Central Bank of Malta

THIRTY-NINTH ANNUAL REPORT

AND

STATEMENT OF ACCOUNTS

2006

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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.

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*As at 30 March 2007

THE BOARD OF DIRECTORS

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

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

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

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

Organisation Chart*

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

*As at 30 March 2007

LETTER OF TRANSMITTAL

CENTRAL BANK OF MALTA
VALLETTA

30 March 2007

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 31 December 2006, 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
LFS	Labour Force Survey
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 was marked by decisive progress towards the satisfaction of the Maastricht convergence criteria and the objective of an early adoption of the euro.

The process of fiscal consolidation continued to unfold in line with the update of the Convergence Programme 2006 – 2009 and the general government deficit is expected to have fallen to 2.6% of GDP, going below the 3% reference value for the first time in several years. Reflecting this improvement in public finance as well as the receipt of privatization proceeds, the debt ratio declined by four percentage points to 68% in 2006, with a projected further drop to below the 60% reference value by 2009.

On the inflation front, the twelve-month HICP moving average rate developed a rising trend last year following the introduction in 2005 of measures to align fuel and energy prices more closely with market rates, at a time when the latter were rising sharply. As a result, inflation exceeded 3% between July and October. In the following months the deceleration in the rate caused by the base effect was reinforced by softer conditions in world oil markets, such that at the end of 2006 inflation had eased to 2.6%, below the 2.9% reference value.

In line with the commitment made upon entry in ERM II in May 2005, the Maltese lira exchange rate was unchanged at its central parity rate against the euro throughout 2006. Against a background of rising euro area interest rates and the consequential narrowing of the yield premium on Maltese lira instruments, however, the Bank lent support to the currency by tightening its monetary policy stance through a 25 basis point rise in its central intervention rate in May and a further increase of the same magnitude in October. The long-term interest rate, measured by the yield on ten-year government bonds, declined marginally to 4.3% in 2006, well below the Maastricht reference value of 6.2%. Over the year, the Bank's net external assets rose by around Lm20 million to Lm951 million, equivalent to almost eight months of merchandise imports, largely on the strength of one-off additions.

A sustained growth performance

These generally favourable developments in the nominal convergence criteria were accompanied by a consolidation of the economic recovery that became established in 2005. The 2.9% GDP growth rate recorded in 2006 was comparable with the previous year's increase, while the negative output gap narrowed further. Another encouraging sign was that while higher domestic demand provided the main impetus to growth in the first quarter, it was replaced by faster growth in net exports as the year progressed.

The sustained output growth in 2006 was, however, accompanied by an increase in the combined current and capital account deficit to 5.9% of GDP in the first three quarters from 3.6% a year earlier. While this deterioration partly reflects the higher cost of imported oil, it remains true that the pace of economic growth in the past few years did not fully reflect the recovery in world markets. As a result, the shortfall in per capita GDP at purchasing power standards widened progressively from 78% of the EU average level in 2000 - a level which reflects the rapid growth experienced by the Maltese economy during the previous decade - to around 72% in 2006.

The comparison of recent growth rates with the faster rates achieved in earlier periods requires a qualification that bears important implications from a policy perspective. That earlier growth, particularly in the late 1990s, was in part driven by substantial fiscal deficits. The resulting internal and external imbalances that persist to this day indeed reflect a policy bias that, while delivering higher levels of activity, also permitted the delay of the structural reforms necessary to underpin sustainable longer-term growth.

Limited policy options

The future thrust of economic policy will, therefore, need to be guided by two key considerations. The first derives from Malta's recent growth experience, the other from the approaching prospect of full membership of Economic and Monetary Union (EMU).

The fact that the Maltese economy has not benefited to the same extent as other economies from the favourable global conditions of the past three years suggests that the downturn after 2000 was only partly cyclical and that there are structural impediments to growth. An early removal of barriers to greater efficiency, particularly the remaining rigidities in the product and labour markets, would contribute to an acceleration of the convergence process towards EU income levels.

A similar conclusion emerges from an analysis of the policy constraints typical of a monetary union. In such a union, monetary and exchange rate policies are no longer available to individual member countries as output adjustment mechanisms; and the single monetary policy of a currency union cannot alone influence output growth differentials. In the euro area, moreover, fiscal policy can only be used for adjustment purposes within the limits set by the Stability and Growth Pact (SGP). Given this limited room for manoeuvre, therefore, an economy can only adjust successfully to asymmetric shocks to the extent that it is flexible and uses resources efficiently. This conclusion is particularly relevant for Malta's open economy because its capacity to generate wealth on a sustainable basis depends on its ability to respond rapidly to changing demand patterns in overseas markets and to offer competitive prices.

The competitiveness challenge

Success in this endeavour depends critically on how fast unit labour costs in Malta increase in relation to those in competitor countries. In the four years to 2005, these costs grew at an annual average rate of 2.4%, faster than the 1.5% reported for the euro area. Further analysis of the components of these costs, namely growth in compensation levels and productivity gains, shows that the annual average rate of growth in compensation per employee broadly matched the 2.4% inflation rate.

While this moderate pace of pay growth helps to explain the stability in unemployment levels in recent years, it cannot, therefore, fully account for the slippage in international competitiveness. An additional, important cause of the latter is the failure of productivity gains to compensate for even such relatively subdued wage growth. In fact, the disparity between wage and productivity growth is wider in Malta than in the euro area, and is reflected in the resulting faster increase in Malta's unit labour costs.

In the four years to 2005, productivity trends have been erratic and resulted in an annual average increase of only 0.1%. In contrast, productivity in the euro area rose by an average of 0.5% over the same period. Neither rate was sufficient to compensate for the annual wage growth of 2.5% in Malta and 2% in the euro area. The shortfall was, however, greater in Malta.

Faster productivity growth essential

The message, therefore, is clear. Since Malta's major foreign exchange earners in both the manufacturing and services sectors are price takers on world markets, the price of domestic inputs must be competitive relative to their productivity. This is especially true of labour, which is the largest single component of total production costs. This means that while continued wage moderation is essential in to-day's competitive global environment, higher productivity levels are indispensable to sustain economic growth and living standards.

The response to this challenge must include measures designed to influence all the determinants of productivity growth. A key factor is the quality of human capital and its ability to adapt to the challenge of rapid technological change. In this regard the situation in Malta has been characterised by slow progress towards some of the key objectives of the Lisbon Agenda. These include the number of persons who complete an upper secondary education or higher, the number of early school leavers and the number of science and technology graduates.

The relatively poor record in this area cannot be attributed to under-funding of the educational sector, as the proportion of the GDP that is allocated to expenditure on education is similar to the euro area average. The disparity in performance, therefore, needs to be addressed through an improvement in the quality of education and the provision of more life-long learning and training; and through increased investment in R&D and innovation.

Heavier investment in human capital alone, however, is not sufficient. If productivity is to rise significantly, such investment must be accompanied by a similar effort to strengthen the economy's physical capital base. For Malta, this means that greater efforts must be made to attract foreign direct investment, which on average already accounts for more than a third of annual gross fixed capital formation. Not only is it an important catalyst for the transfer of technology and expertise, but it is also associated with new market opportunities and greater scale economies. It is, therefore, necessary to create a more investment friendly business environment, including through better regulation and a reduction in bureaucratic procedures and costs.

Government has an important role to play in the upgrading of both human and fixed capital. In the context of a fiscal consolidation process that has not yet run its full course, however, increasing recurrent spending beyond the natural creep caused by existing commitments such as pensions is clearly not an option. The only way forward is through a rationalisation of recurrent budgetary expenditures. Ways must be found, including a wider application of means testing, to shift resources away from the health and social welfare systems. The latter alone already absorbs about one-sixth of GDP. Since any attempt to align the country's spending priorities more closely with its Lisbon Agenda goals implies challenging the continued existence of what have come to be regarded as acquired rights, moreover, achieving the desired reallocation of funds will require broad-based support, particularly that of the social partners. Their cooperation should also be enlisted to achieve greater labour market flexibility and more efficient work practices.

The efficient delivery of support services by both public and private suppliers is also essential for the achievement of faster growth. In particular, regulatory bodies must be more effective in promoting competition across a broader range of product and resource markets. While the external trade regime has been generally liberalised, the same cannot be said of all internal markets, some of which determine prices that are critical to external competitiveness. The market for internal transport services, where the issue of Malta's uncompetitive port charges stands out, is a case in point.

Efforts to boost output growth should also include measures to raise the labour participation rate, particularly for women. Putting more people to work should be a priority. In this regard there needs to be a better balance between ensuring adequate income support for the unemployed and making work pay, so as to discourage an undue reliance on State handouts.

In conclusion, the sustained economic recovery experienced in 2006, albeit somewhat modest in some areas, suggests that the restructuring process necessitated by accession to the EU single market and by the pressures of globalisation has begun to manifest itself in the macroeconomic indicators. The current year, moreover, has the potential to prove to be a watershed in Malta's economic history, marked by the expected qualification for membership of the euro area. The adoption of the euro should indeed enhance the economy's capacity to grow faster. It is not, however, a sufficient condition. The full benefits of membership of EMU can only be derived if further structural reforms are implemented such that the economy can respond flexibly and competitively to the new opportunities opening up to it.

Bank operations

The Bank's independence in the conduct of monetary policy was complemented during 2006 by the introduction of a greater degree of transparency. In May the Bank was invited to report to parliament on its monetary policy for the first time after the terms of reference of the Public Accounts Committee of the House of Representatives had been expanded to permit it to conduct monetary policy hearings. At the Committee's request, a second report was presented in November.

The implementation of its monetary policy required the Bank to continue to conduct weekly open market operations to absorb excess liquidity from the banking system through auctions of term deposits. It this way the Bank ensured that domestic money market rates were compatible with its tighter policy stance. In addition, the Bank continued to use standing facilities and minimum reserve requirements as monetary policy instruments. During the year, the Central Bank of Malta directive on minimum reserve requirements was amended to allow the Bank to review more frequently exemptions granted to credit institutions. In October, following such a review, two more banks were required to hold reserve deposits with the Bank.

In exercising its statutory responsibility to ensure financial stability, the Bank continued to monitor the condition of the financial system. Its findings were shared regularly with the MFSA, which is responsible for the regulation and supervision of the system. During the year, the Ministry of Finance, the MFSA and the Bank took part in an EU-wide simulation exercise to test procedures for the management of financial crisis situations.

The Bank continued to provide banking services to the public sector and to credit and financial institutions during the year and to manage the domestic payment and settlement system. As the sole issuer of currency, the Bank also 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.

During the year the Bank strengthened its relations with the ECB and the other national central banks which, collectively, make up the ESCB. Bank officials participated regularly in the ongoing work of the General Council, the ESCB committees and their working groups.

Preparations for the euro changeover gathered pace during 2006 across the whole range of the Bank's activities. At a national level, the Bank participated actively in the work of both the Steering Committee for Euro Adoption and the National Euro Changeover Committee (NECC). In this connection, the Bank undertook further work to ensure that Maltese legislation was compatible with the Treaty establishing the European Community and with the Statutes of the ECB and the ESCB. It also helped the NECC in drafting the legal framework necessary for the adoption of the euro and contributed to the Euro Changeover Master Plan.

Preparatory work was undertaken to align the domestic framework governing the minimum reserve requirements with that of the Eurosystem and to ensure that, following euro adoption, the Bank will be in a position to manage part of the ECB's portfolio of foreign assets. The Bank also took steps to ensure that the domestic payment system will be smoothly integrated with payment systems in the euro area.

As the year progressed, the Bank stepped up its preparations for the physical cash changeover, during which euro notes and coins will be distributed to the public and Maltese lira notes and coins will be withdrawn from circulation. During 2006 a process involving the public in the selection of the designs for the national side of the Maltese euro coins was completed. Following an international tender process, *Monnaie de Paris*, the French mint, was awarded the contract for minting Malta's euro coins.

The euro changeover also necessitated work on the Bank's premises and the construction of a secure warehouse – which should be completed in June 2007 – as well as a consolidation of the Bank's core information technology systems. At the same time, work continued to ensure that data collection would conform with ECB guidelines before the euro adoption date. The Bank organised an internal training programme for its staff and launched a number of activities as part of a broader information campaign on the euro that will intensify in the course of this year.

The Bank's profit for the year amounted to Lm11.2 million as against Lm10.8 million in 2005.

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

Against a background of high oil prices and persistently large structural imbalances, the world economy grew by 3.9% in 2006, 0.6 percentage points faster than in 2005. While the US growth rate edged upwards by 0.2 points to 3.4%, the euro area surpassed expectations, growing by 2.7%, up from 1.4% the year before (see Table 1.1). The Asian economies continued to grow robustly, with China and India registering growth rates of 10.7% and 9.0%, respectively. Meanwhile, the Japanese economy expanded by 2.2% compared with 1.9% in the preceding year. Inflation in the OECD area stood at 2.6%, unchanged from the previous year's level.

Higher consumption expenditure and exports fuelled growth in the US economy in 2006. After a strong performance in the first half of the year, growth slowed in the third quarter in response to a decline in residential investment. The economy rebounded in the last quarter, boosted by robust consumer spending that was only partly offset by a continued decline in residential investment. At 3.2%, the average rate of inflation was 0.2 percentage points lower than in 2005. Meanwhile, in the labour market, conditions improved further in 2006 with the unemployment rate declining by a half percentage point to 4.6%.

The acceleration in euro area activity reflected stronger investment, supported by higher consumer expenditure and net exports. Germany's growth rate rose to 2.7%, from 0.9% in 2005, while the French economy expanded by 2.2%, one percentage point higher than in the previous year. The average inflation rate of 2.2% in the area was unchanged from 2005, although it declined below 2.0% in the final months of 2006. At 7.8%, the unemployment rate was substantially down from the previous year's level of 8.6%, with Germany showing the largest percentage point decline.

In the United Kingdom, the economy recovered from the slowdown experienced in 2005. The increase in the growth rate to 2.7%, from 1.9% in the previous year, was due primarily to higher consumer spending and investment. The average inflation rate during 2006 accelerated by 0.3 percentage points to 2.3%, mainly as a result of higher energy prices. Unemployment hovered around 5.4%, compared with an average of 4.8% the year before.

An improvement of 0.3 percentage points in the growth rate of the Japanese economy to 2.2% in 2006 was supported by stronger exports and investment spending. Deflation persisted into the first few months

Table 1.1
INTERNATIONAL ECONOMIC INDICATORS
% change from previous year

	Real GDP			Consumer prices		
	2005	2006	2007[1]	2005	2006	2007[1]
United States	3.2	3.4	2.7	3.4	3.2	1.7
Euro area	1.4	2.7	2.1	2.2	2.2	2.0
United Kingdom	1.9	2.7	2.6	2.0	2.3	2.3
Japan	1.9	2.2	1.9	-0.3	0.2	0.2
World total	3.3	3.9	3.3	2.8	2.8	2.3

[1] Forecasts

Sources: Consensus Forecasts; ESRI, Japan.

of the year, but consumer prices registered low year-on-year increases after May. The general improvement in the economy helped to further reduce the unemployment rate to 4.1%.

Interest rates

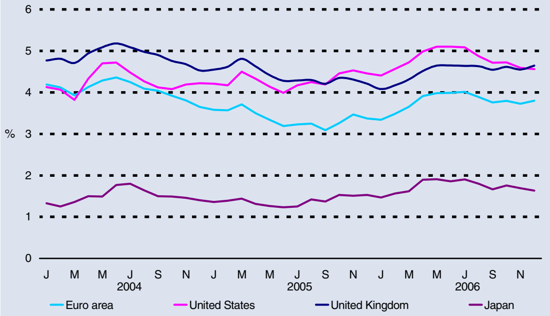
During the first half of 2006, the Federal Reserve tightened further its policy stance, raising the federal funds rate target by a quarter of a percentage point on each of four occasions, to 5.25% by end-June (see Chart 1.1). The target rate was unchanged for the balance of the year, marking a suspension in a two-year cycle of interest rate increases.

Addressing renewed concerns about inflation in the context of a more buoyant euro area economy, the ECB raised the minimum bid rate on its main refinancing operations on five occasions during 2006, each time by 25 basis points, to finish the year at a rate of 3.50%.

The Bank of England's repo rate, which was unchanged at 4.50% during the first seven months of the year, was raised by a quarter of a percentage point in August, in response to firm economic growth along with expectations of continued above-target inflation. The repo rate was raised again in November, to 5.0%, in reaction once again to inflationary pressures.

The Bank of Japan maintained its policy of monetary easing during the first two months of 2006. In March, though, the Bank reversed its stance and restored the overnight call rate as its main intervention rate, setting it at an effective level of zero. In July the Bank raised this rate to 0.25%. In addition, it increased the basic discount rate for the first time in five years, from 0.1% to 0.4%. During the rest of the year, rates were left unchanged.

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



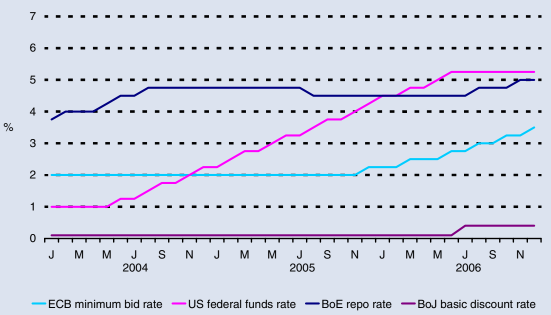
* *Long-term interest rates refer to yields on ten-year government bonds.*
Source: Reuters.

Ten-year bond yields in the US and the euro area followed a broadly similar pattern during 2006 (see Chart 1.2). The increase through June reflected inflation expectations and the improved global economic outlook. Long-term rates generally eased from July on, before rising again in December on positive economic data. There were similar developments in the United Kingdom, while in Japan long-term rates increased following the termination of the Bank of Japan's easier monetary policy.

