipulate that financial relations between the Government of Malta and public undertakings should be transparent, as provided in EU Commission Directive 80/723/EEC of 25 June 1980 as amended by Directive 85/413/EEC of 24 July 1985, Directive 93/84/EEC of 30 September 1993 and Directive 2000/52/EEC of 26 July 2000.

1 March: ***Regulations governing set-off and netting on insolvency amended, through Legal Notice 53.***

Minor amendments are made to the regulations governing set-off and netting on insolvency to bring these in line with EU Directive 2002/47/EC.

4 March: ***Regulations governing off-exchange trading amended, through Legal Notice 56.***

Minor amendments are made to the regulations governing off-exchange trading to bring these in line with EU Directive 93/22/EEC.

11 March: ***Regulations governing European Passport rights for credit institutions, through Legal Notice 66.***

The application of the principle Regulations governing European Passport Rights for Credit Institutions is extended to electronic money institutions.

12 March: ***Regulations governing the fair presentation of investment recommendations and the disclosure of conflicts of interest, through Legal Notice 106.***

Regulations are issued under the Prevention of Market Abuse Act (Act IV of 2005) governing the fair presentation of investment recommendations and the disclosure of conflicts of interest.

12 March: ***Regulations governing market practices and manipulative behaviour, through Legal Notice 107.***

Regulations are issued under the Prevention of Market Abuse Act (Act IV of 2005) to implement the relevant provisions of the Market Abuse Directive regarding market practices and manipulative behaviour and all related implementing measures.

12 March: ***Regulations governing disclosure and notification, through Legal Notice 108.***

15 March: ***Act to prevent financial market abuse introduced***

Parliament enacts the Prevention of Financial Markets Abuse Act 2005. The purpose of the Act is to safeguard the integrity of Maltese and European Community financial markets and to enhance investor confidence in those markets. The Act transposes and implements the Market Abuse Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation and includes any implementing measures issued there under.

1 April: ***Quotation and publication of Maltese lira exchange rate***

Banks in Malta begin quoting and publishing the exchange rate of the Maltese lira against the euro solely in terms of units of Maltese lira per EUR 1.00, thus conforming with the market convention for quotations of the euro against other currencies. All dealings in euro against the Maltese lira start being transacted at the day's applicable exchange rate quoted on this basis.

8 April: ***Central Bank of Malta raises central intervention rate***

The Central Bank of Malta raises the central intervention rate by 25 basis points to 3.25%. The decision aims to curb excessive credit growth, dampen resulting inflationary pressures and help to correct the existing imbalance between saving and spending, which is not sustainable in the medium-term. It also echoes the Monetary Policy Advisory Council's view that concerns over this imbalance outweigh concerns about the possible impact of higher interest rates on economic activity.

22 April: ***Regulations governing third Investment Registration Scheme issued***

Regulations governing the Investment Registration Scheme are issued through Legal Notice 121. The regulations provide for the establishment of the Scheme, the third to be launched, whereby residents of Malta who held assets outside Malta without the necessary exchange control authorisation, and/or without declaring the relevant income (including capital gains) for the purposes of the Income Tax Act, may regularise their position under the External Transactions Act, the Income Tax Act and other relevant laws.

26 April: ***Implementation of EU Directive establishing a new organisational structure for financial services committees.***

Through Legal Notice 124 (Order 2005 under the European Union Act of 2003), EU Directive 2005/1/EC, which establishes a new organisational structure for financial services committees, is implemented.

29 April: ***Entry of the Maltese lira into ERM II approved***

The euro area members, the ECB and the monetary authorities of Denmark, Estonia, Lithuania and Slovenia – the current participants in ERM II – approve the entry of Cyprus, Latvia and Malta into ERM II as from 2 May 2005.

Malta's decision to apply for entry into ERM II is taken by the Prime Minister and Minister of Finance on the recommendation of the Central Bank of Malta, against the background of a comprehensive economic assessment and consultations with the European Commission, the Economic and Financial Committee and the ECB. The Maltese lira enters ERM II with a central parity rate of MTL/EUR 0.429300. In order to retain the same stability and benefits of a fixed exchange rate regime enjoyed in the past, the Maltese authorities decide unilaterally to maintain the MTL/EUR rate unchanged during the ERM II phase.

The Communiqué issued by the European Commission following the meeting of 29 April states that the Maltese Authorities and the EU will monitor closely Malta's progress towards the fiscal targets set out in the Convergence Programme of the Government to ensure that any slippages are promptly detected and corrected. They will also monitor wage developments to ensure that these continue to reflect productivity developments. This, as well as the continuation of structural reforms, will be necessary to preserve the economy's capacity to adapt to external developments and its competitiveness.

7 June: ***Malta joins the International Finance Corporation (IFC)***

Malta signs the Articles of Agreement of the IFC and thus becomes the 178th Member of the IFC, an affiliate of the World Bank Group. This signifies that Maltese entities can partner the IFC in financing private sector projects in developing countries.

5 July: ***Malta Membership of the European Bank for Reconstruction and Development Act amended***

Parliament enacts the Malta Membership of the European Bank for Reconstruction and Development (Amendment) Act, 2005. This amendment enables the Minister of Finance to issue regulations under the Act and to ratify any amendments to the EBRD Agreement of 1990. As a result of the amendment the Minister of Finance was able to bring into force Malta's ratification of a change in the EBRD's Articles of Agreement enabling the EBRD to admit Mongolia as a country of operations.

5 July: ***Central Bank of Malta Act amended***

Parliament enacts the Central Bank of Malta (Amendments) Act, 2005. Among other measures, these amendments provide for the setting up of an Audit Committee chaired by one of the non-executive Board Directors to assist the Board in fulfilling its responsibilities in matters related to the Bank's internal and external audit process, risk management and internal control and financial reporting. The amendments also enable the Bank to own shares and take up other participations in international and national organisations as well as to participate in international monetary agreements to the extent necessary to carry out its tasks and duties under the law and in fulfillment of its international obligations.

4 July – 26 August: The following licences are issued to new credit institutions by the MFSA:-

4 July: ***To Finansbank (Malta) Ltd***

A banking licence in terms of the Banking Act 1994 is issued to Finansbank (Malta) Ltd. The bank is a subsidiary of the Netherlands registered Finans International Holding N.V., a wholly-owned subsidiary of Finansbank A.S., which in turn is incorporated in Turkey.

18 July: ***To Mediterranean Bank plc***

A banking licence in terms of the Banking Act 1994 is issued to Mediterranean Bank plc. The bank is licensed to carry out the business of banking mainly through the provision of private wealth management services to high net worth individuals and corporate clients. The envisaged activities include portfolio management, the accepting of deposits and lending in foreign currency.

26 August: ***To CommBank Europe Ltd***

A banking licence in terms of the Banking Act 1994 is issued to CommBank Europe Ltd. The bank, which is a subsidiary of Commonwealth Bank of Australia, is licensed to carry out the business of banking in Malta, specialising in the provision of wholesale banking services. In view of the granting of this banking licence, CommFinance Ltd, also a subsidiary of the Commonwealth Bank of Australia, surrenders its licence to carry on the business of a financial institution that was issued on 7 December 2004.

14 September: ***Change in name of credit institution***

The MFSA grants permission, in terms of Banking Directive BD/01, to Disbank Malta Ltd to change its name to Fortis Bank Malta Ltd. The change in name follows the regulatory approval for the purchase of shares from the majority shareholders of Turk Dis Ticaret Bankasi A.S. (the parent of Disbank Malta Ltd) in Turkey, by Fortis.

30 September: ***Rules governing disclosure and notification amended***

Legal Notice 322, issued under the Prevention of Financial Markets Abuse Regulations, amends Legal Notice 108 of 2005, setting rules governing disclosure and notification applicable to issuers of financial instruments, persons acting on behalf of such issuers, persons discharging managerial responsibilities within such an environment and professional persons arranging transactions in financial instruments.