Exchange rates

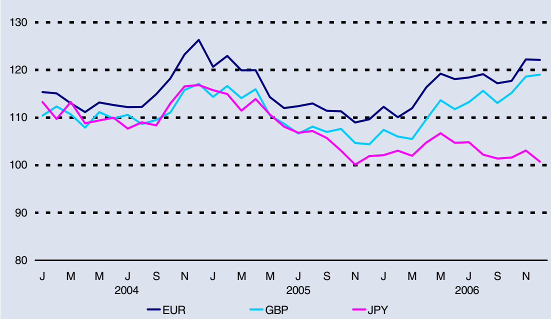
In 2006 foreign exchange markets were characterised by a narrowing interest rate differential in favour of the US dollar and a widening external imbalance in the US (see Chart 1.3). Following strong gains in 2005, the dollar fell by 11.3% against the euro and by 14.0%

Chart 1.1
OFFICIAL INTEREST RATES
(end of month)



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

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.

Table 1.2
EXCHANGE RATES OF SELECTED MAJOR CURRENCIES AGAINST THE US DOLLAR - 2006

	USD/EUR	USD/GBP	JPY/USD
Closing rate on 30.12.05	1.1836	1.7218	117.50
Closing rate on 29.12.06	1.3179	1.9629	118.86
Lowest rate during the year	1.1849 (27 Feb.)	1.7256 (13 Mar.)	119.67 (12 Oct.)
Highest rate during the year	1.3355 (05 Dec.)	1.9805 (05 Dec.)	109.27 (17 May)
% appreciation (+)/depreciation (-) vs the US dollar from closing on 30.12.05 to closing on 29.12.06	11.3	14.0	-1.2

Source: Reuters.

against the British pound in 2006, while it appreciated vis-à-vis the Japanese yen (see Table 1.2).

Renewed market attention to the large US fiscal and current account deficits drove the US dollar down against the euro and sterling in the first half of the year. Going into the third quarter, subdued US economic data, together with a narrower interest rate differential vis-à-vis other major currencies, led to a further depreciation of the US currency. The continued decline of the dollar in the final months of the year mainly reflected concern about the slowdown in the US housing market.

In terms of the Japanese yen, the US dollar depreciated in the first half of the year as markets anticipated a rise in yen interest rates. In the second half, however, the yen/dollar rate reversed course, ending the year 1.2% above the closing position for 2005.

Along with its appreciation against the dollar, the euro also registered strong gains vis-à-vis the Japanese yen, while easing against the British pound. The euro ended the year at JPY156.65, 12.6% above the closing rate in 2005, but declined 2.3% against the pound sterling.

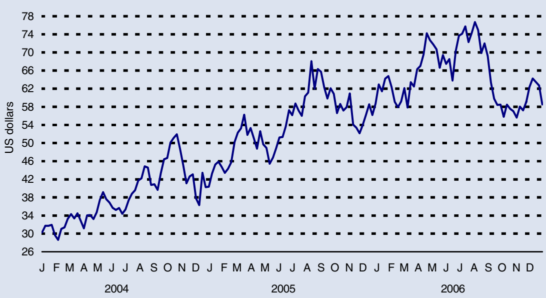
Commodities

Oil

The upward trend in oil prices persisted in the first eight months of 2006 (see Chart 1.4). Brent crude reached a historical high of USD78.46 per barrel in early August, spurred by a further deterioration in the political situation in the Middle East and concerns about a prospective reduction in oil supplies by major OPEC countries. The price dropped thereafter, reaching a low of USD55.18 on 31 October. This decline reflected a mild hurricane season in the US and the ending of the Israel-Lebanon conflict. Moreover, a downward revision of expected oil demand further reduced pressure on prices.

Oil prices were volatile in the remaining months of the year, reflecting production cuts by OPEC on the one hand and weather-related cuts in demand for heating oil on the other. Consequently, the price closed the year at USD58.51.

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

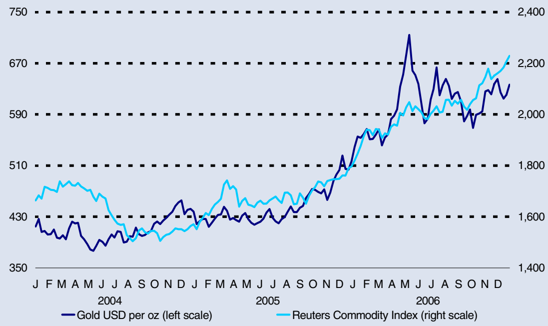


** Brent Blend.*
Source: Reuters.

Gold

Gold prices rose steadily in the first half of the year, in response to concerns about oil supplies, the depreciation of the dollar and gold's safe-haven attraction at a time of geopolitical uncertainty (see Chart 1.5). In fact, gold reached a price of USD600 in April and breached the USD700 mark in May. From mid-June onwards, however, the price declined on account of reduced energy prices and hedge fund selling. Gold prices closed 2006 at USD636.30, an increase of 23.0% over the position at the end of 2005.

Chart 1.5
COMMODITY PRICES
(end of week)



Source: Reuters.

Other commodities

During 2006, non-energy commodity prices as measured by the Reuters' Commodity Index rose by 24.1% (see Chart 1.5).[1] Strong gains in metal prices reflected strong world-wide demand, limited production growth and low inventory levels. Food products also contributed to the rise in prices, albeit to a lesser degree.

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

2. Monetary and Financial Developments

The Central Bank of Malta tightened its monetary policy stance during 2006, raising its central intervention rate by 25 basis points in May and October. As a result, the rate went up from 3.25% in December 2005 to 3.75% in October, and remained stable until the end of the year. Money market interest rates increased in line with movements in the central intervention rate. In the capital market, yields on 5-year government bonds rose during the year, while those on 10-year securities declined. Corporate bond yields moved downwards, while the MSE's share index, after having peaked in March, ended December lower than a year earlier.

The pace of monetary growth quickened during 2006, as domestic credit expanded at a faster pace. Credit growth was mainly driven by increased lending to the non-bank private sector, especially to households. Net foreign asset holdings also grew strongly, primarily reflecting equity capital inflows from abroad into the banking system, which boosted the other counterparts of M3 but had no impact on monetary aggregates.

The monetary base[1]

The monetary base (M0) expanded by Lm25.4 million, or 3.9%, during 2006, driven by bank deposits placed with the Central Bank of Malta (see Table 2.1).[2] The latter increased by Lm41.4 million, mainly because two more credit institutions were required to hold minimum reserve deposits with the Bank towards the end of the year. In contrast, currency in issue contracted by Lm16.1 million.

Table 2.1
THE MONETARY BASE AND ITS SOURCES

Lm millions

	2005	2006	Change Amount	Change %
Currency in issue	520.0	504.0	-16.1	-3.1
Bank deposits with the Central Bank of Malta[1]	135.5	177.0	41.4	30.6
Monetary base (M0)	**655.6**	**680.9**	**25.4**	**3.9**
Central Bank of Malta assets				
Foreign assets	923.0	949.2	26.2	2.8
Claims on government	9.1	30.3	21.2	+
Fixed and other assets	58.8	57.0	-1.8	-3.1
less:				
Remaining liabilities				
Private sector deposits	3.7	12.1	8.4	+
Government deposits	147.5	106.6	-40.9	-27.7
SDR allocations	5.9	5.5	-0.4	-5.5
Foreign liabilities	0.0	0.0	0.0	+
Other liabilities	94.1	153.7	59.5	63.2
Capital and reserves	84.3	77.7	-6.6	-7.8

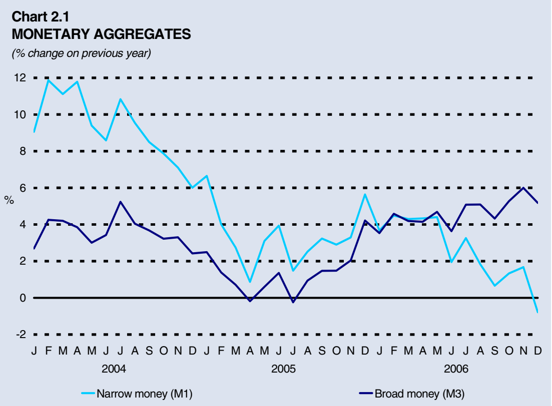
+ indicates a value exceeding +/- 100%

[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 (IFRS). These data may differ from those on monetary aggregates and their counterparts, which are produced in line with international standards on the compilation of monetary statistics.

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

An increase in the monetary base can be traced to rises in the Central Bank of Malta's assets or falls in its remaining liabilities. During 2006 growth in the monetary base mainly reflected a drop in government deposits with the Bank, which fell by Lm40.9 million. Increases in the Bank's foreign assets and in its holdings of government securities also contributed. However, the Bank absorbed liquidity from the banking system through auctions of term deposits, leading to a significant rise in its 'other liabilities' and dampening growth in M0.



Monetary aggregates

Broad money (M3) expanded by Lm157.4 million, or 5.2%, during 2006 (see Table 2.2). As Chart 2.1 shows, broad money growth accelerated steadily during the year, with the private sector showing increased demand for monetary assets triggered by rising deposit rates.

Following a number of years of relatively strong growth, narrow money (M1), which accounts for more than half of M3, contracted by 0.8% during 2006. Currency in circulation fell by Lm21.1 million, partly reflecting the increasing opportunity cost of holding cash in an environment of rising interest rates. In addition, it appears that the private sector began to build up euro cash holdings in anticipation of the euro changeover, and this led to a fall in the demand for cash in the second half of the year. In contrast, deposits withdrawable on demand rose by Lm7.9 million, driven by an increase in Maltese lira balances belonging to private non-financial companies and households, though their annual rate of growth slowed down. As a result, the annual rate of growth of M1, which had stabilised in 2005, fell during the year, turning negative in December 2006 (see Chart 2.1).

Intermediate money (M2) expanded by Lm157.4 million, or 5.2%, as the drop in M1 was offset by a Lm171.3 million surge in deposits with agreed maturities of up to two years. The rise in the latter stemmed mainly from households' Maltese lira balances, which contributed to more than three-fourths of the increase. Foreign currency denominated deposits, particularly those belonging to private non-financial companies, also expanded

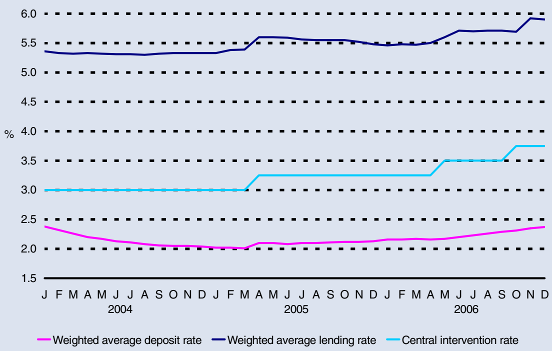
Table 2.2
MONETARY AGGREGATES

Lm millions

	Annual growth rates (%)			Amount outstanding	Change
	2004	2005	2006	2006	2006
NARROW MONEY (M1)	**6.0**	**5.6**	**-0.8**	**1,656.8**	**-13.2**
Currency in circulation	5.6	2.7	-4.2	477.8	-21.1
Deposits withdrawable on demand	6.3	7.0	0.7	1,179.0	7.9
INTERMEDIATE MONEY (M2)	**2.4**	**4.2**	**5.2**	**3,199.0**	**157.4**
Narrow money (M1)	6.0	5.6	-0.8	1,656.8	-13.2
Deposits redeemable at notice up to 3 months	4.4	4.7	-2.0	30.8	-0.6
Deposits with agreed maturity up to 2 years	-1.7	2.5	12.8	1,511.4	171.3
BROAD MONEY (M3)[1]	**2.4**	**4.2**	**5.2**	**3,199.0**	**157.4**
of which foreign currency deposits	4.4	13.7	15.4	440.8	58.7

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

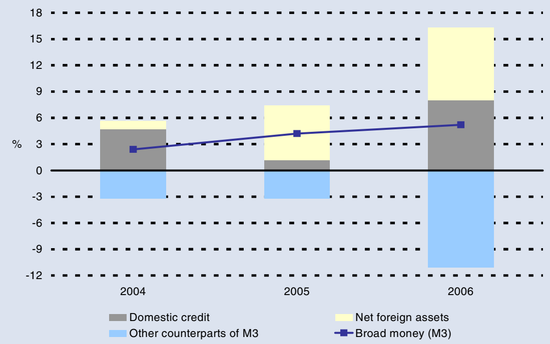
Chart 2.2
DEPOSIT AND LENDING RATES



significantly. The considerable pick-up in the growth of deposits with agreed maturities of up to two years probably reflected depositors' response to rising interest rates. Meanwhile, the remaining component of M2, deposits redeemable up to three months' notice, fell marginally.

Banks reacted to the increases in the central intervention rate by adjusting their deposit and lending rates. However, whereas lending rates responded immediately, deposit rates rose gradually, with higher rates being applied only to new deposits. The weighted average interest rate on Maltese lira deposits rose by 23 basis points during the year, from 2.13% at the end of 2005 to 2.37% (see Chart 2.2). While the average interest rate on savings deposits was stable throughout 2006, corresponding rates on demand and time deposits rose by 12 and 30 basis points,

Chart 2.3
CONTRIBUTIONS TO MONETARY GROWTH



respectively, ending the year at 0.57% and 3.27%. Likewise, the weighted average lending rate went up by 42 basis points to 5.90% in December.

Counterparts of monetary growth

Monetary growth during 2006 was mostly attributable to an expansion in domestic credit – mainly to the non-bank private sector – which had increased only moderately during the preceding year. Net foreign assets also grew substantially, but this had only a limited effect on monetary dynamics as most of the rise reflected an injection of equity capital into two foreign-owned banks, which boosted the other counterparts of M3 but had no real impact on monetary aggregates (see Chart 2.3).

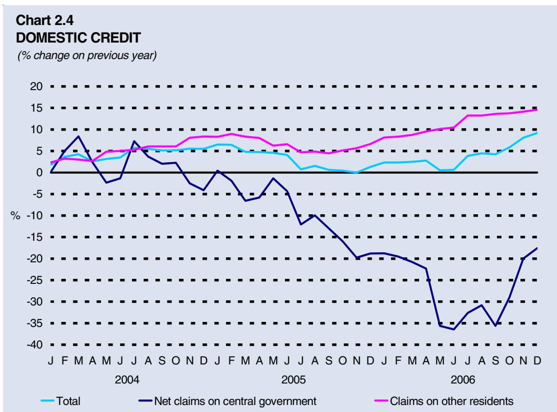
Domestic credit expanded considerably in 2006, with credit demand rising as economic activity recovered.

Table 2.3
BROAD MONEY AND ITS COUNTERPARTS

Lm millions

	Annual growth rates (%)			Amount outstanding	Change
	2004	2005	2006	2006	2006
Broad money (M3)	**2.4**	**4.2**	**5.2**	**3,199.0**	**157.4**
Domestic credit	**5.5**	**1.3**	**9.2**	**2,878.9**	**242.2**
Net claims on central Government	-4.1	-18.8	-17.6	365.0	-77.7
Claims on other residents	8.4	6.6	14.6	2,513.9	319.9
Net foreign assets	**1.7**	**11.3**	**14.0**	**2,062.1**	**252.6**
Central Bank of Malta	-5.4	7.2	2.0	950.8	18.2
Banks	11.3	16.1	26.7	1,111.2	234.3
less:					
Other counterparts of M3[1]	**7.7**	**7.2**	**24.0**	**1,741.9**	**337.3**

[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.



The annual rate of credit growth accelerated to 9.2% from 1.3% in 2005 (see Table 2.3). This rise was entirely attributable to strong growth in claims on other residents, which went up by 14.6% on a year-on-year basis. In contrast, a 17.6% drop in net claims on central government had a dampening effect on domestic credit growth (see Chart 2.4).

Despite rising lending rates, loans and advances, which account for more than 98% of claims on other residents, went up by 14.9% during the year, driven predominantly by demand for credit from the non-bank private sector. Loans to the latter grew by Lm305.0 million, fuelled primarily by lending to households, most of which was for house purchases (see Table 2.4). Nonetheless, while credit growth to the latter category slowed down on a year-on-year basis, lending to most of the remaining economic sectors increased at a faster pace when compared to 2005, with credit to the real estate, renting & business activities sector and to the construction industry also expanding significantly in absolute terms.

Table 2.4
CLAIMS ON OTHER RESIDENTS[1]

Lm millions

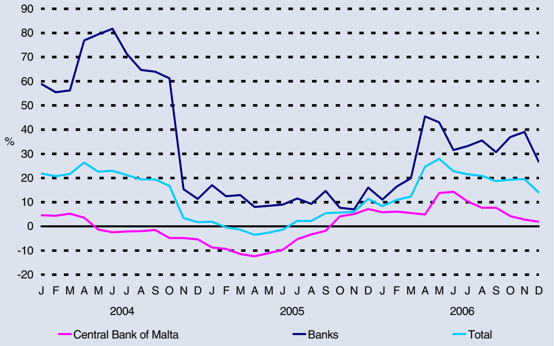
	Annual growth rates (%)			Amount outstanding	Change
	2004	2005	2006	2006	2006
Claims on the non-bank private sector	7.9	9.0	15.3	2,356.5	312.7
of which loans and advances	7.9	10.0	15.2	2,306.6	305.0
Claims on the non-bank public sector	14.0	-17.7	4.7	156.6	7.1
of which loans and advances	17.4	-25.1	9.1	130.0	10.8
Claims on other general government[2]	19.5	-6.1	15.6	0.8	0.1
of which loans and advances	19.5	-6.1	15.6	0.8	0.1
TOTAL CLAIMS	**8.4**	**6.6**	**14.6**	**2,513.9**	**319.9**
of which loans and advances					
Electricity, gas & water supply	55.9	-35.9	32.7	81.1	20.0
Transport, storage & communication	-7.3	-1.8	18.7	146.3	23.0
Agriculture & fishing	7.4	-11.7	13.1	9.8	1.1
Manufacturing	-6.7	-12.5	6.1	113.1	6.5
Construction	7.9	-0.7	16.8	251.7	36.1
Hotels & restaurants	-0.6	-0.8	3.8	211.6	7.8
Wholesale & retail trade; repairs	0.7	2.2	3.5	306.9	10.3
Real estate, renting & business activities	6.9	52.1	37.3	261.8	71.2
Households & individuals	17.8	16.4	15.5	968.7	129.8
Other[3]	11.8	10.9	13.3	86.2	10.1
TOTAL LOANS AND ADVANCES	**8.6**	**7.1**	**14.9**	**2,437.4**	**316.0**

[1] Claims on other residents consist mainly of loans and advances 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)



During 2006 net claims on central government contracted further, dropping by 17.6%. This mainly reflected the receipt of proceeds from the privatisation of Maltacom plc, which led to a rise in government deposits with the Central Bank of Malta, as well as a drop in the banking sector's holdings of government securities.