30 September: ***Restrictions on interest rates lifted***

The Prime Minister and Minister of Finance issues Legal notice 323 under the Interest Rate (Financial Transactions) Order, 2005. This Legal Notice, which was issued in terms of the powers conferred on the Minister of Finance by Article 1855A(2) of the Civil Code, lifts restrictions on interest rates and the compounding of interest on various specified categories of obligations in order to attract certain financial business to Malta. The lifting of these restrictions is limited to those financial transactions where at least one of the contracting parties is a designated entity (as defined in the Order) operating in a reputable jurisdiction (also as defined in the Order).

13 October: ***Malta International Airport privatisation***

The Government of Malta offers for sale 13,530,000 shares, or 20% of the share capital of Malta International Airport plc. As a result, the shareholding of the Government of Malta in the company drops to 20%.

!4 October: ***IMF Executive Board approves Staff Report on Malta***

Following the visit to Malta of an IMF Article IV Consultation Mission in the spring, a Staff Report is approved by the IMF's Executive Board. The Report focuses on the Government's efforts to address macroeconomic imbalances and the ongoing privatisation programme, which would contribute to economic efficiency and reduce the high level of debt. It also stresses the need for further structural reform to complement fiscal consolidation and the need to streamline public bureaucracy and lower costs of operating in Malta.

31 October 2005: ***Measures introduced in the Budget for 2006***

The Prime Minister in his capacity as Minister of Finance presents the Budget for 2006 to Parliament. The main policy measures include:

Cost of living increase

- A cost of living increase of Lm1.75 and an additional Lm0.50 per week as compensation for the increase in the water and electricity surcharge that was announced in October.

Taxation

- A final withholding tax of 12 per cent on the value of property sales instead of the current system where profit on property transfers is taxed at 35 per cent. The sale of one's own residence is to remain tax exempt and there are no changes with regard to the tax treatment of property transfers by companies.
- A reduction in the registration tax on new commercial vehicles exceeding five tonnes.

Privatisation

- In 2006 the Government intends to complete the sale of its shares in Maltacom and Bank of Valletta. It is also seeking partners for Tug Malta and Kordin Grain Terminal.

Incentives to industry

- The Government announces new incentives under the Business Promotion Act for firms investing in ICT, research and development, back-office services and e-business services. Fiscal incentives are also targeted at the film industry. In addition, funds are allotted to upgrade industrial estates.
- Additional funding is to be made available for small and medium-sized enterprises and micro-enterprises.
- In tourism, a comprehensive branding exercise is being carried out, while a project is planned for the conservation of pre-historic temples.
- Additional measures are aimed at encouraging the generation of energy from alternative sources.

Administrative measures

- Tax evasion and the abuse of social benefits is to be reduced by strengthening the authorities' investigative powers and by making lending for property development available only against contracts of acquisition and fiscal receipts.

2 November: ***National Reform Programme launched***

The Government launches a National Reform Programme (NRP) for Malta covering the years 2005-2008. The NRP is intended to outline Malta's strategy for securing competitiveness, economic growth and job creation in terms of the EU's Lisbon Agenda.

4 November: ***New regulations amend legislation governing investment services***

New regulations, issued through Legal Notice 364 under the Investment Services Act (Control of Assets), amend earlier legislation to identify those entities that are authorised to act as custodians for collective investment schemes

8 November: ***Rules governing finance leasing***

These rules, issued through Legal Notice 369, define a financial lease for tax purposes and stipulate the manner in which the income of a lessor and that of a lessee is liable to tax, taking into consideration excess payments made for the purposes of transfer of ownership. The rules also provide for early termination of a lease term. These rules are to come into force as from the year of assessment 2006.

25 November: ***Regulations exempting advertisements and prospectuses issued by European based close-ended schemes from requiring approval in Malta***

Regulations exempting advertisements and prospectuses issued by European based closed-ended schemes drawn up in accordance with Directive 2003/71/EC of the European Union from requiring approval in Malta are issued through Legal Notice 388 in terms of the Investment Services Act.

25 November: ***Regulations governing the powers of the competent authority, advertisements relating to offers of securities, right of appeal and co-operation with other regulatory authorities***

Regulations dealing mainly with the powers of the competent authority, advertisements relating to an offer of securities to the public, the right of appeal and co-operation with other regulatory authorities are issued through Legal Notice 389 in terms of the Companies Act.

25 November: ***Regulations governing the content of prospectuses issued by companies constituted in EU Member States and EEA States***

Regulations setting out the prescribed content of prospectuses issued by companies constituted in an EU Member State or an EEA State, and the requirements for their approval and publication, are issued through Legal Notice 390 in terms of the Companies Act. The regulations also address issues related to the exercise of passport rights.

25 November: ***Order implementing Directive 2003/71/EC of the European Union***

This Order, which amends the Companies Act (Cap. 386) and introduces a number of additional provisions, including the definitions of "offer of securities to the public" and of "qualified investors", is issued through Legal Notice 391 in terms of the same Act.

25 November: ***Regulations governing the issuance of prospectuses by collective investment schemes***

Regulations governing the issuance of prospectuses by collective investment schemes and including provisions to allow the exercise of passport rights are issued through Legal Notice 392 in terms of the Investment Services Act.

9 December: ***Regulations governing financial collateral extended to collective investment schemes***

Through Legal Notice 401, minor amendments are made to the regulations governing financial collateral arrangements so as to include collective investment schemes within the scope of the regulations.

9 December: ***MFSA guidelines extended to custodial arrangements of professional investor funds***

The legislation governing financial services is further amended, through Legal Notice 400, to make custodial arrangements of professional investor funds subject to the relevant MFSA Guidelines.

16 December: ***Agreement on EU Budget***

Leaders of EU Member States, meeting in Brussels, reach agreement on the EU Budget for 2007-2013. The decisions on the Budget are expected to affect Malta as follows:

- The amount allocated to Malta is EUR 805 million. Net of its contribution to the Budget, Malta stands to gain EUR 455 million.
- Malta will benefit from EUR 728 million in Cohesion and Structural Funds and EUR 72 million in agricultural funds. These funds can be used for projects including improvements to the road network, solid waste management and health infrastructure.
- Adjustment to the Structural and Cohesion Funds should enable Member States to absorb funds over a longer period.

- The EU co-financing rate for projects is raised from 75 per cent to 85 per cent, improving budgetary cash flow for the Member States.

22 December: *Lombard Stockbrokers Ltd surrenders licence*

Lombard Stockbrokers Ltd surrenders its Category 2 Investment Services Licence issued in terms of the Investment Services Act, 1994. The surrender is entirely voluntary and does not arise from any regulatory action taken by the MFSA.

Part III

FINANCIAL STATEMENTS
FOR THE YEAR ENDED
31 DECEMBER 2005

Directors' report

The Directors present their report and the audited financial statements of the Bank for the year ended 31 December 2005.

Principal activities and review of operations

The Bank's Mission and Objectives are set out on page 3 of the Annual Report. The Governor's Statement and the Bank's Policies, Operations and Activities, included in the Annual Report on pages 11 to 15 and pages 57 to 77 respectively, give a detailed account of the Bank's activities and operations during 2005.

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 2005, and of its profit, its changes in equity and its cash flows for the year to that date. The financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards issued by the International Accounting Standards Board and in accordance with the requirements of the Central Bank of Malta Act (Cap. 204).

Financial results

The Bank's financial statements for the year ended 31 December 2005 are set out on pages A-6 to A-43 and disclose an operating profit of Lm10.8 million (2004: Lm14.9 million). The amount payable to Government is Lm10 million (2004: Lm14 million).

Directors' report – continued

Board of Directors

The members of the Board of Directors during the year were:

Mr Michael C. Bonello - Governor
Mr David A. Pullicino - Deputy Governor
Mr Joseph V. Gatt
Ms Philomena Meli
Mr Charles J. Falzon

During the financial year under review, Dr Bernadette Muscat was the Secretary to the Board.

Auditors

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

By order of the Board

M. C. Bonello	D. A. Pullicino
Governor	Deputy Governor

Castille Place
Valletta
Malta

22 February 2006

Statement of Directors' responsibilities in respect of the financial statements

The Central Bank of Malta is governed by the provisions of the Central Bank of Malta Act (Cap. 204). The Bank has also chosen to prepare financial statements in accordance with the requirements of International Financial Reporting Standards. The Board of Directors is responsible for ensuring that these financial statements give a true and fair view of the state of affairs of the Bank as at 31 December 2005, and of the profit, changes in equity and cash flows for the year to that date. The Board of Directors is also responsible for ensuring that the financial statements are drawn up in accordance with the requirements of the Central Bank of Malta Act (Cap. 204).

The Board of Directors is responsible for ensuring that proper accounting records are kept, which disclose at any time the financial position of the Bank and enable the Board of Directors to ensure that the financial statements comply with the requirements set out above. The Board of Directors is 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 Board of Directors confirms that suitable accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, have been used in the preparation of the financial statements of the Bank.

Report of the auditors

To the Board of Directors of the Central Bank of Malta

We have audited the financial statements set out on pages A-6 to A-43. As described in the statement of Directors' responsibilities on page A-4, these financial statements are the responsibility of the Bank's Board of Directors. 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. These Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Directors, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of the financial position of the Bank at 31 December 2005 and its profit, its changes in equity and its cash flows for the year then ended, in accordance with International Financial Reporting Standards and have been properly prepared in accordance with the Central Bank of Malta Act (Cap. 204).

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

Malta

22 February 2006

John B. Zarb (Partner) for and on behalf of
PRICEWATERHOUSECOOPERS

Malta

22 February 2006

Profit and loss account

	Notes	**Year ended 31 December**	
		2005 **Lm'000**	2004 Lm'000
Interest and similar income	3	**24,831**	25,741
Interest expense and similar charges	4	**(7,564)**	(8,905)
Net interest income		**17,267**	16,836
Net fee and commission expense		**(237)**	(217)
Net (losses)/gains from foreign exchange activities	5	**(2,283)**	717
Other net trading gains/(losses)	6	**2**	(208)
Gains less losses on disposal of available-for-sale financial assets	7	**1,454**	2,035
Gains on currency demonetisation	8	**-**	1,369
Other operating income		**57**	123
Administrative expenses	9	**(4,690)**	(4,572)
Depreciation on property, plant and equipment	21	**(317)**	(342)
Currency issue expenses	10	**(457)**	(840)
Profit for the financial year		**10,796**	14,901
Transfer to reserves for risks and contingencies	30	**(795)**	(900)
Payable to the Government of Malta in terms of Section 24(4) of the Central Bank of Malta Act (Cap. 204)		**10,001**	14,001

Balance sheet

	Notes	As at 31 December 2005 Lm'000	2004 Lm'000
Assets			
Cash and balances with banks	11	**6,305**	5,470
Gold balances		**664**	496
Placements with banks	12	**279,170**	391,789
Available-for-sale investment securities	13	**598,413**	426,777
Claims on the International Monetary Fund	14	**37,514**	35,136
Participating interest in the European Central Bank	15	**107**	107
Other foreign currency assets		**865**	779
Total external assets		**923,038**	860,554
Available-for-sale local assets:			
Treasury bills	17	**1,865**	8,209
Domestic debt securities	18	**7,253**	13,129
Derivative financial instruments	19	**1,937**	567
Other assets	20	**35,771**	34,240
Property, plant and equipment	21	**8,754**	8,931
Prepayments and accrued income		**12,366**	10,513
Total assets		**990,984**	936,143
Liabilities and equity			
Liabilities			
Notes and coins in circulation	22	**520,044**	506,405
Deposits by:			
Central banks	23	**15**	15
Banks	24	**182,321**	166,303
Government	25	**147,461**	115,661
Others	26	**9,511**	11,147
Profits payable to Government		**10,001**	14,001
Derivative financial instruments	19	**575**	1,298
Other liabilities	27	**34,198**	32,632
Accruals and deferred income		**2,568**	2,665
		906,694	850,127
Capital and reserves			
Capital	28	**5,000**	5,000
General reserve fund	29	**23,000**	23,000
Special reserve fund	29	**13,000**	13,000
Reserves for risks and contingencies	30	**44,745**	43,950
Fair value reserve	31	**(1,455)**	1,066
		84,290	86,016
Total liabilities and equity		**990,984**	936,143

The financial statements on pages A-6 to A-43 were approved for issue by the Board of Directors on 22 February 2006 and were signed on its behalf by:

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

Statement of changes in equity

	Capital Lm'000	General reserve fund Lm'000	Special reserve fund Lm'000	Reserves for risks and contingencies Lm'000	Fair value reserve Lm'000	Retained earnings Lm'000	Total Lm'000
Balance at 1 January 2004	5,000	23,000	13,000	43,050	4,175	-	88,225
Arising in the financial period: - net losses from changes in fair value of available-for-sale assets	-	-	-	-	(1,074)	-	(1,074)
Transfers: - net gains transferred to net profit on disposal of available-for-sale assets	-	-	-	-	(2,035)	-	(2,035)
Net losses not recognised in the profit and loss account	-	-	-	-	(3,109)	-	(3,109)
Profit for the financial year	-	-	-	-	-	14,901	14,901
Total recognised (expense)/income for 2004	-	-	-	-	(3,109)	14,901	11,792
Transfer to reserves for risks and contingencies	-	-	-	900	-	(900)	-
Transfer to profits payable to Government	-	-	-	-	-	(14,001)	(14,001)
Balance at 31 December 2004	5,000	23,000	13,000	43,950	1,066	-	86,016

Statement of changes in equity - continued

	Capital Lm'000	**General reserve fund Lm'000**	**Special reserve fund Lm'000**	**Reserves for risks and contingencies Lm'000**	**Fair value reserve Lm'000**	**Retained earnings Lm'000**	**Total Lm'000**
Balance at 1 January 2005	5,000	23,000	13,000	43,950	1,066	-	86,016
Arising in the financial period:							
- net losses from changes in fair value of available-for-sale assets	-	-	-	-	(1,067)	-	(1,067)
Transfers:							
- net gains transferred to net profit on disposal of available-for-sale assets	-	-	-	-	(1,454)	-	(1,454)
Net losses not recognised in the profit and loss account	-	-	-	-	(2,521)	-	(2,521)
Profit for the financial year	-	-	-	-	-	10,796	10,796
Total recognised (expense)/income for 2005	-	-	-	-	(2,521)	10,796	8,275
Transfer to reserves for risks and contingencies	-	-	-	795	-	(795)	-
Transfer to profits payable to Government	-	-	-	-	-	(10,001)	(10,001)
Balance at 31 December 2005	**5,000**	**23,000**	**13,000**	**44,745**	**(1,455)**	**-**	**84,290**

Cash flow statement

	Notes	**2005** **Lm'000**	2004 Lm'000
		Year ended 31 December	
Cash flows from operating activities			
Interest and similar income received		**29,672**	25,213
Interest and similar charges paid		**(7,538)**	(8,939)
Net fee and commission paid		**(237)**	(217)
Net trading and other expense		**(4,305)**	(386)
Cash payments mainly to employees and suppliers		**(5,282)**	(5,408)
Cash flows from operating profits before changes in operating assets and liabilities		**12,310**	10,263
Net changes in operating assets and liabilities:			
Placements with banks		**(21,242)**	203,844
Other foreign exchange assets		**(2,632)**	590
Treasury bills		**6,898**	(7,929)
Malta Government securities		**5,936**	(5,852)
Other assets		**(1,531)**	1,018
Currency in issue		**13,639**	21,032
Deposits		**(9,580)**	7,279
Other liabilities		**1,566**	(1,130)
Net cash from operating activities		**5,364**	229,115
Cash flows from investing activities			
Purchase of securities		**(627,282)**	(617,238)
Proceeds from sale and maturity of securities		**447,674**	407,369
Acquisition of participating interest in the European Central Bank	15	**-**	(107)
Purchase of property, plant and equipment	21	**(140)**	(4,580)
Net cash used in investing activities		**(179,748)**	(214,556)
Cash flows from financing activities			
Payment to the Government under Section 24(4) of the Central Bank of Malta Act (Cap. 204)		**(14,001)**	(18,233)
Movement in cash and cash equivalents		**(188,385)**	(3,674)
Cash and cash equivalents at 1 January		**203,049**	206,723
Cash and cash equivalents at 31 December	32	**14,664**	203,049

Notes to the financial statements

1. Accounting policies

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

(a) Basis of preparation of financial statements

These financial statements have been drawn up so as to give a true and fair view of the state of affairs of the Bank and its profit, its changes in equity and its cash flows. They have been prepared under the historical cost convention as modified by the fair valuation of available-for-sale investments, all derivative contracts and certain other assets. The financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards (IFRSs) and with the requirements of the Central Bank of Malta Act (Cap. 204).