The net foreign assets of the banking system continued to expand in 2006, with their annual growth rate rising from 11.3% in 2005 to 14.0% (see Chart 2.5).

The net foreign assets of the Central Bank of Malta put on Lm18.2 million, or 2.0%, during the year under review (see Table 2.3). The rise in the Bank's net holdings was driven mainly by privatisation receipts, which were partly offset by the sale of foreign currency to the rest of the banking system.

At the same time, the net foreign assets of the rest of the banking system expanded by 26.7%, reflecting entirely a sizeable increase in the holdings of international banks – which deal mostly with non-residents – due to an inflow of equity capital into two foreign-owned banks. In contrast, the net holdings of the deposit money banks contracted by 17.3%, mainly reflecting demand for foreign exchange from their customers.

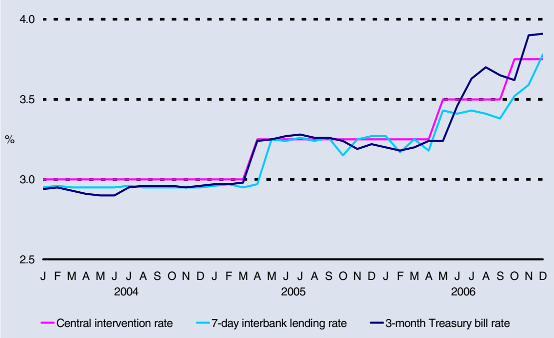
The other counterparts of M3 increased by 24.0% in 2006 (see Table 2.3). This was mainly attributable to the large inflow of share capital mentioned above, which was, however, partly offset by lower retained earnings and a reduction in revaluation reserves.

The money market

Activity in the interbank market slowed down during 2006, with the value of transactions falling to Lm240.0 million from Lm368.9 million in 2005. The number of credit institutions required to hold minimum reserves with the Central Bank of Malta increased, which allowed more banks to manage their liquidity through their reserve deposit balances and reduced their reliance on interbank funding. Liquidity within the banking sector was asymmetrically distributed, with three banks accounting for more than 80% of total trading. More than four-fifths of interbank loans had a term to maturity of one week or less. The interest rate on 7-day loans increased during 2006, in line with the rise in official interest rates in May and October, ending the year at 3.78%, 51 basis points above its level at the end of 2005 (see Chart 2.6).[3]

The Treasury relied less on short-term financing during 2006, issuing Lm396.1 million worth of bills as opposed to Lm462.1 million in the preceding year. At the same time, the amount of maturing bills also contracted, falling by Lm91.3 million to Lm425.9 million. Hence, at the end of the year, the balance of Treasury bills outstanding totalled Lm160.5 million, down from Lm190.2 million in 2005. Three-month bills accounted for more than two-thirds of the total amount issued during the year, with the rest consisting mainly of

Chart 2.6
MONEY MARKET INTEREST RATES
(end of month)



[3] As no interbank deals in this maturity took place in December 2006, the official fixing rate was used instead.

one-year and six-month bills. As in previous years, banks participated heavily in Treasury bill auctions, subscribing to more than half of the total bills issued, with insurance companies and collective investment schemes taking up most of the remainder. The yield on the three-month bill rose during the year in an environment of increasing official interest rates, adding 69 basis points to end the year at 3.91%.

In the secondary market for Treasury bills turnover dropped considerably, falling to Lm90.8 million from Lm144.4 million in 2005. Almost all transactions involved the Bank, which was a net buyer of bills in its market-making role. Secondary market yields moved in tandem with those in the primary market, with the yield on the three-month bill reaching 3.91% by end-December.

The capital market

Net issues of long-term debt securities in the primary market declined substantially during 2006, falling from Lm82.7 million in 2005 to Lm6.5 million, reflecting a drop in issuance activity by Government (see Table 2.5).

Government bond issues contracted by Lm120.7 million to Lm44.3 million as the Government resorted to privatisation proceeds to finance the deficit. The Government issued bonds on two occasions – in March and July. At the same time, an equivalent amount of government securities were redeemed, such that net issues of government stocks in the primary market during the year amounted to zero. The two stock issues had a term to maturity of ten years and eight years, respectively, and offered coupon rates of 4.8% and 5.1%. Almost half of the total amount issued was purchased at par by households, while the remainder was sold by auction, mainly to collective investment schemes. As in previous years, such bond issues were well received by investors.

At the same time, while issues by the non-government sector amounted to Lm17.7 million, Lm11.2 million worth of private sector bonds were redeemed, resulting in a net issue of Lm6.5 million in 2006. The private sector issued four bonds during the year, with terms to maturity ranging between six and ten years. Two of the issues, which accounted for more than half the amount raised, were denominated in euro. Coupon rates varied between 5.6% and 6.7% for ten-year paper, reflecting differences in currency denomination and credit risk.

Turnover in the secondary market for government bonds increased for the fourth consecutive year, rising

Table 2.5

ISSUES OF LONG-TERM DEBT SECURITIES[1]

Lm millions

	2004	2005	2006
Government			
Total issues [2]	144.5	165.0	44.3
Redemptions	44.6	55.0	44.3
Net issues	99.9	110.0	0.0
Non-government sector			
Total issues	10.0	0.0	17.7
Redemptions	0.0	27.3	11.2
Net issues	10.0	-27.3	6.5
Total net issues	**109.9**	**82.7**	**6.5**

[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 Lm1.7 million in 2004, Lm0.6 million in 2005 and Lm1.5 million in 2006.

Sources: Central Bank of Malta; The Treasury.

Table 2.6

SECONDARY MARKET TRADING IN GOVERNMENT STOCKS

Lm millions

	2004	2005	2006
Central Bank of Malta purchases	13.4	3.9	30.1
Central Bank of Malta sales	7.6	8.8	7.6
Other deals[1]	32.2	53.7	30.3
Total	**53.1**	**66.4**	**68.0**

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

Sources: Central Bank of Malta; MSE.

to Lm68.0 million in 2006 from Lm66.4 million in the preceding year (see Table 2.6). The Central Bank of Malta, acting as market-maker, was a net buyer in the market and accounted for more than half the value traded. Activity was concentrated in short- and medium-term securities, with long-term bonds contributing around one-fifth of the total. Yields on 5-year government bonds rose by 52 basis points during 2006, reaching 4.17% at end-December. In contrast, those on 10-year securities declined by 5 basis points, ending the year at 4.33% (see Chart 2.7).

Trading activity in the secondary market for corporate bonds decreased during 2006, with turnover falling from Lm7.4 million in 2005 to Lm4.7 million. Slightly more than half of this turnover involved just seven bonds – less than one quarter of the number of listed instruments – with the rest being fairly evenly spread among the remaining securities. In general, corporate bond yields moved downwards during the year.

In contrast, turnover in the equity market expanded further in the year under review, reaching Lm88.0 million compared with Lm52.0 million in 2005. Trading was mostly concentrated in bank shares, which accounted for almost three-fourths of total turnover. At the beginning of the year the MSE share index extended its upward trend, peaking at 6508.7 in March, the highest level since the Exchange commenced its operations in 1995. Thereafter, falling prices for most equities led to the index ending the year at 4873.5, down by 2.2% from its level at end-2005.

Chart 2.7
GOVERNMENT BOND YIELDS
(end of month)

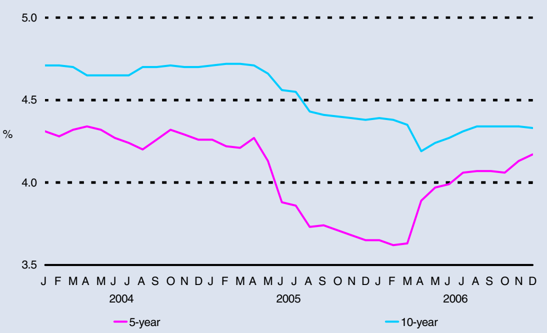


Chart 2.8
MSE SHARE INDEX
(end of month)

Source: MSE.

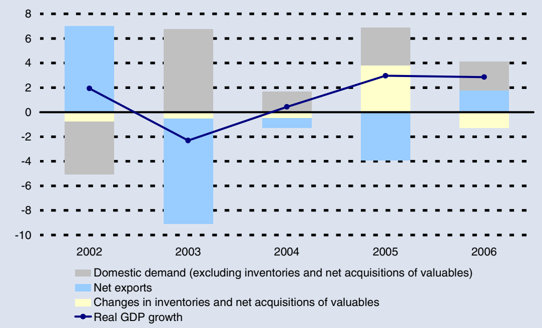
3. Output, Prices and Employment[1]

Gross domestic product

The economy continued its recovery in 2006, growing by 2.9%, marginally below the previous year's rate. While higher domestic demand was the primary source of growth in the first half of the year, net export growth was the major contributor in the second half. For the year as a whole, economic growth was mainly driven by external demand, even though private consumption increased substantially (see Chart 3.1).

The implicit GDP deflator, used to convert nominal GDP into real terms, rose by 2.6% from 2.4% a year earlier (see Table 3.1). The deflators for all the individual components of GDP increased. Prices of investment goods rose by 3.5%, up from 1.6% a year earlier. The deflator for private consumption increased by 2.0%, a slower rate than the previous year's 2.6% rise. At the same time, the external terms of trade improved, with an 11.6% rise in export prices exceeding an increase of 10.2% in import prices.

Chart 3.1
CONTRIBUTIONS TO REAL GDP GROWTH
(percentage points)



Source: NSO.

Domestic demand

Domestic demand contributed 1.1 percentage points to the overall growth rate, as private consumption expenditure remained buoyant, especially in the fourth quarter. Reflecting an increase in real incomes, private consumption rose by 2.6%, as against 2.2% during 2005, and contributed 1.8 percentage points to GDP growth. Meanwhile, a rise of 3.9% in government

Table 3.1
GROSS DOMESTIC PRODUCT

Lm millions

	2002	2003	2004	2005	2006
	(constant 2000 prices)				
Household & NPISH final consumption expenditure	1,089.1	1,126.7	1,148.1	1,172.9	1,203.6
Government final consumption expenditure	339.1	349.0	353.7	352.1	365.8
Gross fixed capital formation	262.3	331.5	333.8	362.1	358.5
Changes in inventories & net acquisitions of valuables	-22.4	-31.3	-39.0	25.4	3.3
Domestic demand	**1,668.2**	**1,775.9**	**1,796.6**	**1,912.5**	**1,931.2**
Exports of goods & services	1,616.8	1,579.0	1,655.8	1,612.8	1,635.1
Imports of goods & services	1,567.9	1,677.4	1,767.6	1,790.5	1,782.0
Net exports	**49.0**	**-98.4**	**-111.8**	**-177.7**	**-146.9**
GROSS DOMESTIC PRODUCT	**1,717.1**	**1,677.6**	**1,684.8**	**1,734.8**	**1,784.3**
GDP deflator (annual percentage change)	2.7	4.6	1.4	2.4	2.6
	(market prices)				
GROSS DOMESTIC PRODUCT	**1,814.4**	**1,853.5**	**1,888.4**	**1,990.5**	**2,099.6**
Net income received from the rest of the world	10.7	-4.9	-27.6	-67.2	-27.0
GROSS NATIONAL INCOME	**1,825.1**	**1,848.6**	**1,860.8**	**1,923.3**	**2,072.6**

Source: NSO.

[1] The cut-off date for data in this Chapter was 9 March 2007.

Table 3.2
GROWTH RATE OF GDP AND ITS COMPONENTS

% change

	2002	2003	2004	2005	2006
Household & NPISH final consumption expenditure	-2.2	3.5	1.9	2.2	2.6
Government final consumption expenditure	3.8	2.9	1.3	-0.4	3.9
Gross fixed capital formation	-18.7	26.4	0.7	8.5	-1.0
Exports of goods & services	6.1	-2.3	4.9	-2.6	1.4
Imports of goods & services	-1.6	7.0	5.4	1.3	-0.5
GROSS DOMESTIC PRODUCT	**1.9**	**-2.3**	**0.4**	**3.0**	**2.9**

Source: NSO.

consumption added 0.8 percentage points to overall growth (see Table 3.2).

A 1% decline in fixed capital formation mainly reflected developments in government capital projects, notably reduced expenditures on the new state hospital as this neared completion and a less extensive roadwork programme relative to the previous year. Indeed, statistics on capital formation by type show that in nominal terms construction declined marginally on a year earlier while outlays on machinery & equipment rose by 8.4%. Inventory changes made a negative 1.3 percentage point contribution to total growth, whereas they had added 3.8 points in the previous year (see Chart 3.1).

External demand

Export activity picked up in 2006, reflecting the strong performance in electronics, pharmaceuticals and fisheries and rapid expansion in the remote gaming sector. In real terms, the 1.4% expansion in exports contributed 1.3 percentage points to overall growth. In contrast, imports dropped by 0.5%. As a result, the contribution of net exports was 1.8 percentage points, as against a negative contribution of 3.9 points in 2005.

Output developments

Measured from the income side, GDP in nominal terms rose by 5.5% in 2006, while gross value added, defined as the difference between output and intermediate consumption, went up by 4.9%, driven by a rise in operating surplus and, to a lesser degree, an increase in employee compensation.[2]

Gross value added grew most significantly in the 'other services' sector. Its 2.2 percentage-point contribution to overall growth in nominal GDP was mainly accounted for by the remote gaming industry, which continued to expand strongly over the year. Other large gains were reported in real estate, renting & business activities, financial intermediation, construction and manufacturing. On the other hand, the hotels & restaurants and the wholesale & retail trade sectors recorded reductions in value added, which lowered GDP growth by 0.2 and 0.1 percentage points, respectively (see Table 3.3).

The main boost to value added came from operating surpluses, which increased by 11.1% and contributed 3.0 percentage points to GDP growth. The largest increase in profits was in 'other services', reflecting in part the solid growth of the remote gaming industry. Strong gains were also registered in manufacturing, construction, electricity and in real estate, renting & business activities. In contrast, profits earned by the wholesale and retail trades declined marginally, while the slowdown in tourism during most of 2006 resulted in losses for the hotels & restaurants sector.

Compensation of employees, the other major component of value added, rose by 2.1% over the year. Most major sectors registered an increase, except for manufacturing and transport, storage &

[2] Measured from the production side, GDP is the sum of the value added by all sectors. Gross value added includes employment compensation, operating surplus, taxes and subsidies on production as well as consumption of fixed capital.

Table 3.3
CONTRIBUTION TO GROWTH OF NOMINAL GDP BY SECTOR AND FACTOR INCOMES

percentage points

	2005			2006		
	Gross value added	Employment income	Operating surplus	Gross value added	Employment income	Operating surplus
TOTAL ECONOMY	**4.0**	**1.3**	**3.9**	**4.2**	**0.9**	**3.0**
Agriculture	0.0	0.0	0.0	0.0	0.0	0.1
Fishing	0.1	0.0	0.0	0.1	0.0	0.0
Mining	0.0	0.0	0.0	0.0	0.0	0.0
Manufacturing	0.7	0.2	0.3	0.3	-0.1	0.4
Electricity	-0.4	0.0	-0.2	0.1	0.0	0.3
Construction	0.0	0.0	-0.1	0.4	0.1	0.3
Wholesale & retail trade	0.6	0.3	0.2	-0.1	0.1	-0.2
Hotels & restaurants	0.0	0.1	-0.1	-0.2	0.1	-0.3
Transport, storage & communication	0.3	0.0	1.5	0.1	-0.1	0.0
Financial intermediation	1.0	0.2	0.9	0.4	0.2	0.1
Real estate, renting & business activities	0.7	0.2	0.5	0.5	0.2	0.2
Public administration	0.1	0.0	0.0	0.1	0.1	0.0
Education	0.3	0.2	0.0	0.1	0.1	0.0
Health & social work	0.2	0.1	0.0	0.2	0.1	0.0
Other services	0.5	0.1	0.9	2.2	0.2	2.0
Private households with employed persons	0.0	0.0	0.0	0.0	0.0	0.0

Source: NSO.

communication, which together lowered GDP growth by 0.2 percentage points. In spite of the slowdown in tourism, employment income in the hotels & restaurants sector continued to rise, accounting for 0.1 percentage points of nominal GDP growth. Labour income rose strongly in financial intermediation, real estate, renting & business activities and in ‘other services’. In total these contributed 0.6 percentage points to the overall growth rate.

Gross national income

Gross national income, which is equal to the GDP plus net income received from abroad, rose by 7.8% in 2006. Gross national income was boosted by higher net incomes received by residents from abroad.

Manufacturing

National accounts data indicate a turnaround in manufacturing, with gross value added rising by 2.2%, mainly in the form of a higher operating surplus. The manufacturing sector contributed 0.3 percentage points to GDP growth, although employment income declined as a result of closures and job shedding in the labour-intensive clothing, textiles & leather sub-sector during the first few months of the year. Job losses in this sub-sector levelled off later in the year.

The NSO’s survey of manufacturing firms revealed that turnover in the first nine months of 2006 grew by Lm54.6 million, or 7.8%, due entirely to gains in export markets (see Table 3.4).

In contrast to the previous year, overseas sales rose by Lm58.8 million, or 11.0%, mainly due to a turnaround in the radio, TV & telecommunications sub-sector, which includes electronics. Strong export gains were also reported by the chemicals sub-sector, reflecting the further expansion by the pharmaceuticals industry. On the other hand, exports of clothing, textiles & leather goods declined, in response to severe competition from low-cost foreign producers. The food, beverages & tobacco sub-sector also reported a fall in foreign sales, as did the electrical machinery sub-sector.