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

Standards, interpretations and amendments to published standards effective in 2005

In 2005 the Bank adopted new standards, amendments and interpretations to existing standards that are mandatory for the Bank's accounting period beginning on 1 January 2005. The adoption of these revisions to the requirements of IFRSs did not result in substantial changes to the Bank's accounting policies.

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

Certain new standards, amendments and interpretations to existing standards have been published by the date of authorisation for issue of these financial statements, that are mandatory for the Bank's accounting periods beginning on or after 1 January 2006 or later periods. The Bank has not yet adopted these revisions to the requirements of IFRSs and the Bank's Board is of the opinion that there are no requirements that will have a possible significant impact on the Bank's financial statements in the period of initial application.

1. Accounting policies - continued

(a) Basis of preparation of financial statements - continued

The Bank has considered the requirements of IFRS 7, Financial Instruments: Disclosures, and a complementary amendment to IAS 1, Presentation of Financial Statements – Capital Disclosures (effective from 1 January 2007). IFRS 7 requires the disclosure of qualitative and quantitative information about exposure to market risks arising from financial instruments, including specified minimum disclosures such as sensitivity analysis to market risk. The amendment to IAS 1 introduces disclosures about the level of an entity's capital and how it manages capital. The Bank assessed the impact of IFRS 7 and the amendment to IAS 1 and concluded that certain additional disclosures would be necessary upon application of these requirements.

(b) Interest income and expense

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

(c) Fee and commission income and expense

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

1. Accounting policies - continued

(d) Foreign currency transactions and balances

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

(e) Demonetised currency notes and coins

(1) Demonetised currency notes

In accordance with Section 42 of the Central Bank of Malta Act (Cap. 204), after the expiration of one year following the end of the period established in the notice of demonetisation, any unpresented demonetised notes shall cease to be included in the Bank's currency liabilities. The value of such notes, after deducting therefrom the value of any notes which are subsequently redeemed, are recognised in the profit and loss account of the Bank until the expiration of ten years from the end of the period above mentioned. After the expiry of ten years from the notice of demonetisation, demonetised currency notes not yet presented are no longer redeemed by the Bank.

(2) Demonetised coins

In accordance with Section 43 of the Central Bank of Malta Act (Cap. 204), after the expiration of six months following the end of the period established in the notice of demonetisation, any unpresented demonetised coins shall cease to be included in the Bank's currency liabilities. The value of such coins, after deducting therefrom the value of any coins which are subsequently redeemed, are recognised in the profit and loss account of the Bank until the expiration of two years from the end of the period above mentioned. After the expiry of two years from the notice of demonetisation, demonetised coins not yet presented are no longer redeemed by the Bank.

1. Accounting policies - continued

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

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

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

This category has two sub-categories: 'financial assets held for trading', and those designated at fair value through profit or loss at inception. A financial asset is classified in this category if acquired principally for the purpose of selling in the short-term or if so designated by management on initial recognition. Securities which are either acquired for generating a profit from short-term fluctuations in price, or are included in a portfolio in which a pattern of short-term profit taking exists, are classified as instruments held for trading. Derivatives are also categorised as 'held for trading' unless they are designated as hedges. On 1 January 2005, upon adoption of the requirements of IAS 39 (revised), and during the financial year under review, the Bank's management has not designated any financial assets at fair value through profit or loss at inception.

(ii) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Bank provides money directly to an issuer or borrower with no intention of trading the asset. In prior years, investments acquired by the Bank at original issuance directly from the issuer by transferring funds directly to the issuer were classified as originated loans and receivables, even though they were quoted in an active market, unless they were acquired with the intent to be sold immediately or in the short-term in which case they would have been classified as held for trading. The application of the revised requirements in this respect had no impact on the Bank's financial statements.

1. Accounting policies - continued

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

(iii) Held-to-maturity

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

(iv) Available-for-sale

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

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

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

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

1. Accounting policies - continued

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

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

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

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

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

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

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

1. Accounting policies - continued

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

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

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

(g) Derivative financial instruments

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

1. Accounting policies - continued

(h) Gold balances

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

(i) Claims on the International Monetary Fund

The International Monetary Fund Reserve Tranche Position and Special Drawing Rights are translated at the prevailing representative rate for the Maltese lira of SDR1.92896 to Lm1 as quoted by the Fund at the close of business on 31 December 2005. The International Monetary Fund Maltese lira holdings are revalued against the SDR at the representative rate for the Maltese lira quoted by the Fund at 31 December 2005. Adjustments on revaluation of the International Monetary Fund holdings are reflected in the corresponding asset - Currency Subscription.

(j) Participating interest in the European Central Bank

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

(k) Sale and repurchase agreements and lending of securities

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

1. Accounting policies - continued

(l) Other financial instruments

The Bank's other financial assets which have not been referred to in the accounting policies disclosed above, comprising principally placements with banks and other similar assets, are classified as loans and receivables in accordance with the requirements of IAS 39 (revised). The recognition and measurement rules applicable to loans and receivables are outlined in Note 1(f) to the financial statements. Essentially these financial assets are measured at their face or nominal values. All regular way transactions in assets classified in this category are accounted for using settlement date accounting. In prior years these assets were classified as originated loans and receivables. The application of the revised requirements in this respect had no impact on the Bank's financial statements.

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

(m) Offsetting financial instruments

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

(n) Property, plant and equipment

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

1. Accounting policies - continued

(n) Property, plant and equipment - continued

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

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

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

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

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in the profit and loss account.

(o) Leases

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

(p) Cash and cash equivalents

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

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

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

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

3. Interest and similar income

	2005	2004
	Lm'000	Lm'000
Income from:		
Placements with banks	**7,844**	14,900
Available-for-sale investment securities	**15,153**	9,340
Claims on the International Monetary Fund	**727**	499
Other foreign currency assets	**432**	353
External assets	**24,156**	25,092
Treasury bills and debt securities issued by the Government of Malta	**538**	599
Assets arising from monetary policy instruments	**97**	-
Other assets	**40**	50
	24,831	25,741

4. Interest expense and similar charges

	2005	2004
	Lm'000	Lm'000
Expense on:		
Bank deposits	**4,128**	3,964
Liabilities arising from monetary policy instruments	**1,281**	3,116
Government deposits	**2,114**	1,763
Other deposits and banking arrangements	**41**	62
	7,564	8,905

5. Net (losses)/gains from foreign exchange activities

	2005	2004
	Lm'000	Lm'000
Amounts recognised in the profit and loss account	**(2,283)**	717

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

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

6. Other net trading gains/(losses)

	2005	2004
	Lm'000	Lm'000
Net fair value losses on held for trading foreign currency securities	**(12)**	(166)
Net fair value gains/(losses) on other derivative contracts (Note 19)	**14**	(42)
	2	(208)

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

	2005	2004
	Lm'000	Lm'000
Net gains on disposal of:		
Foreign currency investment securities	**1,419**	2,030
Treasury bills and debt securities issued by the Government of Malta	**35**	5
	1,454	2,035

8. Gains on currency demonetisation

These gains represent the face value of demonetised 50c 1st series and 25c 1st series coins not presented on the expiration of two years following the end of the period established in the notice of demonetisation i.e. by 17 June 2004. These amounts were no longer redeemable by the Bank and accordingly have been recognised in the profit and loss account for the preceding financial year.