Table 3.4
MANUFACTURING PERFORMANCE - SELECTED INDICATORS[1]

Lm millions

	2004	2005	Jan.-Sep. 2005	Jan.-Sep. 2006
Total turnover	**1,000.8**	**945.4**	**700.7**	**755.3**
Change in exports	**-4.1**	**-58.4**	**-56.9**	**58.8**
Radio, TV, telecommunications	-1.0	-86.6	-79.6	68.6
Medical & precision equipment	4.0	2.7	1.0	1.5
Printing & publishing	-0.2	2.6	-0.5	-0.7
Clothing, textiles & leather	-4.0	-3.6	-2.1	-14.8
Chemicals	-8.5	18.5	11.2	14.6
Electrical machinery	8.0	4.7	7.9	-9.0
Machinery & equipment	-0.7	1.4	0.8	1.9
Food, beverages & tobacco	-1.1	4.5	4.0	-0.4
Others	-0.7	-2.5	0.4	-2.9
Change in local sales	**-16.5**	**3.0**	**1.6**	**-4.1**
Food, beverages & tobacco	-3.7	-8.4	-5.6	-6.9
Machinery & equipment	0.3	1.3	0.8	-2.0
Other non-metallic minerals	0.3	6.5	5.0	1.1
Printing & publishing	-0.5	1.5	1.2	0.3
Fabricated metal products	-1.3	3.3	2.3	0.6
Clothing, textiles & leather	-3.1	-2.7	-1.9	-0.5
Furniture	-3.9	2.3	1.4	0.4
Others	-4.6	-0.9	-1.5	2.8
Change in investment	**4.4**	**-3.2**	**-5.1**	**10.4**
Radio, TV, telecommunications	0.7	3.5	-0.6	14.7
Chemicals	3.5	-3.3	-2.9	0.0
Food, beverages & tobacco	-3.2	0.5	-0.1	-1.3
Printing & publishing	2.6	-2.7	-2.2	-1.7
Games & toys	-0.8	-0.3	0.2	-1.6
Others	1.8	-0.9	0.5	0.3
Change in employment[2]	-928	-381	-278	-1,143
Change in wages per employee (%)	2.6	0.6	0.5	6.6

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

[2] Figures represent differences in average employment levels between the respective periods.

Source NSO.

Domestic sales dropped by Lm4.1 million, or 2.5%, from the year-ago level, mainly a result of the continuing downturn in the food, beverages & tobacco sub-sector. Sales by the latter decreased by Lm6.9 million, or 7.4%, reflecting the competition from food imports in particular. Local sales of machinery & equipment declined by Lm2.0 million, or more than half over the corresponding period of 2005. On the other hand, domestic sales of other non-metallic minerals, printing & publishing goods and fabricated metal products rose from the previous year's levels, though at a slower rate.

Investment undertaken by the manufacturing sector during the first three quarters of 2006 rose by Lm10.4 million. The radio, TV & telecommunications sub-sector registered an increase of Lm14.7 million, but this was partly offset by reduced outlays by firms in the food, beverages & tobacco, printing & publishing and games & toys sub-sectors.

Over the same period, employment in manufacturing contracted by 1,143, mainly as a result of layoffs in the clothing, textiles & leather sub-sector. Similarly, manufacturers of plastic & rubber products and fabricated metal goods continued to shed workers. These losses were partly compensated for by additional recruitment in the radio, TV & telecommunications sub-sector.

Notwithstanding the net reduction in employment, the manufacturing sector's gross wage bill continued to rise. Consequently, wages per employee increased by 6.6%, compared with 0.5% in the corresponding period of 2005, as the attrition in labour-intensive production was partly offset by job creation in the higher value-added industries, which demand a more skilled labour force.

Tourism

The number of tourists departing by air fell by 4.0% during 2006, while tourist expenditure contracted by a more moderate 1.2% (see Table 3.5). In the last two months of the year, however, tourist traffic was boosted by a significant increase in flights by low-cost airlines, following the introduction of targeted incentives by the Government. Tourist activity was also boosted by strong growth in cruise line passengers.

In a break from the recent rise in the relative importance of non-package holidays, expenditure on this category fell, while package-holiday and other forms of spending increased marginally.[3] Total nights stayed decreased by 3.9%, despite continued growth in nights spent in higher-end accommodation, as those spent in three-star hotels dropped sharply. Meanwhile, the overall average length of stay was unchanged from 2005, at 9.5 nights.

Reduced tourist arrivals from three of the main source markets, the UK, Germany and France, were mitigated by higher numbers from other markets, particularly Italy, with the growth in arrivals from the latter in part attributable to the introduction of low-cost airline operations in mid-year.

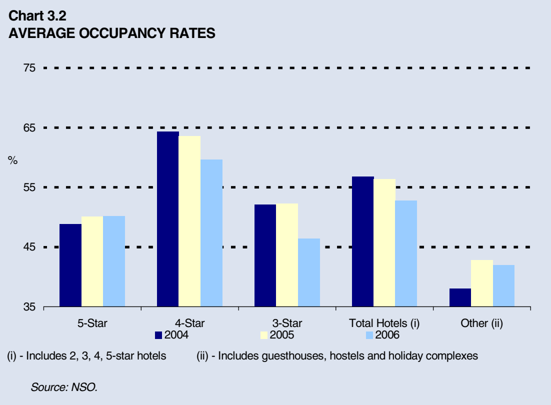
The bed stock stood at 39,494 in December 2006, 1.6% below the end-2005 level. There was an increase of 232 places in five-star hotels, while the stock in other categories, particularly three-star hotels, declined by 881. The drop in the bed stock was accompanied by

Table 3.5
TOURISM ACTIVITY INDICATORS

	2004	2005	2006	*% change* 2006
Tourist departures by air (thousands)	**1,127.4**	**1,150.8**	**1,104.3**	**-4.0**
UK	452.0	482.0	431.0	-10.6
Germany	134.8	138.1	125.6	-9.1
Italy	81.0	78.4	96.1	22.5
France	86.1	81.8	73.1	-10.6
Others	373.6	370.5	378.5	2.2
Nights stayed (millions)	**11.0**	**10.9**	**10.5**	**-3.9**
Average length of stay (nights)	**9.7**	**9.5**	**9.5**	**0.0**
Expenditure (Lm millions)	**432.3**	**427.6**	**422.4**	**-1.2**
Package	219.5	203.7	205.1	0.7
Non-package	69.3	82.5	75.6	-8.3
Accommodation	26.2	32.3	29.0	-10.3
Airfares	43.0	50.1	46.6	-7.0
Other	143.5	141.4	141.7	0.2
Cruise passengers (thousands)	285.0	312.3	392.9	25.8

Source: NSO.

[3] The 'other' component of expenditure consists of all spending excluding air or sea fares, accommodation expenses and package expenses.



a fall in the overall hotel occupancy rate, which shed 3.6 percentage points to 52.8%, reflecting the decrease in tourist numbers. The largest decline in occupancy was experienced by the three-star category, down by 5.9 percentage points. On the other hand, the five-star occupancy rate was marginally higher, despite the increased bed stock (see Chart 3.2).

Industry surveys for the first three quarters of 2006 confirmed the official figures on occupancy rates. However, the surveys also reported continuing growth in average achieved room rates in all hotel categories, especially in the four-star category. But despite higher achieved room rates in three-star hotels, the overall contraction in occupancy rates in this category lowered the revenue earned on each available room.[4]

The number of cruise line visitors rose by 25.8% in 2006, to just below 393,000. The highest number was recorded in August, when the number of visitors doubled on a year earlier. The majority of cruise line passengers came from EU countries, but other markets also showed gains. During the year the number of cruise liner calls rose by 29 to 356.

Construction

After increasing by 2.8% in 2005, the output of the construction industry rose by a further 9.1% in 2006 (see Table 3.6). The number of dwelling permits increased by 14.6%, well below the rise of 35.4% registered in 2005 (see Table 3.7). In line with recent patterns, the vast majority of permits issued related to the development of apartments, especially the redevelopment of older premises into a larger number of smaller units. Nevertheless, there was also a relatively large rise in permits issued for the construction of buildings on undeveloped land.

ETC data show that the private construction industry added over 350 full-time jobs during the first nine months of the year, compared with a rise of just over 200 in 2005. The LFS reports a drop of 1.7% in per-employee income in construction in the first nine months, compared to the 2.8% increase across all sectors.

Table 3.6
CONSTRUCTION ACTIVITY INDICATORS[1]

	2004	2005	2006
Output (Lm millions)	**139.3**	**143.2**	**156.3**
Net value added (Lm millions)	**73.0**	**72.0**	**80.2**
Share of value added in GDP (%)	3.9	3.6	3.8
Total employment	**10,535**	**10,585**	**11,067**
Private employment	**7,462**	**7,664**	**8,022**
Share of private sector in total construction employment (%)	70.8	72.4	72.5

[1]Employment data for 2004 and 2005 are averages for the respective years, while those for 2006 are averages for the first nine months of the year.

Source: NSO.

[4] *Malta Hotels and Restaurants Association Hotel Survey* June, September, December 2006.

Table 3.7
APPROVED DWELLING UNITS BY TYPE

	2002	2003	2004	2005	2006
Apartments	3,420	4,548	5,265	7,539	8,961
Maisonettes	910	1,085	966	1,058	932
Terraced houses	135	414	353	363	375
Other	1,016	81	123	121	141
Total	**5,481**	**6,128**	**6,707**	**9,081**	**10,409**

Source: Malta Environment & Planning Authority.

Residential property prices

The slowdown in the rate of increase in property prices observed in 2005 continued throughout 2006, particularly in the latter half of the year. Advertised property prices rose by 3.7%, significantly less than the 10.4% recorded in 2005 (see Chart 3.3).

This slowdown in house price inflation reflects a deceleration across most property types, particularly terraced houses, maisonettes and finished flats, the latter accounting for over 40% of sampled properties. In contrast, asking prices for town houses rose by 2.3%, after having declined in the previous year, while prices of flats in shell form and villas rose at a faster pace than in 2005.

The labour market

The labour market remained buoyant in 2006 with growth in both employment levels and in the labour force. Official statistics based on the LFS for the first nine months reveal a 1.6% growth in the labour force, with increases in the number of both employed and unemployed persons (see Table 3.8). Reflecting an ongoing shift from the public to the private sector, a 3.2% decline in public sector employment was accompanied by a 3.7% rise in private sector payrolls.

Chart 3.3
RESIDENTIAL PROPERTY PRICES
(year-on-year % change)

The average unemployment rate rose to 7.4% in the first three quarters of 2006, from 7.2% in the corresponding period in 2005. The female unemployment rate went up 0.6 percentage points, while that for males declined by 0.1 percentage points. The data also show changes in jobless duration periods away from long-term towards short- and medium-term unemployment. There was also a decrease in the over-55 category of the unemployed, in contrast to the 25 – 34 year category, which increased.

The overall employment rate, which measures the proportion of the working-age population in employment, increased by 0.4 percentage points to 54.7%. The activity rate, which tracks the labour force as a proportion of the working-age population, also rose, by 0.3 points to 59.1%.

Growth was recorded mainly in full-time jobs, although part-time employment and employment on reduced hours also increased. Meanwhile, the average gross annual salary rose by 2.8% on the previous year.

Similarly, the ETC's administrative records point to an increase in the labour supply and the gainfully occupied population during the first nine months of 2006, along with a marginal decline in the number of unemployed. The corresponding unemployment rate fell to 5.0%, 0.2 percentage points below the previous year's level (see Table 3.9).

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

	2005 Jan.-Sep.	2006 Jan.-Sep.	
			Annual percentage change
Labour force	**161,767**	**164,418**	**1.6**
Unemployed	11,728	12,197	4.0
Employed	150,039	152,221	1.5
By type of employment:			
Full-time	135,603	136,972	1.0
Full-time with reduced hours	1,486	1,742	17.3
Part-time	12,951	13,507	4.3
By economic sector:			
Private	101,107	104,851	3.7
Public	48,932	47,370	-3.2
Average annual gross salary (Lm)	**5,201**	**5,346**	**2.8**
			Absolute change
Activity rate (%)	**58.8**	**59.1**	**0.3**
Male	79.4	79.6	0.2
Female	38.0	38.3	0.3
Employment rate (%)	**54.3**	**54.7**	**0.4**
Male	74.0	74.4	0.4
Female	34.5	34.8	0.3
Unemployment rate (%)	**7.2**	**7.4**	**0.2**
Male	6.6	6.5	-0.1
Female	8.7	9.3	0.6

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

Source: NSO.

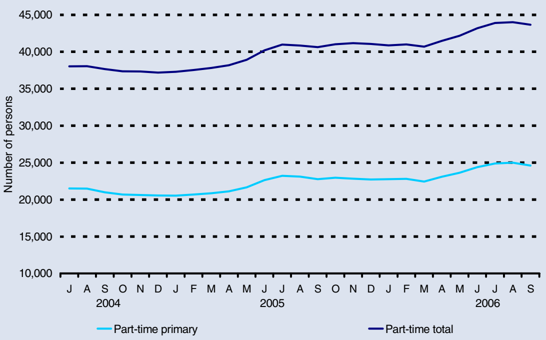
Table 3.9
LABOUR MARKET INDICATORS BASED ON ADMINISTRATIVE RECORDS[1]

	2005 Jan.-Sep.	2006 Jan.-Sep.	*Annual percentage change*
Labour supply	**145,915**	**146,215**	**0.2**
Gainfully occupied	**138,397**	**138,854**	**0.3**
Registered unemployed	**7,518**	**7,361**	**-2.1**
Unemployment rate (%)	**5.2**	**5.0**	
Public sector	**45,686**	**43,946**	**-3.8**
Public majority	5,598	4,313	-23.0
Government departments	31,351	30,797	-1.8
Independent statutory bodies	8,737	8,836	1.1
Private sector	**92,711**	**94,908**	**2.4**
Private direct production	**33,104**	**32,594**	**-1.5**
Manufacturing	22,919	21,977	-4.1
Construction	7,601	8,022	5.5
Private market services	**58,993**	**61,915**	**5.0**
Wholesale & retail	21,153	21,299	0.7
Hotels & catering establishments	8,639	8,678	0.5
Transport, storage & communication	6,507	7,349	12.9
Banks & financial institutions	4,562	4,671	2.4
Real estate, renting & business activities	9,078	10,411	14.7
Other	9,054	9,507	5.0
Temporary employed	**614**	**399**	**-35.0**

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

Source: NSO, from data provided by the ETC.

Chart 3.4
PART-TIME EMPLOYMENT TRENDS



Source: ETC.

Chart 3.5
REGISTERED UNEMPLOYED

Source: NSO.

The shift in the LFS statistics from public to private sector employment was corroborated by the ETC data. The latter show that private sector employment expanded by 2.4% on average over the first three quarters of 2006, compared with the corresponding period of the previous year. The largest increases were registered in real estate, renting & business activities and in transport, storage & communication. On the other hand, the number of persons employed in private direct production contracted further, as job losses in manufacturing were only partly balanced by gains in construction. The 3.8% decline in public sector jobs reflected both the Government's efforts to restrict employment in government departments and the privatisation of state-owned enterprises.[5]

In 2006 part-time employment continued to increase, though at a more moderate pace (see Chart 3.4). Persons holding only a part-time job increased by 8.6%, from an average of 21,837 in the first nine months of 2005 to one of 23,730 in the same period of 2006.

The number of unemployed persons registered with the ETC fell from a monthly average of 7,446 in 2005 to one of 7,326 in 2006. Job losses in textile firms contributed to higher unemployment in the first four months of the year, but the level subsequently eased, reaching a low point in June. The unemployment figure remained stable in the following months, though it rose temporarily in November due to job losses in the manufacturing sector (see Chart 3.5).

Table 3.10
REGISTERED UNEMPLOYED[1]

	2004	2005	2006
Skilled	6,388	6,347	6,961
Unskilled	1,866	1,099	365
Total	**8,255**	**7,446**	**7,326**
by duration			
Under 20 weeks	3,558	3,133	3,166
21 to 52 weeks	1,871	1,498	1,562
53 weeks and over	2,825	2,815	2,598
by age			
Under 30 years	3,458	3,118	3,102
30 to 49 years	3,464	3,107	3,023
50 years and over	1,333	1,222	1,203
Placements to vacancies ratio (%)	47.5	56.0	36.9

[1] Figures are annual averages and may not add up due to rounding.
Source: NSO, from data provided by the ETC.

[5] This included the sale of government shares in Maltacom plc, the sale of Air Supplies and Catering Co. Ltd and the closing down of Sea Malta Co. Ltd.

In terms of the skills distribution of the unemployed population, a large fall in the unskilled category was balanced by higher numbers in the skilled group. In part, this reflected the ongoing reclassification exercise initiated by the ETC in mid-2005, but it was also due to the provision of training schemes for the unemployed. In terms of duration, there was a drop in long-term unemployment, with a considerable decline in the number of persons who had been jobless for over a year. Meanwhile, the age distribution of the unemployed population was broadly unchanged from 2005 (see Table 3.10).

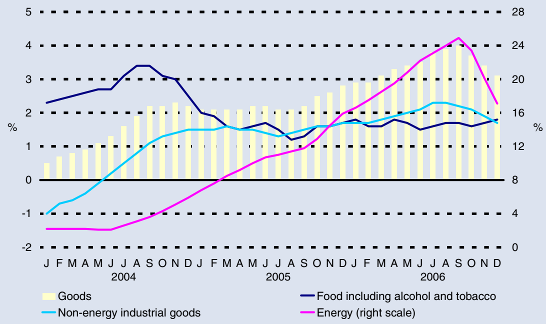
Prices and wages[6]

HICP inflation

Inflation picked up during 2006, with an average increase of 2.6% as measured by the HICP. This extended the upward trend in evidence since the last few months of 2005. HICP inflation peaked at 3.2% in September, before it eased in the final three months of 2006, to end the year marginally up from the level of 2.5% registered in 2005 (see Chart 3.6). This acceleration and subsequent slowdown mainly reflected developments in fuel and electricity costs, which were influenced by the earlier spike in international energy prices. Excluding the impact of energy, inflation remained stable, in the region of 2%, for most of 2006, before sliding to 1.6% at the end of the year.[7]

The year-on-year inflation rate was generally volatile

Chart 3.7
INFLATION IN GOODS PRICES
(12-month moving average)



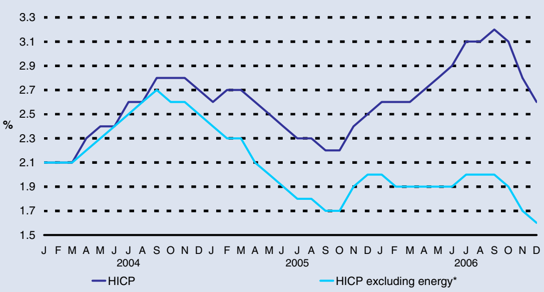
Source: Eurostat.

during 2006, accelerating to around 3.5% between April and July. It then receded sharply, to 0.8% in December, when the base effect attributable to energy prices was neutralised.

As in most of 2005, the HICP energy component, which reflects fuel and electricity prices, continued to record double-digit growth. However, with international oil prices rising in the first half of the year, the increase in this component during 2006 was more pronounced (see Chart 3.7). On the other hand, the average inflation rate of non-energy industrial goods, which include products such as motor cars, furniture and household appliances, remained close to 2%. Likewise, food prices (including alcohol and tobacco) continued to rise at an average annual rate of just below 2%.

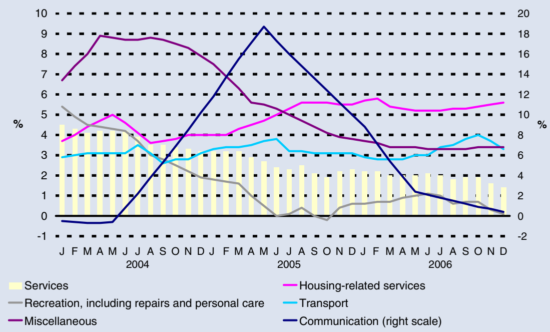
Inflationary pressures in the services sector, in turn, appeared to abate. On average, the prices of services increased by 1.4% during 2006, almost one percentage

Chart 3.6
HICP INFLATION RATES
(12-month moving average)



* Excludes 'liquid fuels and lubricants for personal transport equipment' and 'electricity, gas and other fuels'
Source: Eurostat.

Chart 3.8
INFLATION IN SERVICES PRICES
(12-month moving average)



Source: Eurostat.

6 Average consumer price inflation corresponds to the twelve-month moving average.

7 Eurostat publishes the HICP excluding energy. This index excludes the following two sub-indices: 'fuels and lubricants for personal transport' and 'electricity, gas and other fuels'. In Malta, bills for water consumption are also linked to developments in international energy prices in view of the extensive use of reverse osmosis technology, which in turn relies heavily on electricity. However, this element is not factored into the compilation by Eurostat of the energy component of the HICP.

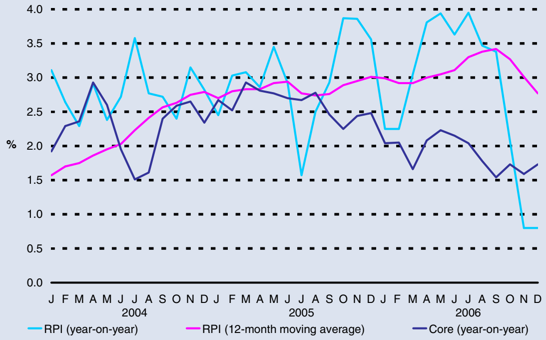
point slower than in the previous year (see Chart 3.8). Prices of recreation-related items, which account for the bulk of the services component within the HICP, were stable after having risen by 0.6% in the previous year. This component mainly includes expenditure in hotels and restaurants and carries a relatively large weight in the index, which also includes tourist expenditures. This deceleration may reflect the slack in the tourism sector during the year. Moreover, whereas prices in the communications sector had risen substantially during 2005, they were stable during 2006.

In areas of services that are more strongly oriented towards the domestic consumer, inflation was higher. Prices of services relating to housing, mainly maintenance, continued to rise at around 5% per annum, while transport-related services, such as car repair, continued to experience inflation in the region of 3%. Prices of miscellaneous services, mainly health and education, also rose by around 3% during 2006, though they slowed down when compared to trends in recent years.

RPI and core inflation

Inflation as measured by the RPI was similar to that recorded by the HICP. The average inflation rate based on the RPI accelerated to 3.4% in September, before easing to 2.8% by the end of the year (see Chart 3.9).

Chart 3.9
RPI AND CORE INFLATION



Sources: Central Bank of Malta estimates, NSO.

As in the previous year, the 'transport & communications' and the 'water, electricity, gas & fuels' sub-indices contributed most to inflation (see Table 3.11). Movements in these sub-indices reflected ongoing adjustments to utility and fuel prices resulting from the rise in international energy prices. Food and housing prices also continued to rise, at a similar pace as that registered in 2005. The remaining sub-indices were generally stable during the year.

The absence of significant underlying inflationary pressures was further evidenced by a deceleration in the Bank's estimate of core inflation, to 1.7% in December 2006 from 2.5% twelve months earlier.[8]

Wages

Central Bank of Malta estimates derived from collective

Table 3.11
CONTRIBUTION TO RPI INFLATION

percentage points

	Weights	2004	2005	2006
Food	23.82	0.1	0.4	0.5
Beverages & tobacco	6.11	0.6	0.2	0.1
Clothing & footwear	8.24	-0.2	0.0	-0.1
Housing	7.57	0.3	0.4	0.4
Water, electricity, gas & fuels	2.25	0.0	0.5	0.7
Household equipment & house maintenance costs	7.65	0.2	0.2	0.1
Transport & communications	23.13	0.9	0.9	0.8
Personal care & health	6.22	0.3	0.2	0.2
Recreation & culture	8.84	0.1	0.1	0.0
Other goods & services	6.17	0.5	0.2	0.2
RPI	**100.00**	**2.8**	**3.0**	**2.8**

Source: NSO.

[8] This measure excludes those RPI components that do not exhibit persistence, namely water, electricity, gas & fuels; transport & communications; clothing & footwear; food; and beverages & tobacco.

Table 3.12
ESTIMATED CHANGE IN AVERAGE WAGES[1]

	2004	2005	2006
			%
Unskilled	5.4	2.9	3.2
Skilled	3.3	3.2	2.6
Clerical	2.6	3.4	2.3
Administrative[2]	2.3	2.2	2.1
Average for all categories	**3.8**	**3.1**	**2.7**
Excluding civil service employees	**3.9**	**3.2**	**2.9**

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

agreements point to an annual wage growth of 2.7% in 2006 for workers covered by these agreements, and 2.9% when government employees are omitted from the calculation. These figures represent a further deceleration in wage growth, though not for the unskilled category (see Table 3.12). Estimated increases ranged from 2.1% for administrative workers to 3.2% for the unskilled group.[9]

According to the Bank's estimates, unit labour costs dropped by 0.5% during 2006, reflecting a slightly faster rate of growth in productivity than in employee compensation. While productivity growth (measured in terms of real output per person in employment) was up by 2.0%, nominal compensation per employee grew by only 1.5%.

Short-term outlook

EU integration and globalisation dynamics have continued to drive the further transformation of the Maltese economy. This process has involved a gradual winding down of certain manufacturing activities that are no longer competitive, a restructuring of others - which has enabled them to compete in export markets - and the emergence of new productive and service industries that have found in Malta a congenial operating environment.

Against this background, the Bank has analysed, on the basis of its model together with judgemental inputs, recent past and current economic developments in Malta and its main trading partners to forecast the economy's performance in 2007. It is pertinent to note in this regard that Malta's main macroeconomic indicators are often characterised by high volatility because of the small size of the economy and its vulnerability to external shocks. As a result, actual outcomes may deviate significantly from forecasts.

Assumptions

The Bank's macroeconomic forecasts for 2007 are mainly based on an assessment of past and current economic indicators, and are contingent on developments in foreign demand, more specifically in Malta's main trading partners, and on the projected conduct of fiscal policy.

Foreign demand is assumed to slow down in 2007, as both economic growth and external trade are expected to decelerate in Malta's main trading partners. At the same time, international inflation is assumed to decline following the drop in oil prices in the second half of 2006 and the limited second-round effects of the earlier price increases. In 2007 oil prices are assumed to

[9] This exercise includes only unionised employees covered by collective agreements. These number 64,245 and comprise around 46% of the gainfully occupied population. Wage estimates incorporate cost-of-living adjustments but exclude overtime pay, production bonuses and all other allowances and income in kind.

Table 3.13
OUTLOOK FOR SELECTED ECONOMIC INDICATORS

%

	2005	2006	2007 [1]
GDP growth at constant prices	**3.0**	**2.9**	**2.8 - 3.4**
Growth in GDP components at constant prices			
Private consumption expenditure	2.2	2.6	2.5 - 3.1
Government consumption expenditure	(0.4)	3.9	0.0 - 0.6
Gross fixed capital formation	8.5	(1.0)	4.5 - 5.1
Inventories (% of GDP)	1.5	0.2	0.2
Exports of goods and services	(2.6)	1.4	2.9 - 3.5
Imports of goods and services	1.3	(0.5)	2.4 - 3.0
External goods and services balance (% of GDP)	(7.7)	(5.5)	(4.1) - (4.7)
General government balance (% of GDP)[2]	(3.1)	(2.6)	(2.2) - (2.5)
Inflation rate	3.0	2.8	1.4 - 1.8
Unemployment rate[3]	7.3	7.4	7.0 - 7.3

[1] Central Bank of Malta estimates.

[2] Since the general government balance to GDP ratio was computed using GDP data published in March 2007, the ratio for 2005 does not tally with that published in the latest Update of the Convergence Programme.

[3] The unemployment rate for 2006 refers to the average between January and September.

Note: Figures in parentheses are negative.

Sources: Central Bank of Malta estimates; NSO; Ministry of Finance.

remain stable at around US$60 per barrel, implying a drop of about 8% from the average price in 2006.

The forecasts take into account the current stance of fiscal policy in Malta. It is assumed that the fiscal deficit to GDP ratio will decline to below 2.5% of GDP in 2007, in line with the projections published in the Update of the Malta Convergence Programme 2006 - 2009.

Nominal exchange rates in 2007 are assumed to remain constant, at the average rate of the fourth quarter of 2006, while the differential between euro area and Maltese short-term interest rates is assumed not to change from the level observed in the final quarter of 2006. With regard to the inventories component of GDP, this is assumed to be 0.2% of GDP, the same level applied in 2006.

The forecast

In 2007 the economy is expected to grow faster than in 2006. A range of 2.8% - 3.4% is projected, compared with the 2.9% rate recorded in 2006 (see Table 3.13). While economic growth last year was largely driven by a rebound in exports, in 2007 stronger private consumption and gross fixed capital formation are expected to be the main factors. In turn, the latter is expected to be underpinned by a surge in government capital expenditure, although growth in private investment should pick up further. The external sector should also contribute positively, as export growth is expected to be stronger. On the other hand, this may be offset to some extent by an acceleration in import growth, reflecting in part the rise in import leakages associated with the higher consumption and investment activity.

The projected strengthening of domestic private consumption stems from a number of factors. These include the easing of the direct tax burden following the downward revision of the income tax bands announced in the Budget for 2007, which is estimated to boost disposable incomes by about Lm12 million. A pick up in real wage growth due to lower inflation, coupled with higher employment growth, is also expected to have a positive impact on household disposable income in 2007, and hence on private consumption. Higher spending may also result as a spill-over effect of cash de-hoarding by the public in anticipation of the euro changeover. On the negative side, however, higher interest rates may have a dampening impact on borrowing, and thus consumption, while encouraging savings.

The growth rate in government consumption is also expected to slow down somewhat in 2007, to around 0.0% - 0.6%, reflecting the commitment to further reduce the fiscal deficit through tighter controls on expenditure, particularly on supplies related to operational and maintenance activities. Although wage growth is projected to accelerate modestly, job shedding in the public sector through attrition is expected to contain growth in the government wage bill.

As regards investment growth, this is projected to accelerate to around 4.5% - 5.1%, largely as a result of a substantial rise in capital expenditure by the public sector compared with the previous year, when this was estimated to have declined by around 5%. The planned projects are expected to be financed partly by structural funds from Malta's allocation under the EU Budget for 2007 - 2013. Meanwhile, private sector investment is expected to grow at a stronger pace than in the previous year, as conditions in the construction sector remain buoyant while newly established enterprises in the manufacturing and the financial and business services sectors continue to expand.

Following the rebound in 2006, exports of goods and services are projected to pick up further, growing within a range of 2.9% - 3.5%. The increase is expected to be distributed across several sectors. Growth in manufacturing exports is expected to accelerate, partly due to the fact that the decline in the clothing industry is likely to have bottomed out. In the electronics sub-sector, export sales in nominal terms are expected to slow down, but in real terms these are projected to grow at a faster pace, particularly in the second half of the year, due to an expected decline in the international price of electronic components. Meanwhile, exports by other sub-sectors, such as pharmaceuticals, scientific instruments and printing, are expected to expand further. At the same time, the services industry is also forecast to report higher sales, particularly in respect of new business activities such as call centres and remote gaming, with the number of firms operating in the latter industry expected to increase significantly during the year. As regards tourism, gross earnings are expected to rise in 2007, as tourist inflows should be boosted by the projected increase in flights operated by low-cost airlines.

After declining in 2006, imports are expected to grow by 2.4% - 3.0% in 2007, mainly reflecting a rise in the imported inputs of the export-oriented manufacturing sector. Furthermore, imports of consumer and investment goods should be boosted by the acceleration in private consumption and investment discussed above, which will be reflected in additional import leakages.

The external goods and services deficit, on a national accounts basis, is expected to narrow further in nominal terms, from 5.5% of GDP in 2006 to between 4.1% and 4.7% of GDP in 2007. This improvement is mainly attributable to continued favourable developments in the terms of trade. The increase in both export and import prices is projected to be considerably lower in 2007, given an expected deceleration in export prices in Malta's trading partners and generally lower inflation abroad. Nevertheless, the rise in export prices, especially for services, is expected to outpace the increase in import prices, as the latter should also be dampened by the impact of lower oil prices.

The benign international inflation environment is expected to lead to a lower rate of price inflation in Malta. RPI inflation is thus projected to decline from 2.8% in 2006 to a range of 1.4% - 1.8% in 2007. The fall is, however, also attributable to the base effect of energy prices that had risen substantially in the second half of 2005 and early 2006. Since oil prices in 2007 are expected to be around 11% lower in Maltese lira terms, the contribution of energy products to domestic inflation is expected to be negative in 2007, while second round effects of higher energy prices in 2006 on other products should remain limited.

In the labour market, conditions in 2007 are forecast to improve as job opportunities respond to stronger economic growth. The rate of unemployment is thus projected to decline to around 7.0% - 7.3%. At the same time employment growth is expected to pick up to around 1%, spurred by new activity in services, even as public sector employment contracts further.

Forecast risk

The projections discussed above are subject to both downside and upside risks. On the downside the main risk is a sharper-than-anticipated slowdown in international economic activity. Although the projections already incorporate a deceleration in activity and trade in Malta's main export markets, particularly the US, these do not provide for a more marked decline that could be triggered by upward pressures on oil prices.

On the upside the risks mainly relate to the pace of the economic transformation process in Malta, particularly if new export-oriented services grow at a faster pace than anticipated. Furthermore, there is a possibility that growth forecasts for the euro area, which constitutes the largest export market for Malta, may be underestimated. A more favourable outturn could also give rise to increased optimism in consumer sentiment, which, coupled with the effects of euro adoption, could give rise to higher growth in private consumption, with possible positive spill-over effects on investment. Consequently, the overall balance of risks to the 2007 economic growth forecasts appears to be on the upside.

4. The Balance of Payments and the Maltese Lira

The balance of payments

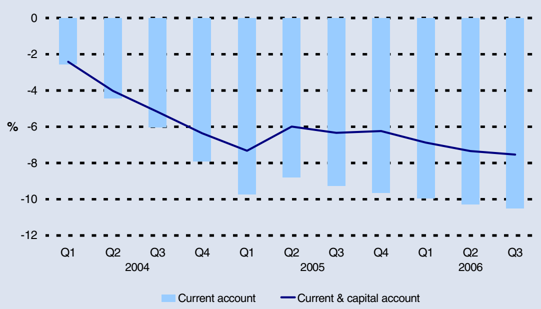
Over the twelve-month period to September 2006 the current account deficit increased to 10.5% of GDP from 9.2% a year earlier (see Chart 4.1). After excluding movements in reserve assets, net inflows on the capital and financial account declined as increases in foreign direct investment and in other investment inflows were offset by larger portfolio outflows. Meanwhile, reserve assets extended the upward trend that began in 2005.

The widening of the deficit on the current account partly reflected a larger merchandise trade gap, as the increasing trend in import values continued to outweigh that of exports (see Chart 4.2). At the same time, net receipts from services, which had been relatively stable in 2004, contracted over the period reviewed (see Chart 4.3). The decline was observed across all the major components: travel, transport and other services. On the other hand, the positive balance on the transfers account continued its sharp upward trend during 2006, mostly boosted by the earnings of the remote gaming industry. Meanwhile, net outflows on the income account decreased, reflecting higher receipts by residents on their foreign portfolio investments.

After having increased to 2.9% of GDP during the year to September 2005, reflecting grants received from Italy under the Financial Protocol and from the EU, the positive balance on the capital account edged up to 3.0% during the twelve months to September 2006. However, the deficit on the combined current and capital account widened to 7.5% of GDP (see Chart 4.1).[1]

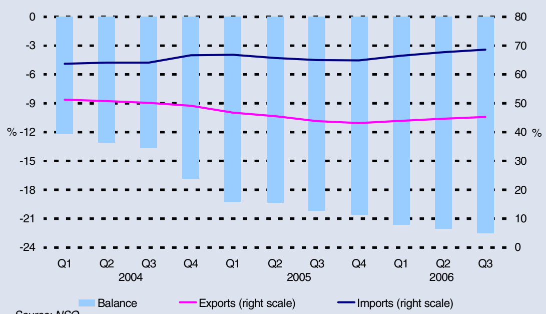
When excluding movements in reserve assets, net inflows on the financial account declined from 24.6% of GDP in the year to September 2005 to 18.0% of GDP over the four quarters to September 2006. As Chart 4.4 shows, this was mainly due to net outflows on the combined portfolio and other investment accounts.[2] These rose significantly during the period reviewed, mainly reflecting transactions of international banking institutions. Conversely, direct investment inflows, which had been broadly constant in 2005, increased strongly on account of privatisation proceeds and equity inflows into the banking sector.

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



Source: NSO.