9. Administrative expenses

	2005	2004
	Lm'000	Lm'000
Staff costs	**3,091**	2,924
Training, welfare and other staff-related expenditure	**262**	326
Market information and communication expenses	**440**	397
Other administrative expenses	**897**	925
	4,690	4,572

Other administrative expenses mainly comprise maintenance expenditure, professional fees, travelling costs and other services or expense items which are incurred in the course of the Bank's operations. Auditors' remuneration for the current financial year amounted to Lm16,000 (2004: Lm16,000).

Compensation to the members of the Board of Directors for the financial year under review amounted to Lm88,396 (2004: Lm89,044). The Governor and Deputy Governor are entitled to such benefits as the use of a leased motor vehicle, health insurance cover and refund of certain other expenses. The other members of the Board of Directors are entitled to health insurance cover and refund of certain other expenses.

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

	2005	2004
	Number	Number
Governors	**2**	2
Divisional Directors	**5**	5
Heads and Executives	**71**	70
Supervisory and clerical staff	**201**	197
Non-clerical staff	**40**	40
	319	314

10. Currency issue expenses

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

11. Cash and balances with banks

	2005	2004
	Lm'000	Lm'000
Cash in hand	**224**	348
Balances with banks - repayable on call and at short notice	**6,081**	5,122
Included in cash and cash equivalents (Note 32)	**6,305**	5,470

Balances with banks are in the main secured by US Treasury bills which the Bank accepted as collateral under repurchase agreements. These balances are principally subject to floating interest rates.

12. Placements with banks

	2005	2004
	Lm'000	Lm'000
Placements subject to fixed interest rates, by remaining maturity		
- One year or less but over three months	**39,923**	38,832
- Three months or less but over one month	**51,943**	93,711
- One month or less	**187,304**	259,246
	279,170	391,789

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

13. Available-for-sale investment securities

	2005	2004
	Lm'000	Lm'000
Investment securities principally subject to fixed interest rates, by remaining maturity		
- Over five years	**57,175**	25,753
- Five years or less but over two years	**131,054**	94,624
- Two years or less but over one year	**162,530**	107,930
- One year or less but over three months	**191,401**	136,624
- Three months or less	**56,253**	61,846
	598,413	426,777

13. Available-for-sale investment securities - continued

The Bank's portfolio of investment securities is composed of listed foreign currency debt securities issued mainly by foreign governments and international financial institutions. As at 31 December 2005, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of USD45 million or Lm16 million approximately (2004: USD20 million or Lm7 million approximately). No amounts were borrowed under these facilities at the balance sheet dates.

14. Claims on the International Monetary Fund

	2005 **Lm'000**	2004 Lm'000
Reserve Tranche Position	**20,871**	19,916
Special Drawing Rights	**16,643**	15,220
	37,514	35,136

Malta's membership subscription to the International Monetary Fund amounts to SDR102,000,000 (2004: SDR102,000,000).

The Bank's position with the International Monetary Fund at 31 December 2005 is reflected in the balance sheet as follows:

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

(b) Special Drawing Rights included above are equivalent to SDR32,104,327. These represent the Special Drawing Rights allocated to Malta amounting to SDR11,288,000, to which a corresponding liability exists in the form of a restricted demand deposit of the Government of Malta included under 'Other deposits' (see Note 26), together with other Special Drawing Rights acquired in accordance with International Monetary Fund requirements and procedures. Special Drawing Rights allocated to Malta cannot be withdrawn unless such advice is received from the Fund. Other Special Drawing Rights have no specified maturity.

14. Claims on the International Monetary Fund - continued

(c) Currency Subscription included with 'Other assets' (see Note 20) is stated at Lm32,007,399 and represents the balance of the quota paid in Maltese liri. A corresponding liability included with 'Other liabilities' (see Note 27) exists in the form of IMF current accounts of Lm32,007,399 or SDR61,740,993.

The Reserve Tranche Position, Special Drawing Rights and SDR allocation (Note 26) are subject to floating interest rates determined by reference to the official rate quoted by the Fund on a weekly basis. The effective interest rate applicable to the interest-bearing instruments as at the balance sheet date was 3.03% (2004: 2.22%). The Currency Subscription and IMF current accounts are not subject to interest.

15. Participating interest in the European Central Bank

On 1 May 2004 Malta joined the European Union (EU) and consequently the Bank became a member of the European System of Central Banks (ESCB). In accordance with Article 28 of the Statute of the ESCB and the European Central Bank (ECB), the Bank became the subscriber of the capital of the ECB. This balance represents the Bank's participating interest in the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the ESCB Statute and which must be adjusted every five years and every time that a new member state joins the EU in accordance with Article 49.3. The share of Malta in the ECB's capital is 0.0647% and was calculated in accordance with Article 29 of the Statute of the ESCB, on the basis of population and GDP data provided by the European Commission. As Malta does not participate in the euro area, the transitional provisions of Article 48 of the Statute apply. Consequently, the Bank was required to pay-up a minimal contribution of 7% of its allocated share capital in the ECB upon entry into the ESCB on 1 May 2004 amounting to EUR252,024. Appendix 1 to these financial statements on pages A-44 and A-45 includes detailed disclosures of participating interests held by euro area and non-euro area National Central Banks (NCBs).

16. External reserve ratio

The ratio of external assets to notes and coins issued, excluding coins issued for numismatic purposes, and deposit liabilities is 107.41% (2004: 107.63%). In accordance with Section 19(1) of the Central Bank of Malta Act (Cap. 204), the minimum ratio in this respect is 60%.

17. Available-for-sale Treasury bills

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

	2005	2004
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**1,406**	314
- Three months or less but over one month	**189**	5,973
- One month or less	**270**	1,922
	1,865	8,209

The weighted average effective interest rate as at the balance sheet date was 3.31% (2004: 3.00%). Treasury bills with a contractual maturity of three months or less from the date of acquisition are included in cash equivalents (Note 32).

18. Available-for-sale domestic debt securities

	2005	2004
	Lm'000	Lm'000
Malta Government Stocks subject to fixed interest rates listed on the Malta Stock Exchange	**7,253**	13,129

Amounts include:

	2005	2004
	Lm'000	Lm'000
By remaining maturity		
- Over five years	**3,067**	11,540
- Five years or less but over one year	**2,576**	1,335
- One year or less	**1,610**	254
	7,253	13,129

The weighted average effective interest rate as at the balance sheet date was 6.07% (2004: 7.41%).

19. Derivative financial instruments

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

	Assets	
	2005	2004
	Lm'000	Lm'000
Foreign exchange and other derivatives held for trading:		
Foreign exchange contracts maturing within six months from the balance sheet date		
- forward purchase of EUR341.5 million against GBP	**1,290**	-
- forward purchase of EUR110.8 million (2004: EUR34.2 million) against USD	**126**	174
- forward purchase of EUR3 million against Lm	**-**	27
Foreign exchange contract expiring in 2010 - forward sale of EUR18.4 million (2004: EUR24.1 million) against Lm	**368**	287
Other derivative contracts maturing in 2009 - cross-currency interest rate swaps with principal amounts of Lm10 million (2004: Lm15 million) (see Note on page A-29)	**153**	79
	1,937	567

Settlement of the forward contract entered into with a company owned by the Government of Malta, which expires in 2010, is also guaranteed by the Government.