Chart 4.2
GOODS BALANCE
(four quarter moving sum; percentage of GDP)

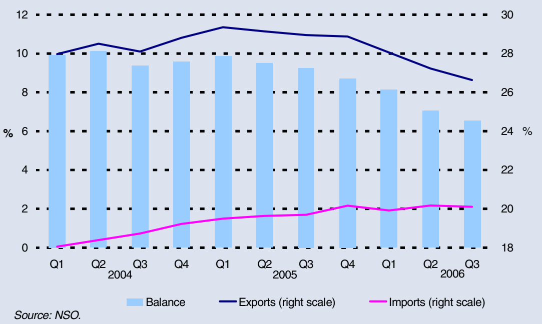


Source: NSO.

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

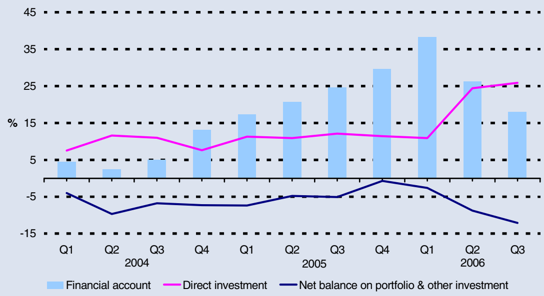
[2] International banking institutions operating in Malta normally channel inflows from the other investment category into portfolio investments overseas. Although this leads to large flows in these two categories of the financial account, the net impact is much smaller.

Chart 4.3
SERVICES
(four quarter moving sum; percentage of GDP)



Source: NSO.

Chart 4.4
FINANCIAL ACCOUNT*
(four quarter moving sum; percentage of GDP)



* Excluding movements in reserves.
Source: NSO.

With the surplus on the capital and financial account exceeding the deficit on the current account, reserve assets increased over the survey period.

The trends discussed above broadly reflect balance of payments developments during the first three quarters of 2006, when the current account deficit stood at Lm114.5 million, or 7.3% of GDP, compared with Lm88.7 million, or 6.0%, a year earlier (see Table 4.1).[3] While a substantial increase in the positive balance on the transfers account and lower net income outflows impacted favourably on the account, a larger merchandise trade gap and a decline in net inflows from services had a negative effect.

When movements in reserve assets are excluded, the

Table 4.1
EXTERNAL BALANCES[1]

Lm millions

	Q1-Q3			
	2005		2006	
	credit	debit	credit	debit
Current account balance		**88.7**		**114.5**
Goods and services	1078.4	1202.1	1134.4	1353.1
Goods balance		281.8		338.7
Goods	626.7	908.5	705.3	1044.0
Services balance	158.1		120.0	
Services	451.7	293.6	429.1	309.1
Transport	107.6	67.0	95.0	64.2
Travel	210.1	65.5	210.3	72.7
Other services	134.1	161.1	123.8	172.2
Income (net)		42.1		26.2
Current transfers (net)	77.0		130.4	
Capital and financial account balance[2]	**200.5**		**184.5**	
Capital account balance	43.1		37.1	
Financial account balance	157.4		147.4	
Direct investment	179.8		489.8	
Portfolio investment		292.5		680.9
Financial derivatives		9.4		93.8
Other investment	279.5		432.3	
Movements in reserves[3]		**44.3**		**54.6**
Net errors and omissions		**67.5**		**15.4**

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

[3] A fuller analysis of balance of payments developments during the first three quarters of 2006 can be found in the Central Bank of Malta *Quarterly Review* 2006:4.

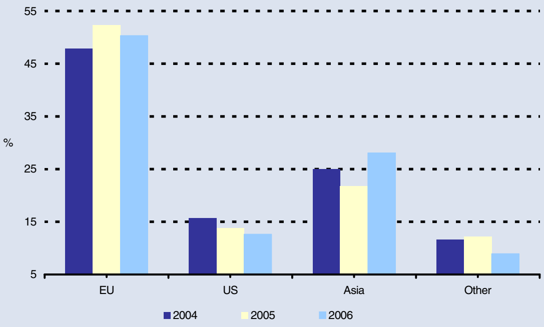
capital and financial account balance fell by Lm16.0 million to Lm184.5 million, or 11.8% of GDP. The decline mainly stemmed from lower net inflows on the financial account, though a reduction in capital account inflows also contributed. Net direct investment inflows contributed positively to the financial account. However, these were offset by net outflows from the combined portfolio and other investment categories, largely attributable to the activities of international banking institutions. Net errors and omissions fell markedly, though they remained negative, while reserve assets increased on a year earlier.

Merchandise trade[4]

On the basis of Customs data available for the full year, the merchandise trade gap widened by a marginal 1.3% during 2006, as against an increase of over one-fifth in 2005 (see Table 4.2). In absolute terms, the rise in imports exceeded that in exports. However, in sharp contrast to the previous year, when they had contracted, exports rose at a faster pace than imports during 2006.

Compared with the previous year, exports grew by 13.7%, with higher sales of machinery and transport equipment accounting for the greater part of the increase. The latter reflected the performance of the electronics sector, which improved significantly

Chart 4.5
DIRECTION OF TRADE - SHARES OF TOTAL EXPORTS



Source: NSO.

following a downturn during 2005. Exports of food and pharmaceuticals also recorded gains, but textile and clothing exports fell further, against a background of declining production, as the sector continued to face strong competitive pressures in foreign markets.

Imports were up by 9.1% on a year earlier. This was mainly attributable to higher purchases of industrial supplies, particularly inputs for the machinery and transport equipment sub-sector. On the other hand, the fuel bill, which had risen during 2005 on account of a marked rise in the international price of oil, was slightly lower. At the same time, purchases of consumer goods increased modestly.

Exports to the EU, Malta's largest market, were up significantly on a year earlier, though as a share of the

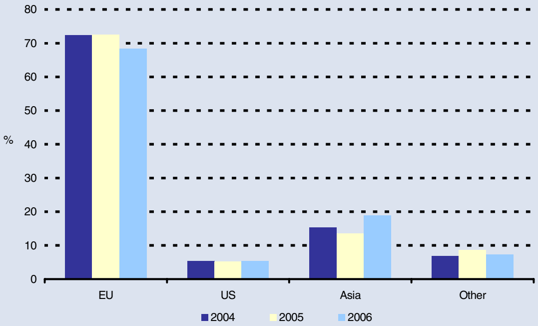
Table 4.2
MERCHANDISE TRADE
(based on Customs data)

	2004	2005	2006[1]	% change 2005	% change 2006
Imports	**1,300.8**	**1316.8**	**1,436.0**	**1.2**	**9.1**
Consumer goods	339.5	355.0	365.5	**4.6**	**3.0**
Industrial supplies	623.6	593.5	699.9	**-4.8**	**17.9**
Capital goods & others	235.9	227.8	239.7	**-3.4**	**5.2**
Fuel & lubricants	101.8	140.5	130.9	**38.0**	**-6.8**
Exports	**896.5**	**822.9**	**935.8**	**-8.2**	**13.7**
Trade deficit	**404.3**	**493.9**	**500.2**	**22.2**	**1.3**

[1] Provisional
Source: NSO.

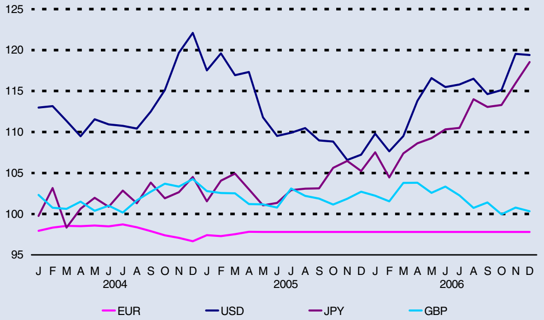
[4] Merchandise trade figures are compiled by the NSO from Customs data, which are recorded on a cost, insurance and freight basis. These data are then adjusted in the compilation of the balance of payments to cater for differences in coverage, valuation and timing. In addition, insurance and freight 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.

Chart 4.6
DIRECTION OF TRADE - SHARES OF TOTAL IMPORTS



Source: NSO.

Chart 4.7
EXCHANGE RATE MOVEMENTS OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES
(index of end-of-month rates, January 2003 = 100)



total they shed 1.9 percentage points to 50.4% (see Chart 4.5). Exports to Asia grew sharply, mainly reflecting the recovery of the electronics sub-sector, and accounted for 28.1% of the total, as against 21.8% in 2005. With sales to the US increasing at a moderate pace, their share in the total fell from 13.8% to 12.6%. Exports to other countries fell both in absolute terms and as a proportion of the total.

Meanwhile, imports from the EU expanded on a year earlier after having declined in 2005. Nevertheless, the proportion of Malta's imports sourced from the Union contracted by 4.1 percentage points on the previous year, to 68.4% of the total (see Chart 4.6). Imports from Asia increased sharply in absolute terms and accounted for 19.0% of total imports. The share of imports from the US remained stable at 5.4%, while imports from other countries fell.

The Maltese lira

Exchange rate developments

In line with the Maltese authorities' unilateral commitment to maintain the exchange rate of the Maltese lira unchanged against the euro in ERM II, the domestic currency remained at the central parity rate of Lm0.4293 to the euro throughout 2006 (see Chart 4.7). The Maltese lira thus followed the euro's trend against the major currencies. It appreciated by 11.3% against the US dollar over the year as a whole, reaching a high early in December. Against the Japanese yen, it rose by 12.6%. In terms of the pound sterling, however, the lira lost ground during most of 2006, reaching its lowest level for the year in October, and falling by 2.3% over the year as a whole (see Table 4.3).

Meanwhile, on an average basis, the lira was marginally

Table 4.3
EXCHANGE RATES OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES FOR 2006

	EUR[1]	USD	GBP	JPY
Average for 2005	0.4299	2.8960	1.5910	318.3
Average for 2006	0.4293	2.9259	1.5882	340.2
% appreciation (+)/depreciation (-) of the MTL against the respective currency	0.1	1.0	-0.2	6.9
Closing rate on 30.12.2005	0.4293	2.7570	1.6012	324.0
Closing rate on 29.12.2006	0.4293	3.0699	1.5639	364.9
% appreciation (+)/depreciation (-) of the MTL against the respective currency	0.0	11.3	-2.3	12.6
High for the MTL during the year	N/A	3.1108 (05 Dec.)	1.6339 (05 Apr.)	364.9 (29 Dec.)
Low for the MTL during the year	N/A	2.7600 (27 Feb.)	1.5565 (30 Oct.)	319.8 (12 Jan.)

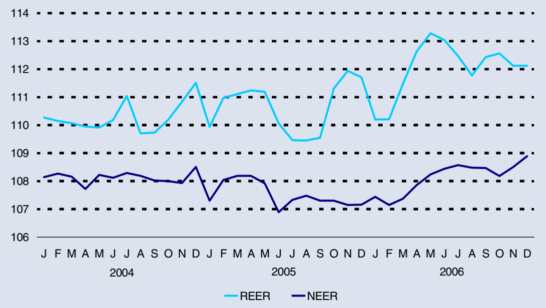
[1] As from 1 April 2005, the Central Bank of Malta started to quote the Maltese lira against the euro exclusively in terms of units of Maltese lira per euro. As a result, an increase in the MTL/EUR exchange rate implies a depreciation of the Maltese lira against the euro and vice-versa. The other currencies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

lower against the euro in 2006, reflecting exchange rate movements during the first four months of 2005, before the lira entered ERM II. The lira appreciated against the dollar and the Japanese yen, by 1.0% and 6.9%, respectively. On the other hand, it edged down against sterling.

Effective exchange rates

In December 2006 the Nominal Effective Exchange Rate (NEER) of the Maltese lira was up by 1.6% on December 2005, reflecting the gains of the Maltese currency against the US dollar and the Japanese yen. Meanwhile, after having put on 0.2% during 2005, the lira's Real Effective Exchange Rate (REER) rose by 0.4% during the year reviewed, as the impact of the nominal effective appreciation of the currency was partly offset by lower inflation in Malta compared to its main trading partners.[5] The REER peaked in May, but subsequently declined as inflation in Malta fell (see Chart 4.8).

Chart 4.8
REAL AND NOMINAL EFFECTIVE EXCHANGE RATE INDICES FOR THE MALTESE LIRA
(1995 = 100)

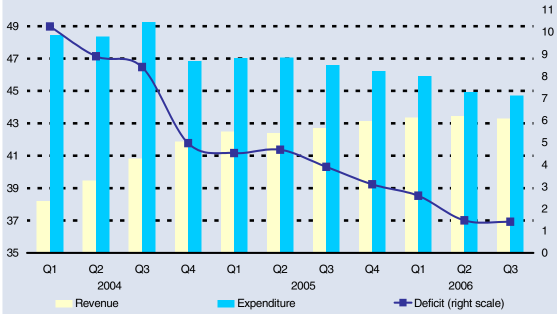


[5] The REER index is based on movements in exchange rates and consumer prices in 25 partner and competitor countries.

5. Government Finance

The general government deficit is expected to have fallen below 3% of GDP in 2006, with revenue increasing more rapidly than expenditure. According to the latest Update of Malta's Convergence Programme,[1] the deficit declined to 2.6% of GDP from 3.2% in 2005, mirroring developments in the Consolidated Fund.[2] As a share of GDP, both the deficit and the debt are expected to continue on a downward trend between 2007 and 2009.

Chart 5.1
GENERAL GOVERNMENT FISCAL INDICATORS
(4-quarter moving sum; % of GDP)



Source: NSO.

General government

Data available for the first three quarters of 2006 show a declining trend in the deficit-to-GDP ratio resulting from slower growth in expenditure coupled with a relatively strong rise in revenue (see Chart 5.1).[3]

According to the latest Update of Malta's Convergence Programme, the general government deficit was expected to fall to 2.6% of GDP in 2006 from 3.2% a year earlier (see Table 5.1). Revenue was projected to have grown at a faster pace than expenditure, mainly on account of higher tax receipts. At the same time, expenditure growth was expected to have moderated as a result of lower government employment and a reduction in subsidies. As a result, the primary surplus, which is obtained by deducting interest payments from expenditure, should have increased to 1.1% of GDP in 2006 from 0.8% a year earlier.

With economic activity picking up, part of the improvement in the fiscal position reflects the favourable impact of the business cycle. Nevertheless, the budgetary stance tightened, as indicated by the contraction in the cyclically-adjusted budget deficit

Table 5.1
UPDATED CONVERGENCE PROGRAMME: KEY FISCAL INDICATORS

% of GDP

	2005	2006	2007	2008	2009
Total revenue	44.2	43.8	43.9	41.8	40.1
Total expenditure	47.4	46.4	46.2	42.7	40.1
Interest payments	3.9	3.7	3.4	3.4	3.1
Budget balance	-3.2	-2.6	-2.3	-0.9	0.1
Primary balance	0.8	1.1	1.1	2.5	3.2
Cyclically adjusted budget balance	-2.3	-1.9	-1.8	-0.8	-0.3
Gross debt	74.2	68.3	66.7	63.2	59.4

Source: Update of Convergence Programme 2006-2009, Ministry of Finance.

1 As a Member State of the European Union, Malta is required to submit Convergence Programmes to the European Commission 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 General government data are taken from NSO News Release No. 3/2007 published on 10 January 2007 and GDP data are taken from NSO News Release No. 39/2007 published on 9 March 2007.

Table 5.2
GOVERNMENT BUDGETARY OPERATIONS

Lm millions

	2005	2006 [1]	Jan-Nov 2005	Jan-Nov 2006	Change Lm	Change %
Revenue	**831.3**	**896.1**	**702.3**	**734.0**	**31.7**	**4.5**
Direct tax [2]	352.2	390.1	278.4	307.9	29.5	10.6
Indirect tax	323.0	342.3	290.5	306.7	16.2	5.6
Non-tax	156.1	163.6	133.4	119.4	-14.0	-10.5
Grants	67.0	76.0	54.8	56.5	1.7	3.1
Expenditure	**906.5**	**953.8**	**795.7**	**813.9**	**18.2**	**2.3**
Recurrent expenditure [2]	775.6	803.3	686.6	711.7	25.1	3.7
Social security benefits	220.8	231.7	200.2	213.3	13.1	6.5
Personal emoluments	201.1	205.1	169.1	170.9	1.8	1.1
Contributions to Government entities	76.5	73.1	69.7	67.3	-2.4	-3.4
Interest payments	74.8	77.2	70.6	73.4	2.8	4.0
Capital expenditure	131.0	150.6	109.1	102.2	-6.9	-6.3
Primary balance [3]	-0.6	19.4	-22.8	-6.5	16.3	71.5
Balance on Consolidated Fund	**-75.3**	**-57.8**	**-93.4**	**-80.0**	**13.4**	**14.3**

[1] Data for 2006 are the revised estimates, as shown in the *Financial Estimates 2007* and the *Budget Speech 2007* published in October 2006.
[2] Excluding the state contribution to the social security account.
[3] Total revenue less total expenditure excluding interest payments.
Source: Ministry of Finance.

from 2.3% of GDP in 2005 to 1.9% of GDP a year later. The reliance on temporary measures also diminished. During 2006, general government debt as a proportion of GDP was expected to have fallen to 68.3% from 74.2% a year earlier, mainly due to the receipt of privatisation proceeds in the first half of the year but also reflecting a larger primary surplus and faster GDP growth.

The Updated Convergence Programme includes projections for key fiscal variables for the period between 2007 and 2009. The deficit-to-GDP ratio is expected to fall further to 2.3% during the current year, with revenue again projected to rise at a faster pace than expenditure. However, both revenue and expenditure are expected to decelerate compared to 2006. The reduction in the fiscal imbalance is based on recurrent expenditure restraint and revenue growth.

Despite the tax cuts announced in the 2007 Budget Speech, greater efficiency in tax collection and increased economic activity are expected to boost revenue. The deficit is expected to continue declining steadily as capital expenditure falls, swinging into a marginal surplus of 0.1% of GDP in 2009. The debt-to-GDP ratio should likewise maintain a downward trend, dropping below 60% by the end of the forecast horizon.

Consolidated Fund performance in 2006[4]

During the first eleven months of 2006, the balance on the Consolidated Fund contracted by Lm13.4 million, or 14.3%, on a year earlier to Lm80.0 million (see Table 5.2). The primary deficit also shrank, dropping by Lm16.3 million over the period. Revenue grew by 4.5% over the comparable period of 2005, surpassing the 2.3% growth in expenditure.

[4] This analysis is based on information for the period January to November 2006. The Consolidated Fund captures most of the transactions of central government on a cash basis.

Revenue

During the period under review revenue continued to expand, entirely on account of higher tax receipts. Direct taxes grew at a faster pace, yielding 10.6% more than in the corresponding period of 2005. Income tax accounted for most of the rise, putting on 13.7% in a favourable economic environment. Social security contributions rose by 5.7%, with greater efficiency in collection playing a part. Indirect tax proceeds expanded by 5.6% over a year earlier, partly driven by an increase in excise duty rates in April, with VAT receipts growing less rapidly.

In contrast, non-tax revenue declined. Central Bank of Malta profits fell and a number of other revenue items, which had boosted such revenue a year earlier, were not repeated in 2006. These included the sale of a telecommunications network licence, the Investment Registration Scheme and capital gains on the sale of Malta Government Stocks (MGS) on the primary market. During the period under review, grants expanded only moderately.

Expenditure

Between January and November 2006 expenditure went up by Lm18.2 million, or 2.3%, on a year earlier as further growth in recurrent expenditure was partly offset by lower capital outlays. Recurrent expenditure, however, increased less rapidly than in the comparable period of 2005, expanding by 3.7% compared with 4.8% a year earlier. Social security benefits - mainly retirement pensions - accounted for nearly half of the rise. The government wage bill increased by 1.1% as a decline in public service employment levels partly offset wage growth in terms of the collective agreement. Interest payments were up by 4%, reflecting the timing of coupon payments on debt issued during 2005. In contrast, subsidies to public non-financial corporations, particularly the shipyards, declined.

On the other hand, after having increased sharply during the first eleven months of 2005, capital expenditure during the period reviewed declined by 6.3%, partly reflecting lower outlays on projects financed by grants received under the Fifth Financial Protocol with Italy. A base effect, which resulted from exceptionally high payments for the acquisition of land a year earlier, also contributed.

Government debt and financing operations

The deficit on the Consolidated Fund during the first eleven months of 2006 was financed by privatisation receipts, as the Government sold its majority shareholding in Maltacom plc. In part, the receipts were used to reduce government debt. Consequently, gross government debt contracted by Lm19.5 million to Lm1,368.4 million.

The composition of the debt also changed, as short-term bills outstanding fell by Lm9.6 million while long-term bonds in issue increased by a modest Lm1.3

Table 5.3
CHANGES IN GOVERNMENT DEBT

Lm millions

	2005	2005 Jan-Nov	2006 Jan-Nov
Gross Government debt[1]	**50.3**	**26.6**	**-19.5**
Malta Government stocks	110.6	110.6	1.3
Treasury bills	-55.1	-78.3	-9.6
Local loans	-1.8	-2.1	-0.5
Foreign loans	-3.3	-3.5	-10.7

[1] Figures exclude government debt held by Sinking Funds.

Source: Central Bank of Malta.

million (see Table 5.3). Foreign borrowing declined by Lm10.7 million as external debt was repaid, while local loans outstanding also contracted marginally.

Consequently, MGS outstanding at end-November amounted to Lm1,126.6 million, or 82.3% of government debt, while Treasury bills totalled Lm163.4 million, or 11.9%. Local and foreign loans, which stood at Lm24.8 million and Lm55.5 million, respectively, accounted for the remainder.

6. Financial Stability Analysis

The steady growth of economic activity during 2006 in an environment of relatively low, albeit rising, interest rates led to a rise in corporate earnings and household income. Growth in the Maltese economy was also supported by more buoyant external demand, as the European economies continued to recover. The financial sector experienced further expansion over the year and its capital base remained adequate. However, profits registered by the banking sector as a whole levelled off. On the other hand, the domestically-oriented banks recorded higher profits, driven largely by lower allocations for loan loss provisions – reflecting a lower credit risk outlook – and reduced write-offs of bad debts, as well as higher interest and non-interest income.[1] Furthermore, stress test results indicate that the domestic banking sector is robust enough to withstand extreme but plausible shocks. Consequently, the Bank's assessment of the stability of the domestic financial sector remains favourable.

Looking forward, the main risks to a continuation of this benign condition are increasing interest rates, a possible slowdown in the construction sector, a weakening of the buoyant external economic conditions and/or growing competitive pressures. These may translate into higher credit risks.

Regulatory and legislative developments

During 2006 the European Union enacted several directives relating to financial services. The recast Directive 2006/48/EC, relating to the taking up and pursuit of the business of credit institutions, and Directive 2006/49/EC, on the capital adequacy of credit institutions, were published in June 2006 and came into force in January 2007. Another key piece of legislation was the Markets in Financial Instruments Directive (MiFID), which is due to be implemented in 2007. Meanwhile, progress was made on new solvency regulations, Solvency II, in respect of the insurance sector.

In line with its policy of promoting a better and more integrated regulation of the financial sector, the European Commission embarked on detailed analyses of various issues that can have financial stability implications. These include a review of regulations governing liquidity, deposit guarantee schemes, large exposures, own funds and concentration.

European developments were the driving force behind most of the changes in the domestic regulatory and legislative framework for financial services during 2006. The MFSA is in the process of implementing the necessary changes to the relevant legislation whilst converting its Directives for financial services into a new set of Rules. These Rules will, in particular, transpose and implement EU Directives 2006/48/EC and 2006/49/EC. With regard to the transposition and implementation of the MiFID, the MFSA has issued a number of public consultative documents seeking the industry's views on various amendments to the current Investment Services Guidelines.

The Securitisation Act, which provides a legal framework for the establishment of structured finance, was brought into force during the year. The Insurance Intermediaries Act, which was enacted in July, implemented the provisions of Directive 2002/92/EC on insurance mediation. Regulations governing linked long-term contracts of insurance were changed so as to include the providers of such services under the insurance business.[2] The Civil Code was also amended to create a legal platform that would facilitate factoring activities provided by the financial sector.

[1] Domestically-oriented banks, also referred to as domestic banks, operate mainly with residents.
[2] Legal Notice 320 of 2006, published in terms of the Investment Services Act (Cap 3700).

The financial sector

Structural developments

The banking sector remained dominant within the financial sector, accounting for over 83% of total financial sector assets at the end of 2006. Six institutions are domestically controlled and account for 23.3% of banking assets.[3]

With regard to the domestically-oriented banks, the relatively high concentration in the sector persisted, with the Herfindahl-Hirschman Index (HHI) remaining stable at 2836 during the year, whereas the index for the banking sector as a whole decreased slightly, to 1185.[4] Several credit institutions intensified their operations in other cross-sector business lines, including the selling of export credit insurance and payment protection plan policies, as well as offering index-linked deposit products. Apart from diversifying further the banks' income sources, this could alter the structure of the financial system in the future as the distinction between banks and other financial services providers diminishes. Credit institutions have also increased their internet product offer, which could lower operational costs in the longer term.

The size of the insurance sector remained relatively unchanged during the year, accounting for 3.5% of the total assets of the financial sector as at December 2006. The number of insurance principals increased by ten during the year, to 34, eight of which are locally owned and predominantly operate in the domestic market. Concentration in the domestic insurance sector rose moderately, with the HHI rising from 3382 as at December 2005 to 3657 a year later.

The number of collective investment schemes remained stable at 14, whereas hedge funds, licensed as Professional Investment Funds (PIFs), increased by 11 to 29 by December 2006. During the year, the share of collective investment schemes in the total assets of the financial sector increased by 0.6 percentage points to 4.6%, while the share of PIFs dropped by 0.5 of a percentage point to 8.4%.

The banking sector

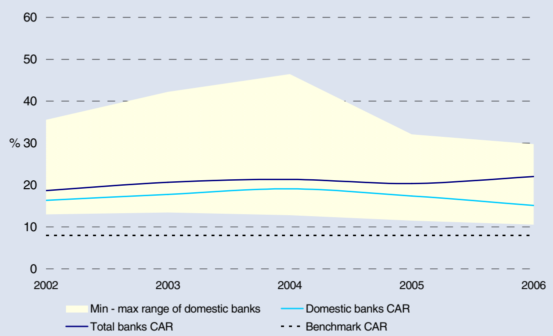
After having declined in the previous year, the core capital adequacy ratio (CCAR) of the banking system as a whole rose slightly in 2006, to 20.8%, with the capital adequacy ratio (CAR) also improving to 22.0% (see Table 6.1). At the same time, the CCAR and the CAR of the domestically-oriented banks dropped by over 2 percentage points to 13.6% and 15.1%, respectively, although with wide variations between banks. This was largely due to an expansion in risk

Table 6.1
FINANCIAL SOUNDNESS INDICATORS - TOTAL BANKS %

	2002	2003	2004	2005	2006
Regulatory capital to risk-weighted assets (CAR)	18.7	20.7	21.3	20.4	22.0
Regulatory Tier 1 capital to risk-weighted assets (CCAR)	16.1	18.6	18.2	19.0	20.8
Non-performing loans net of provisions to capital	53.9	38.4	30.0	20.1	12.4
Non-performing loans to total gross loans	9.7	8.1	6.5	3.9	2.8
Return on assets (ROA)	0.8	1.0	1.3	1.2	1.1
Return on equity (ROE)	9.4	10.2	13.9	14.8	11.9
Interest margin to gross income	71.1	70.9	45.3	48.7	57.1
Non-interest expenses to gross income	68.9	57.9	47.3	41.4	45.1
Liquid assets to total assets	24.5	24.4	24.3	21.7	19.7
Liquid assets to short-term liabilities	54.7	55.8	53.4	58.3	58.1

[3] Domestically-controlled institutions are those banks which, on a group consolidated basis, are ultimately regulated by the MFSA.
[4] The Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in a market and then summing the resulting numbers. A market with an HHI of less than 1,000 is considered to be competitive; a result between 1,000-1,800 reflects a moderately concentrated market; whereas a result of 1,800 or greater reflects a highly concentrated market.

Chart 6.1
CAPITAL ADEQUACY RATIOS



weighted assets (RWA) which was not matched by a corresponding increase in capital. As a result, and taken in isolation, the strong growth in lending, which contributed to the increase in RWA, weakened the capital adequacy position of the domestic banks. Overall, however, the financial strength of credit institutions in Malta remained solid, as indicated in Chart 6.1. The results of stress tests carried out by the Central Bank of Malta on the robustness of the capital of the domestic banking sector also indicate that the capital buffer is strong enough to withstand extreme but plausible credit and market shocks.

The assets of the banking sector breached the Lm13 billion mark by the end of 2006, largely driven by lending to the non-bank sectors, the largest component of the banks' balance sheet. Likewise, the assets of the domestically-oriented banks grew to Lm5.9 billion as a result of an expansion in loan portfolios, mainly relating to mortgage loans and other lending related to the construction industry. This was matched on the liabilities side by growth in deposits and interbank transactions, which ensured that liquidity levels remained high, albeit slightly lower than in 2005.

At the same time, asset quality within the banking sector continued to improve, with the benign credit environment being sustained by domestic economic growth. Consequently by end-2006, the proportion of non-performing loans (NPLs) to total loans dropped by nearly one percentage point to 2.8% for the banking sector as a whole (see Chart 6.2). Furthermore, as NPLs contracted more rapidly than provisions, the coverage ratio increased from 29% in 2005 to 32% by the end of 2006.[5]

The pre-tax profits of the banking sector as a whole levelled off during the year as an increase in non-interest expenditure and a decrease in non-interest income were largely matched by higher net-interest income. As a result of growth in assets and an increase in the equity base, however, the return on assets (ROA) and return on equity (ROE) ratios declined to 1.1% and 11.9%, respectively (see Chart 6.3).

On the other hand, domestically-oriented banks registered a 17% increase in pre-tax profits, with the main contributing factor being the improved credit risk environment. In fact, the amount of loan write-offs was lower than in 2005, while a net reversal of allocated provisions boosted profitability. Moreover, since most loans are contracted at variable interest

Chart 6.2
NON-PERFORMING LOANS

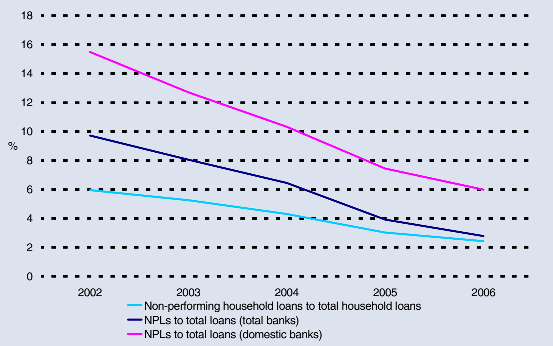
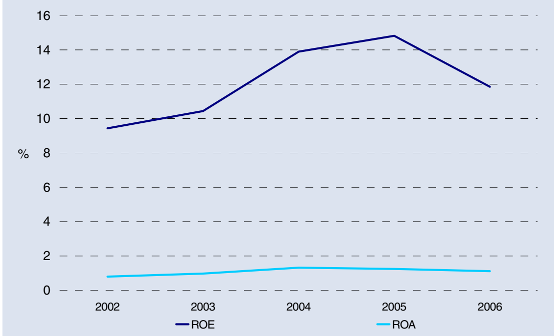


Chart 6.3
PROFITABILITY
(total banks)



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

rates, the stronger growth in the loan book of the banks when compared to their deposit liabilities in a period of rising interest rates enabled them to increase their net-interest income modestly. Furthermore, domestic banks contained their non-interest expenditure, while their non-interest income expanded.

Market risk within the banking sector remained relatively low. In fact, gap analysis indicates that a variation in interest rates would have a negligible effect on the net interest income of the domestic banks. Foreign currency denominated assets and liabilities are well balanced, with the domestic banks carrying an overall short position of foreign currency exposures equivalent to 5.1% of total own funds at end-2006, down from 6.7% twelve months earlier.[6] At the same time, the growth in foreign currency loans during 2006, while transferring currency risk onto the borrower, may entail an increasing exposure of banks to indirect credit risk arising from unhedged positions of household and corporate borrowers. This indirect credit risk is considered low, however, as most of the lending facilities are denominated in euro, to which the Maltese lira is pegged.

The non-bank financial sector

The non-bank financial sector, which accounts for 16.6% of total financial assets in Malta, is still relatively small. Nevertheless, links between non-bank financial institutions and the banking sector, which can take various forms - such as ownership, investments, exposures and common counterparties - can create contagion and reputation risks within the system as a whole. The capital base and profitability of the insurance sector remained strong during 2006. The increase in mortgage lending boosted growth in both the life and the home insurance sectors. In fact, general and life assurance premia increased during 2006, by an estimated 7% and 10%, respectively.[7]

In spite of a bearish domestic stock market, assets held by collective investment schemes grew by 28% during the year. Ample liquidity, relatively low interest rates on bank deposits and strong marketing of these products were the driving forces behind the expansion. The main investors in collective investment schemes are residents, with households accounting for nearly 90% of total shareholders' funds.

Market infrastructure

After having peaked in March 2006, the Malta Stock Exchange Index followed a declining trend thereafter. An overall drop in equity prices outweighed the impact of a new equity issue and lowered market capitalisation, which fell to 137% of GDP in December 2006 from 147% a year earlier. The reversal in market capitalisation resulted from an overall drop in equity prices, largely driven by banks' share prices. The decline in the latter did not appear to indicate investor concern about the health of these institutions, however, as their price-earnings ratio still remained relatively high. Following the rise in interest rates, trading activity in the capital market slowed down. These developments resulted in the market becoming more illiquid, reflecting the lack of depth, which accentuates price changes while creating disincentives for investment in the market.

The non-financial sector

The household sector

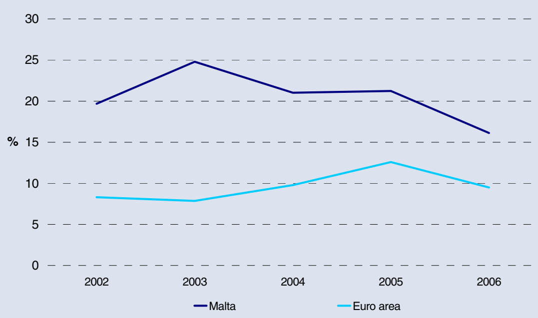
Household indebtedness to banks continued to increase during 2006, with the rate of growth of mortgage lending in Malta remaining higher than the euro area average (see Chart 6.4).[8] However, although households remained vulnerable to shocks, the debt burden still appears to be sustainable. Indeed, while rising interest rates impinged on their debt repayment capability, this negative effect was offset by the positive influences of higher employment levels and

[6] Banking Directive DB/08 sets a limit of 20% on the overall longest (or shortest) position of foreign currency exposures to total own funds. The exposure in each currency may not exceed 5% of total own funds with the exception of exposures in euro, which have a limit of 20%.

[7] Data are based on Central Bank of Malta estimates.

[8] Source: *ECB Monthly Bulletin*, various issues.

Chart 6.4
MORTGAGE LOAN GROWTH
(domestic banks)



Sources: Central Bank of Malta, ECB

growth in national income. Affordability has also improved, while problematic loans have decreased further.[9] Furthermore, households are still accumulating wealth, both financial and property-related, thus indicating an increasing buffer to service debt.

Nevertheless, although the financial position of households remains sound, and even appears to have strengthened during 2006, an acceleration in the debt burden poses some risks going forward. Since most mortgage loans are contracted at variable rates, households with a heavy debt burden, particularly those in the lower income bracket, become more vulnerable in an increasing interest rate scenario.

The corporate sector

Bank lending to the corporate sector grew by 13.7% during 2006, mainly for real estate-related and fixed investment projects. But the corporate sector's net indebtedness to the banking system increased by 16.8%, as an acceleration in lending to the sector outweighed an expansion in corporate deposits.

Although the level of credit risk arising from corporate indebtedness is still considered high, this decreased further during 2006, as shown by the loan repayment performance of firms. In fact the ratio of corporate NPLs to corporate loans dropped by 3.1 percentage points to 10%. The improvement in the liquidity position of the corporate sector was accompanied by improved profitability and gearing, although these still remained at unsatisfactory levels.[10]

Risk outlook

The acceleration in economic growth during 2006 was reflected in an overall healthier position of both the financial and the non-financial sectors. In the case of credit institutions, their exposure to credit, liquidity and market risks diminished during the year and is considered to be relatively low in the short term. Thus, in spite of a decrease in the financial strength of credit institutions, stress tests suggest that the financial system is still robust enough to withstand disturbances.