	Liabilities	
	2005	2004
	Lm'000	Lm'000
Foreign exchange and other derivatives held for trading:		
Foreign exchange contracts maturing within six months from the balance sheet date		
- forward purchase of EUR50 million against USD	**296**	-
- forward purchase of EUR9.3 million against JPY	**63**	-
- forward purchase of USD67 million against Lm	**-**	1,124
- forward purchase of GBP3.5 million against USD	**-**	16
- forward sale of JPY1,270 million against USD	**-**	1
Other derivative contracts maturing in 2009 - cross-currency interest rate swaps with principal amounts of Lm10 million (2004: Lm5 million) (see Note on page A-29)	**216**	157
	575	1,298

19. **Derivative financial instruments** - continued

During the preceding financial year, the Bank has entered into a cross-currency interest rate swap arrangement with an international financial institution whereby the Bank has undertaken to purchase upon inception and sell forward, the principal amount of Lm10 million against EUR, at the same exchange rate. The Bank will pay fixed interest amounts on the Lm principal amount annually and will receive variable interest amounts at quarterly intervals, based on reset floating interest rates linked to 3 month EURIBOR, computed by reference to the EUR principal amount. For the purposes of managing its exposures from this arrangement, the Bank entered into similar swap agreements, offsetting the contract mentioned above, with two local financial institutions. Under each agreement the Bank has undertaken to sell upon inception and buy forward Lm5 million against EUR at the same exchange rate for each respective contract. During the term of these contracts, the Bank will receive fixed interest amounts on the Lm principal amount on an annual basis, and will pay variable interest amounts at quarterly intervals based on 3 month EURIBOR determined by reference to the EUR principal amount.

20. **Other assets**

	2005	2004
	Lm'000	Lm'000
International Monetary Fund Currency Subscription (see Note 14)	**32,007**	30,543
Others	**3,764**	3,697
	35,771	34,240

21. Property, plant and equipment

	Freehold property Lm'000	Leasehold property Lm'000	Others Lm'000	Total Lm'000
At 1 January 2004				
Cost	-	4,500	2,321	6,821
Accumulated depreciation	-	(263)	(1,865)	(2,128)
Net book amount	-	4,237	456	4,693
Year ended 31 December 2004				
Opening net book amount	-	4,237	456	4,693
Additions	4,268	1	311	4,580
Depreciation charge for the year	-	(46)	(296)	(342)
Transfer of property improvements:				
- cost	1,319	(1,319)	-	-
- accumulated depreciation	(71)	71	-	-
Closing net book amount	5,516	2,944	471	8,931
At 31 December 2004				
Cost	5,587	3,182	2,632	11,401
Accumulated depreciation	(71)	(238)	(2,161)	(2,470)
Net book amount	5,516	2,944	471	8,931
Year ended 31 December 2005				
Opening net book amount	5,516	2,944	471	8,931
Additions	55	9	76	140
Depreciation charge for the year	(33)	(47)	(237)	(317)
Closing net book amount	**5,538**	**2,906**	**310**	**8,754**
At 31 December 2005				
Cost	5,642	3,191	2,708	11,541
Accumulated depreciation	(104)	(285)	(2,398)	(2,787)
Net book amount	**5,538**	**2,906**	**310**	**8,754**

During the preceding financial year, the Bank acquired from Government the freehold title to its main premises at Castille Place for a consideration of Lm4.3 million. These premises, which were previously held on a temporary lease from Government, had been extensively altered in prior years to adapt them to the Bank's requirements. The carrying amount of these improvements has been transferred from the leasehold property category to freehold property in the table disclosed above subsequent to the property acquisition.

22. Notes and coins in circulation

	2005	2004
	Lm'000	Lm'000
Notes	**499,934**	487,165
Coins	**20,110**	19,240
	520,044	506,405

23. Central bank deposits

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

24. Bank deposits

	2005	2004
	Lm'000	Lm'000
Reserve deposits held in terms of Section 37 of the Central Bank of Malta Act (Cap. 204)	**135,455**	145,303
Other deposits from local banks	**66**	-
Liabilities arising from monetary policy instruments	**46,800**	21,000
	182,321	166,303

Reserve deposits held in terms of Section 37 of the Central Bank of Malta Act (Cap. 204) are subject to variable interest rates linked to the Bank's Central Intervention Rate which at the financial year-end was 3.25% (2004: 3%). The effective interest rate applied to reserve deposits as at the balance sheet date was 3% (2004: 2.75%). Other deposits from local banks are repayable on demand and are non interest-bearing. These other deposits are included in cash equivalents (Note 32).

Liabilities arising from monetary policy instruments mature within one month from the balance sheet date and are included in cash equivalents (Note 32). The weighted average interest rate applicable to these instruments, based on the Bank's Central Intervention Rate, was 3.2% (2004: 2.95%) as at the balance sheet date.

24. **Bank deposits** - continued

Amounts include:

	2005	2004
	Lm'000	Lm'000
By currency		
MTL	**182,321**	166,301
EUR	**-**	2
	182,321	166,303

25. **Government deposits**

Amounts include:

	2005	2004
	Lm'000	Lm'000
Current accounts by currency		
MTL	**67,383**	50,429
EUR	**16,319**	12,323
USD	**5,987**	1,822
GBP	**386**	348
Others	**115**	110
Sinking fund accounts by currency		
MTL	**37,779**	35,100
EUR	**17,407**	13,732
USD	**1,972**	1,699
Others	**113**	98
	147,461	115,661

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

Current accounts denominated in Maltese lira are subject to floating interest rates linked to the Bank's Central Intervention Rate. Current accounts and sinking fund accounts denominated in foreign currencies are principally subject to floating interest rates based on weekly average rates applied to call funds. Sinking fund accounts denominated in Maltese lira are subject to variable interest rates based on the 91-day Treasury bill monthly weighted average yield or floating rates linked to the Bank's Central Intervention Rate.

26. Other deposits

	2005	2004
	Lm'000	Lm'000
Deposits by public sector corporations and similar entities:		
- Repayable on demand (included in cash equivalents - Note 32)	**1,151**	4,025
International Monetary Fund SDR allocation (see Note 14)	**5,852**	5,584
Others:		
- Repayable on demand (included in cash equivalents - Note 32)	**2,508**	1,538
	9,511	11,147

Amounts include:

	2005	2004
	Lm'000	Lm'000
By currency		
MTL	**2,688**	1,490
EUR	**806**	3,411
SDR	**5,852**	5,584
Others	**165**	662
	9,511	11,147

Deposits by public sector corporations and similar entities denominated in Maltese lira, amounting to Lm0.86 million (2004: Lm0.92 million), are mainly subject to variable interest rates linked to the Bank's Central Intervention Rate. Deposits by these entities denominated in foreign currencies, amounting to Lm0.29 million (2004: Lm3.11 million), are principally subject to floating interest rates based on weekly average rates applied to call funds. Other deposits, excluding SDR allocation, are not subject to interest.

27. Other liabilities

	2005	2004
	Lm'000	Lm'000
International Monetary Fund current accounts (see Note 14)	**32,007**	30,543
Others	**2,191**	2,089
	34,198	32,632

28. Capital

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

29. Reserve funds

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

30. Reserves for risks and contingencies

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

31. Fair value reserve

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

31. Fair value reserve - continued

	Available-for-sale investment securities Lm'000	Available-for-sale local assets Lm'000
At 1 January 2004	4,062	113
Net losses from changes in fair value	(1,017)	(57)
Net gains transferred to net profit on disposal	(2,030)	(5)
At 31 December 2004	1,015	51
Net (losses)/gains from changes in fair value	(1,125)	58
Net gains transferred to net profit on disposal	(1,419)	(35)
At 31 December 2005	**(1,529)**	**74**

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

32. Cash and cash equivalents

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

	2005 Lm'000	2004 Lm'000
Cash and balances with banks (Note 11)	**6,305**	5,470
Treasury bills maturing within three months (Note 17)	**403**	-
Placements with banks maturing within three months (Note 12)	**205,957**	339,818
Deposits maturing within three months (Notes 23, 24, 25 and 26)	**(198,001)**	(142,239)
	14,664	203,049

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

33. Financial instruments

The nature of the Bank's operations implies that financial instruments, including derivatives, are extensively used in the course of its activities. The Bank is potentially exposed to a range of risks and hence operates a risk management strategy with the objective of controlling its exposures. The Bank takes on exposure to market risk, which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices or rates. This is a key operational risk relating to a central bank's role as referred to in Note 30 above. The Board considers credit risk and currency risk as the principal categories of risk faced by the Bank.

Credit risk

The Bank has in place internal control structures to assess and monitor credit exposures and risk thresholds. The Bank places limits on the level of credit risk undertaken from the main categories of financial instruments, covering on and off-balance sheet exposures with specific sub-limits for different classes of transactions, in relation to individual financial institutions and groups of financial institutions classified by country of origin. These limits, which are reviewed on a regular basis, are approved by the Board of Directors and actual exposures are monitored against limits on a daily basis. Funds are placed with, and derivative instruments are entered with, financial institutions having a first class credit rating. The Bank enters into foreign exchange and security transactions only with such counterparties and it invests only in first class quality securities or paper. Credit risk with respect to off-balance sheet exposures is limited since the Bank's customers in this respect are mainly public sector corporations and other entities owned by the Government.

Currency risk

Effective from 2 May 2005, the Maltese lira entered the Exchange Rate Mechanism II (ERM II) with a central parity rate of MTL/EUR 0.4293 and the Maltese Authorities have decided to maintain the MTL/EUR rate unchanged at the central parity level during the ERM II phase. Prior to the entry of the Maltese lira into the ERM II, the Bank's net foreign currency positions, including foreign exchange derivatives, were held in a mix of currencies which principally reflected their respective weighting in the Maltese lira basket. The Bank's net balance sheet exposure to currency risk was managed within controlled parameters. Subsequent to entry into ERM II and the consequential move from a three-currency basket to a 100% euro peg, the Bank's net external assets are maintained in broad terms in the mix of currencies applied prior to 2 May 2005. As a result, the Bank became exposed to the risk of currency movements in respect of its holdings denominated in foreign currencies other than euro. For macro-hedging purposes, the Bank uses derivative transactions for the forward purchase of euro and simultaneous forward sale of sterling or US dollar such that the Bank's net balance sheet exposure is substantially denominated in euro. Information on the Bank's exposures to currency risk in respect of its assets is disclosed in Note 37 to these financial statements, whereas information relating to its liabilities is reflected in Notes 24, 25 and 26.

33. Financial instruments - continued

***Currency risk** - continued*

At 31 December, the Bank's net foreign currency holdings determined by reference to transaction amounts, including amounts arising under derivative financial instruments but excluding claims on the International Monetary Fund, were in the following currencies:

	2005	2004
	%	%
EUR	**99.84**	73.76
GBP	**0.04**	18.99
USD	**-**	7.18
Others	**0.12**	0.07
	100.00	100.00

Interest rate risk

Whilst the majority of the Bank's assets are interest-bearing, the Bank's principal liability is not subject to interest. The Bank mainly invests in, and places funds under, instruments subject to fixed interest rates and has in place techniques to measure the sensitivity of the fair value of its fixed-income instruments to changes in market yields. The Board of Directors sets limits that may be accepted and adherence to these limits is monitored on a regular basis. However interest rate risk is considered by the Directors to be limited in view of the short periods to maturity of placements with banks and the realisable nature of the Bank's available-for-sale investment securities. Moreover, the Bank's interest-bearing deposits, other than reserve deposits, are mainly repayable on demand. All deposits are repriceable within short time periods, with floating interest rates linked to the Bank's Central Intervention Rate or reference market interest rates (see Notes 24, 25, 26). Presentation of an analysis in tabular format disclosing the entire Bank's financial instruments by contractual repricing or maturity groupings was not deemed relevant by the Board in disclosing the Bank's policies relating to financial risk management.

33. Financial instruments - continued

Interest rate risk *- continued*

The table below summarises the effective interest rates by major currencies for the Bank's principal monetary financial instruments as at 31 December:

	Assets		**Liabilities**		
			Government deposits		
	Placements with banks	**Available-for-sale investment securities**	Current accounts	Sinking fund accounts	**Other deposits**
	%	%	%	%	%
MTL					
2005	**-**	**-**	**2.75**	**3.05**	**0.25**
2004	-	-	2.50	2.83	0
EUR					
2005	**2.26**	**2.50**	**1.51**	**1.76**	**1.51**
2004	2.11	2.65	1.26	1.51	1.26
GBP					
2005	**4.51**	**4.70**	**3.72**	**3.97**	**3.72**
2004	4.79	4.78	3.82	4.07	3.82
USD					
2005	**4.29**	**3.76**	**3.31**	**3.56**	**3.31**
2004	1.90	3.75	1.20	1.45	1.20

Liquidity risk

The Bank's liquidity risk is relatively insignificant in view of the short-term maturities or realisable nature of the principal categories of its financial assets, as outlined above, and due to the nature of the Bank's main liabilities, comprising reserve deposits and currency in circulation, which have no specified maturity. Only deposits by Government together with public sector corporations and similar entities are repayable on demand. The Bank's assets and liabilities are analysed into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date in the respective Notes to the financial statements. Considering the nature and level of liquidity risk managed by the Bank, these disclosures were deemed sufficient by the Board of Directors for the purposes of disclosing the Bank's policy in this respect.

33. Financial instruments - continued

Fair values of financial assets and liabilities

The fair value of the Bank's available-for-sale financial assets, which are traded in active markets, is based on quoted market prices (see Notes 13, 17 and 18). Fair values for the Bank's derivative contracts are determined using forward exchange market rates at the balance sheet date for forward foreign exchange contracts and currency swaps (see Notes 5 and 19), and using valuation techniques, including discounted cash flow models, for other derivative contracts (see Notes 6 and 19). The valuation techniques used are supported by observable market prices or rates since their variables include only data from observable markets.

The following financial assets and liabilities include the main categories of instruments not presented on the Bank's balance sheet at their fair value: cash and balances with banks, balances with the International Monetary Fund, placements with banks together with deposits by banks, the Government of Malta, public sector corporations and other similar entities, and currency in circulation. The carrying amount of these instruments approximates fair value due to their nature or short-term maturity. Deposits by banks mainly comprise reserve deposits. The face value of reserve deposits, balances with the International Monetary Fund and currency in circulation is essentially their fair value in view of the substance of the instruments or arrangements in place. Placements with banks mature essentially within a period of three months from the financial year end. All deposit liabilities, excluding reserve deposits and International Monetary Fund SDR allocation, are repayable within one month from the balance sheet date.

34. Contingent liabilities and commitments

	2005	2004
	Lm'000	Lm'000
Contingent liabilities		
Guarantees and letters of credit	**27,073**	20,436
Commitments		
Repayment of foreign loans received by the Bank on behalf of the Government under Financial Conventions	**8,609**	10,333
Total	**35,682**	30,769

34. Contingent liabilities and commitments - continued

By remaining maturity:

Guarantees and letters of credit	**2005**	2004
	Lm'000	Lm'000
- Five years or less but over one year	**353**	3,949
- One year or less but over three months	**13,160**	10,027
- Three months or less	**13,560**	6,460
	27,073	20,436

Commitments in respect of foreign loans received by the Bank on behalf of the Government under Financial Conventions and repayable in due course from funds to be made available by Government

	2005	2004
	Lm'000	Lm'000
- Over five years	**1,474**	2,354
- Five years or less but over one year	**5,385**	5,973
- One year or less but over three months	**1,604**	1,870
- Three months or less	**146**	136
	8,609	10,333

The Bank's customers with respect to guarantees and letters of credit are mainly public sector corporations, government departments and other entities owned by the Government. The Bank's foreign currency exposure with respect to these contingent liabilities and commitments is principally in US dollar and euro.

35. Related parties

In the course of its operations, the Central 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 Central 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 25 and 26 to the financial statements. The principal impact of banking transactions entered into with the Government and the entities referred to above, on the Bank's profit and loss account, is interest payable on deposits as disclosed in Note 4 to the financial statements. The Bank provides these entities with foreign exchange and related services, which do not have a significant impact on the Bank's profit and loss account. In this respect, the principal outstanding transactions as at the balance sheet date are reflected in Notes 19 and 34 to the financial statements. The Bank acts as market maker in Government securities and Treasury bills and ensures their liquidity in the secondary market by being ready to trade in such securities on the initiative of the market (see Notes 17 and 18). Income earned by the Bank from these assets is disclosed in Notes 3 and 7 to the financial statements.

35. Related parties - continued

The Bank's key management personnel are deemed to be the members of the Board of Directors. The Bank's transactions with key management personnel consist principally of compensation payable, which has been disclosed in Note 9 to the financial statements.

36. General

(a) Demonetised currency notes and coins

Demonetised currency notes

During 2005, demonetised currency notes presented for redemption amounted to Lm190,689 (2004: Lm170,541). At 31 December 2005, the value of unpresented demonetised currency notes amounted to Lm2,512,646 (2004: Lm2,703,335) analysed as follows:

	2005	2004
	Lm'000	Lm'000
Ten year period expires in:		
- 2008	**930**	940
- 2010	**1,583**	1,763
	2,513	2,703

Demonetised coins

On 17 June 2004, the two year period from the notice of demonetisation of the 50c 1st series and 25c 1st series coins expired. Coins presented for redemption during the preceding financial year until the aforementioned date amounted to Lm8,984.

(b) Assets held in custody

At 31 December 2005, assets held in custody by the Bank in terms of the Insurance Business Act amounted to Lm19,771,000 (2004: Lm24,159,000).

36. General - continued

(c) Management of funds belonging to the Investor and Depositor Compensation Schemes

During the financial year ended 31 December 2003, the Bank had been appointed as investment manager in respect of funds belonging to the Investor and Depositor Compensation Schemes. The Bank manages these funds on a discretionary basis but in accordance with the investment parameters set by the Management Committees of the respective Schemes. The amount of funds belonging to the Schemes, managed by the Bank, is adjusted by the amount of investments so effected. Accordingly as at 31 December 2005, the Investor and Depositor Compensation Schemes had interest-bearing deposits of Lm11,714 (2004: Lm669) and Lm2,885 (2004: Lm1,499) respectively, with the Bank.

37. Statement of the Bank's investments

The statement of the Bank's external assets below is disclosed in accordance with the requirements of Section 23(1)(b) of the Central Bank of Malta Act (Cap. 204).

The exposure country is essentially 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.

37. Statement of the Bank's investments - continued

	EUR Lm'000	GBP Lm'000	USD Lm'000	Total Lm'000
Cash and balances with banks				6,305
Gold balances				664
Placements with banks by exposure country				
Australia	8,586	-	-	8,586
Belgium	45,077	6,245	-	51,322
Canada	17,172	6,245	-	23,417
Denmark	6,440	-	-	6,440
France	36,491	-	-	36,491
Germany	6,440	6,245	-	12,685
Italy	8,586	-	3,627	12,213
Netherlands	4,293	-	7,254	11,547
Sweden	15,026	6,245	-	21,271
Switzerland	-	10,992	-	10,992
United Kingdom	61,261	-	3,627	64,888
Other countries	19,318	-	-	19,318
	228,690	35,972	14,508	279,170
Available-for-sale investment securities by issuer category				
Government	70,416	-	5,419	75,835
Monetary financial institutions	319,861	71,880	21,400	413,141
Other financial institutions	40,315	22,747	7,023	70,085
Supranationals	9,878	5,788	6,444	22,110
Insurance sector	4,360	4,390	-	8,750
Non-financial institutions	7,584	-	908	8,492
	452,414	104,805	41,194	598,413
Claims on the International Monetary Fund				37,514
Participating interest in the European Central Bank				107
Other foreign currency assets				865
Total external assets				**923,038**

Supplementary information to the financial statements: Appendix 1

ESCB members' percentage share held in the ECB's capital

	From 1 January to 30 April 2004 %	From 1 May 2004 %
Nationale Bank van België/ Banque Nationale de Belgique	2.8297	2.5502
Deutsche Bundesbank	23.4040	21.1364
Bank of Greece	2.1614	1.8974
Banco de España	8.7801	7.7758
Banque de France	16.5175	14.8712
Central Bank and Financial Services Authority of Ireland	1.0254	0.9219
Banca d'Italia	14.5726	13.0516
Banque centrale du Luxembourg	0.1708	0.1568
De Nederlandsche Bank	4.4323	3.9955
Oesterreichische Nationalbank	2.3019	2.0800
Banco de Portugal	2.0129	1.7653
Suomen Pankki-Finlands Bank	1.4298	1.2887
Subtotal euro area NCBs	**79.6384**	**71.4908**
Česká národní banka	-	1.4584
Danmarks Nationalbank	1.7216	1.5663
Eesti Pank	-	0.1784
Central Bank of Cyprus	-	0.1300
Latvijas Banka	-	0.2978
Lietuvos bankas	-	0.4425
Magyar Nemzeti Bank	-	1.3884
Central Bank of Malta	-	0.0647
Narodowy Bank Polski	-	5.1380
Banka Slovenije	-	0.3345
Národná banka Slovenska	-	0.7147
Sveriges Riksbank	2.6636	2.4133
Bank of England	15.9764	14.3822
Subtotal non-euro area NCBs	**20.3616**	**28.5092**
Total euro area and non-euro area NCBs	**100.0000**	**100.0000**

Appendix 1 - continued

ESCB members' subscribed and paid-up capital

	Subscribed capital from 1 January to 30 April 2004 EUR'000	Paid-up capital from 1 January to 30 April 2004 EUR'000	Subscribed capital from 1 May 2004 EUR'000	Paid-up capital from 1 May 2004 EUR'000
Nationale Bank van België/ Banque Nationale de Belgique	141,485	141,485	141,910	141,910
Deutsche Bundesbank	1,170,200	1,170,200	1,176,171	1,176,171
Bank of Greece	108,070	108,070	105,584	105,584
Banco de España	439,005	439,005	432,698	432,698
Banque de France	825,875	825,875	827,533	827,533
Central Bank and Financial Services Authority of Ireland	51,270	51,270	51,301	51,301
Banca d'Italia	728,630	728,630	726,278	726,278
Banque centrale du Luxembourg	8,540	8,540	8,725	8,725
De Nederlandsche Bank	221,615	221,615	222,336	222,336
Oesterreichische Nationalbank	115,095	115,095	115,745	115,745
Banco de Portugal	100,645	100,645	98,233	98,233
Suomen Pankki-Finlands Bank	71,490	71,490	71,712	71,712
Subtotal euro area NCBs	**3,981,920**	**3,981,920**	**3,978,226**	**3,978,226**
Česká národní banka	-	-	81,155	5,681
Danmarks Nationalbank	86,080	4,304	87,159	6,101
Eesti Pank	-	-	9,927	695
Central Bank of Cyprus	-	-	7,234	506
Latvijas Banka	-	-	16,572	1,160
Lietuvos bankas	-	-	24,624	1,724
Magyar Nemzeti Bank	-	-	77,260	5,408
Central Bank of Malta	-	-	3,600	252
Narodowy Bank Polski	-	-	285,913	20,014
Banka Slovenije	-	-	18,614	1,303
Národná banka Slovenska	-	-	39,771	2,784
Sveriges Riksbank	133,180	6,659	134,292	9,400
Bank of England	798,820	39,941	800,322	56,023
Subtotal non-euro area NCBs	**1,018,080**	**50,904**	**1,586,443**	**111,051**
Total euro area and non-euro area NCBs	**5,000,000**	**4,032,824**	**5,564,669**	**4,089,277**