Financial stability analysis focuses on the downside risks to the base economic scenario, taking into account risks and vulnerabilities that could trigger disturbances to the system. An acceleration in the build-up of household debt linked to variable rate loans in an increasing interest rate scenario is flagged as one such potential source of risk. A related risk could derive from an unanticipated sudden drop in residential house prices, which could adversely affect the profitability of the banking sector. However, although warranting attention, these risks appear to be limited, and the domestic financial stability outlook remains satisfactory.

[9] The affordability index is calculated by the ratio of median household income to the income required to qualify for a mortgage.
[10] Liquidity, profitability and gearing of the corporate sector were estimated on the basis of a sample of financial statements for 2005.

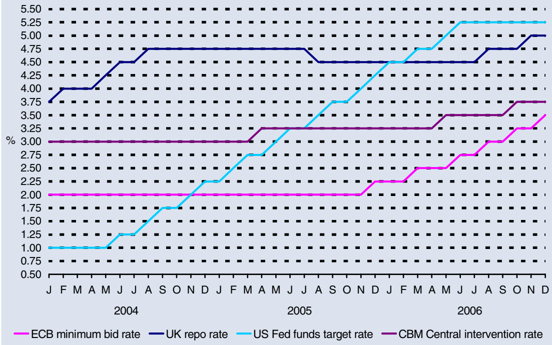
Part II

BANK POLICIES, OPERATIONS AND ACTIVITIES

1. The Conduct of Monetary Policy

The Central Bank of Malta is responsible for the formulation and implementation of monetary policy in Malta. Its main objective is to ensure price stability, which is an essential condition to achieve sustainable economic growth. The Bank pursues this goal through the maintenance of a fixed exchange rate for the Maltese lira. In line with this strategy, the Bank continued to orient its monetary policy stance during 2006, particularly the level of short-term interest rates, to the support of the exchange rate peg.

Chart 1.1
OFFICIAL INTEREST RATES IN MALTA AND ABROAD



Sources: Central Bank of Malta; Reuters.

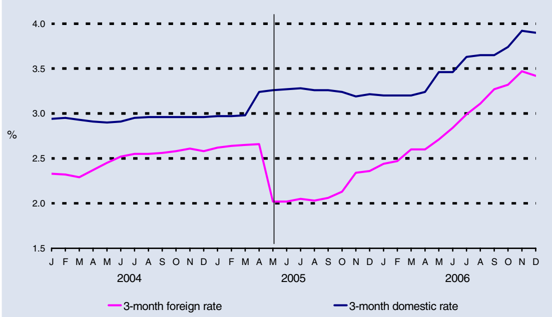
In preparation for full participation in EMU, the Maltese lira had entered the EU's Exchange Rate Mechanism (ERM II) in May 2005. The lira was pegged to the euro at a central parity rate of MTL/EUR 0.4293. Upon entry, the Maltese authorities committed themselves to maintain the MTL/EUR exchange rate at the central parity rate, eschewing the use of the standard fluctuation bands. Reflecting this commitment, the lira was unchanged from the central parity level against the euro throughout 2006.

Monetary policy decisions are taken by the Governor following meetings of the Bank's Monetary Policy Advisory Council (MPAC) during which economic and financial developments in Malta and abroad are analysed. The Governor is the Chairman of the Council, which also includes the Deputy Governor, the members of the Board and the Directors of the Bank's Economics & External Relations, Financial Markets and Financial Stability Divisions.

During the year the Bank adjusted its central intervention rate on two occasions. In May it raised the rate by 25 basis points to 3.50% in the light of an underlying downward trend in the Bank's external reserves and a narrowing of the interest rate differential in favour of the Maltese lira during the first few months of 2006 (see Chart 1.1). Following a further decline in the short-term interest rate premium, which reflected higher euro rates and expectations of a tighter monetary policy abroad, the Bank increased the central intervention rate by an additional 25 basis points to 3.75% in October.

Domestic money market rates moved in line with the central intervention rate, rising in both May and October (see Chart 1.2).[1] Following the 25 basis point rise in official rates in May, the three-month premium on the Maltese lira widened to 75 basis points from 64 basis points at the end of April. However, the premium declined thereafter, reaching a low of 38 basis points in September. Following the second rise in the central intervention rate, the premium increased to 42 basis points and kept on rising till the end of the year, ending December at 49 basis points.

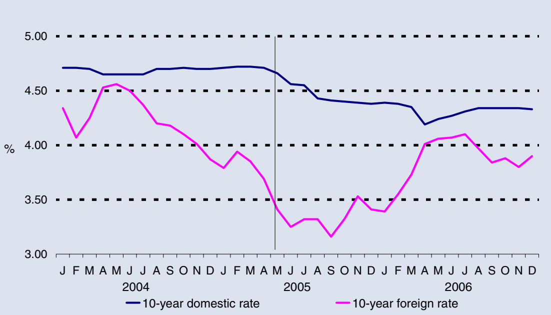
Chart 1.2
DOMESTIC AND FOREIGN SHORT-TERM MARKET INTEREST RATES
(end of month)



Sources: Central Bank of Malta; ECB.

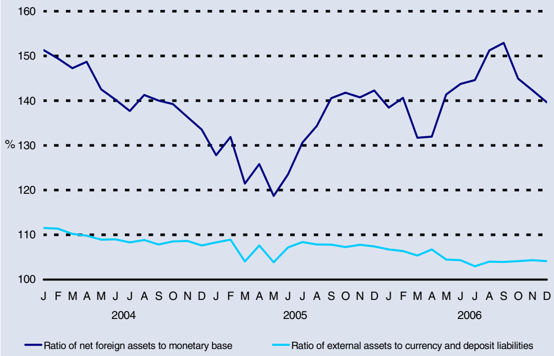
[1] The foreign interest rates shown in Charts 1.2 and 1.3 are computed as basket-weighted averages of the relevant interest rates on the euro, the pound sterling and the US dollar until April 2005. Euro interest rates are shown thereafter. Short-term rates refer to yields on three-month government securities,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

Chart 1.3
DOMESTIC AND FOREIGN LONG-TERM INTEREST RATES
(end-of-month)



Sources: Central Bank of Malta; ECB.

Chart 1.4
TRENDS IN THE CENTRAL BANK OF MALTA'S NET FOREIGN ASSETS



Turning to long-term interest rate differentials, during the first half of the year the ten-year premium on the Maltese lira declined steadily, falling from 97 basis points at end-December 2005 to 20 basis points at end-June (see Chart 1.3). The premium increased thereafter, as euro area yields fell, ending the year at 43 basis points.

External reserves management

The Central Bank of Malta is responsible for maintaining and managing adequate external reserves to safeguard the external value of the Maltese lira. As a result, the Bank is required by law to hold a reserve of external assets equivalent to 60% of its currency and deposit liabilities. In managing these reserves, the Bank's policy is to ensure the stability of the EUR/MTL exchange rate in ERM II, hold adequate foreign currency liquidity to meet domestic demand, and maximise return while safeguarding their value.

The Bank's net foreign assets rose over the year, although they were on a declining trend during the last quarter.[2] Expressed as a proportion of the monetary base, the Bank's net foreign assets contracted during the first quarter of the year. Nonetheless, the ratio recovered through the second and third quarters, peaking in September at 152.9%. It then fell during the last three months of the year, in line with a drop in the Bank's net foreign assets, ending December at 139.6% (see Chart 1.4). At the same time, the statutory ratio between the Bank's external assets and its currency and deposit liabilities followed a downward trend during the first half of the year but remained stable during the second half, ending the year at 104.1%.

The Investment Policy Committee (IPC) is responsible for setting the Bank's overall investment policy, monitoring the performance of the external reserves, evaluating the implementation of investment strategies and reviewing reserve management practices. The IPC, which is chaired by the Governor and includes the Deputy Governor and senior officials of the Bank, met each month during 2006.

The Bank uses extensive quantitative and qualitative techniques to monitor credit and market risk exposures arising from the management of foreign exchange reserves and to ensure that they are kept within the levels prescribed by the IPC. During 2006, to align its risk management techniques more closely with those of the ECB, the Bank added bond futures to its list of eligible instruments. The introduction of bond futures will provide the Bank with better tools to manage interest rate risk and help it to build the necessary expertise in preparation for the management of part of the ECB's portfolio of foreign assets following the adoption of the euro.

The Bank also plays an important role in the foreign exchange market by issuing daily spot and indicative forward exchange rates for the Maltese lira against major currencies. Since joining ERM II, all spot transactions effected by the Bank with credit institutions have been denominated in euro. During 2006 the Bank was a net seller of foreign currency to

[2] In this context, the Bank's external assets include all securities and other assets denominated in foreign currency. The Bank's net foreign assets include all its claims on non-residents, less its liabilities to them.

credit institutions in the spot foreign exchange market, with sales amounting to Lm116.3 million against purchases of Lm23.2 million. In contrast, the Bank was a net buyer of foreign exchange from the Government, with net purchases of Lm72.1 million. A large purchase was related to the privatisation of a local telecommunications company. No swap transactions took place during the year.

The Bank continued to be the dominant player in the Maltese wholesale foreign exchange market. In fact, activity in the interbank foreign exchange market was subdued, with the value of transactions dropping to Lm54.2 million from Lm133.1 million in 2005. Meanwhile, the value of foreign exchange transactions between credit and financial institutions and their customers rose to Lm3.0 billion in 2006 from Lm2.9 billion in the previous year.

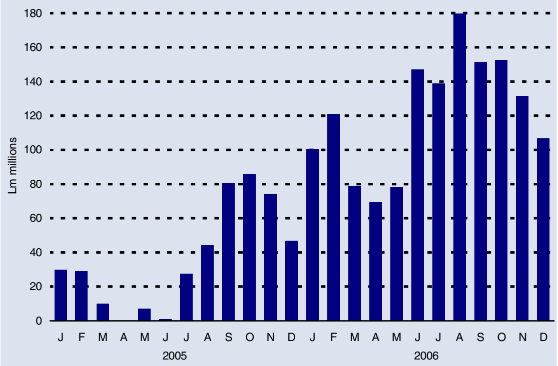
Since joining ERM II, the Bank participates in a daily exchange of information between the ECB and National Central Banks (NCBs) regarding developments in foreign exchange markets in ERM II member countries. The Bank also continued to collect daily statistics on foreign exchange transactions against the Maltese lira, which were transmitted to the ECB.

Open market operations

The Central Bank of Malta conducts open market operations in order to steer short-term money market rates in line with its monetary policy stance. Intervention in the money market typically takes place weekly and is conducted through auctions of term deposits and reverse repos. Whenever there is a shortage of liquidity, the Bank injects funds into the banking system through reverse repo auctions.[3] Conversely, in times of high liquidity, the Bank absorbs funds by auctioning term deposits. Only credit institutions that are obliged to hold reserve deposits with the Bank are eligible for participation in open market operations.

During 2006 banking system liquidity rose. In response, the Bank absorbed an average of Lm119.6 million each week through seven-day term deposits, as opposed to Lm31.5 million in 2005. At the end of the year, the level of outstanding term deposits stood at Lm106.7 million (see Chart 1.5). Reverse repos were not used at all during the year.

Chart 1.5
OUTSTANDING TERM DEPOSITS



The weighted average interest rate paid on term deposits moved in tandem with official rates, increasing by 25 basis points to 3.45%, in May, and by another 25 basis points to 3.70% in October. The rate then remained unchanged until the end of the year.

Standing facilities

The Central Bank of Malta also provides credit institutions with overnight standing deposit and lending facilities. The interest rates on the two facilities set an upper and lower bound for overnight interbank interest rates. Through the overnight deposit facility, banks can place temporary excess liquidity that cannot be absorbed by the market. Conversely, temporary liquidity needs are satisfied by means of a fully-collateralised marginal lending facility. During 2006 credit institutions placed overnight deposits worth Lm154.9 million with the Bank, Lm78.1 million less than in 2005. In contrast, banks borrowed Lm3.6 million through the marginal lending facility, the use of which in the previous year was negligible.

The interest rate on the overnight deposit facility is set at 100 basis points below the Bank's central

[3] In a reverse repo, the Bank agrees to buy eligible securities from a bank and to sell back that collateral at an agreed price when the contract expires.

intervention rate. Similarly, the interest rate charged on the marginal lending facility is 100 basis points above the official rate. Both rates increased in tandem with the central intervention rate during the year, reaching 2.75% and 4.75% at year-end, respectively.

Between February and March 2006, the Bank participated in an ECB test exercise in anticipation of its eventual membership of the Eurosystem, transmitting daily balance sheet data together with a forecast for liquidity in the banking system to the ECB. The exercise also involved the forwarding of excess reserves and collateral management data. Meanwhile, the Bank continued to monitor the collateral management framework of the ECB, analysing new developments in this area.

Reserve requirements

The Central Bank of Malta Act authorises the Bank to impose minimum reserve requirements on all credit institutions. This provides the Bank with an additional monetary policy tool. In certain cases, the Bank may exempt credit institutions from holding minimum reserve requirements on a non-discriminatory basis for a defined period. In June 2006 the Central Bank of Malta Directive on reserve deposits was amended to allow for a more frequent review of these exemptions. At the beginning of 2006, four credit institutions were subject to the reserve deposit requirement. In October, the exemptions granted to certain other banks expired and, following a review, two more banks were required to hold reserves with the Bank.

In 2006 the reserve requirement ratio was left unchanged at 4% of the credit institutions' specified liabilities. To allow banks more flexibility in the way they manage their liquidity and ensure greater stability in short-term interest rates, balances in these accounts may vary, as long as the minimum requirement is met on average during the maintenance period. The latter starts on the fifteenth calendar day of each month and ends on the fourteenth calendar day of the following month. In line with the movement in official rates in May and October, the Central Bank of Malta increased the remuneration applied to reserve requirements twice during the year, from 3.0% to 3.50%.

Market making operations

During 2006, the Central Bank of Malta continued to act as market-maker in the secondary market for Malta Government Stocks (MGS) and Treasury bills. In this way the Bank ensures there is adequate liquidity in the market, thus enhancing investor confidence. The Bank also advises the Government on debt management matters. During 2006, it contributed to the drafting of legislation on the dematerialisation of Treasury bill certificates.

The Bank quoted daily bid prices and yields for listed MGS as well as daily buying and selling rates for Treasury bills. In addition, it also quoted, on a daily basis, International Securities Market Association (ISMA) redemption yields for MGS.[4] The Bank's market rates reflected the average weighted yields stemming from the weekly Treasury bill auctions and changes in the central intervention rate.

During 2006, the Financial Markets Committee (FMC), which provides a forum for the regular exchange of views and information between the Bank and credit institutions on market-related issues, met eight times. Discussions focused on the euro changeover process and the monetary policy operational framework in the euro area, interest rate conventions, the dematerialisation of Treasury bills, cross-border settlement systems and the use of eligible assets in the conduct of monetary policy in the euro area. The FMC also discussed developments in the primary and secondary markets for MGS and issues related to the foreign exchange market.

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

2. Financial Stability

In carrying out its legal responsibility for ensuring financial stability in Malta, the Central Bank of Malta monitors the various components of the financial system, including the domestic payment and settlement systems, in order to detect emerging trends that may lead to a weakening of the system. In such circumstances, the Bank would consult the other relevant authorities to consider measures to address any such weaknesses.

The soundness of the financial system is mainly assessed by monitoring credit institutions and non-bank financial institutions and also by examining how risks emanating from the non-financial sector could be channelled to the financial sector. The assessment exercise is supplemented by stress test analysis of credit and market risks to evaluate the robustness of the capital of credit institutions. The Bank presents its findings to senior officials of the Ministry of Finance and the MFSA. These findings are then discussed in detail during meetings of the Standing Committee that was established under the Memorandum of Understanding signed between the Bank and the MFSA in 2002. Consequently, the MFSA, as the regulator of the financial services sector, takes any corrective measures that may be deemed necessary. The Bank also publishes a summary of its financial stability assessments in its *Quarterly Review* and *Annual Report*.

During the year, the Bank continued to enhance its early warning indicators and to develop its macro stress-testing capacity. The Bank also continued to identify and evaluate financial stability implications arising from the transposition of relevant EU financial and banking services directives in consultation with the MFSA. In particular, the Bank and the MFSA held detailed consultations on the imminent transposition of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions.

The on-going work to strengthen the domestic crisis management framework was taken forward with the establishment of a working group involving the Ministry of Finance, the MFSA and the Bank. The working group is to draw up proposals for a domestic framework in line with the obligations undertaken by the Maltese authorities following the signing of the EU memorandum of understanding (MoU) on co-operation in the management of financial crisis situations. It is also to participate in EU-wide crisis management simulation exercises. In fact, during 2006 the three authorities took part for the first time in an exercise to test the procedures established by the EU MoU for the management of financial crisis situations.

As part of its international responsibilities, the Bank took an active part in the Banking Supervision Committee (BSC) of the ESCB and in its associated working groups on Macro-prudential Analysis (WGMA) and Developments in Banking (WGBD). In this regard, it participated in *ad hoc* task forces that address specific topics of particular relevance in the monitoring of the stability of the financial system, both at a national and at an EU level. Within this context, the Bank undertook a number of surveys of the banking system. Furthermore, together with the MFSA, the Bank continued to participate in, and contribute to, the meetings of the EU Committee of European Banking Supervisors.

During the year, the Bank also continued its active involvement in the IMF's initiative to compile financial soundness indicators, which form the basis of the Fund's Financial Sector Assessment Programme. Finally, the Bank continued to monitor progress in the implementation of the recommendations made by the IMF and the World Bank in their Financial Sector Stability Assessment report issued in September 2003.[1] Satisfactory progress has been achieved by the relevant authorities in implementing these recommendations, which are meant to strengthen further the stability of the financial system.

[1] The FSSA can be downloaded from the IMF site at *www.imf.org/external/pubs/ft/scr/2003/cr03264.pdf* Country Report No 03/264.

3. Banking and Currency Operations

As banker to the Government and to the rest of the domestic banking system, the Central Bank of Malta continued to provide a range of banking services to the public sector and to credit and financial institutions in Malta. Additionally, as sole issuer of the domestic currency, the Bank ensured that the supply of notes and coins was 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 facilities to Government departments and public sector entities.

During 2006 the number of cheques drawn on the Bank by the Government fell by 7.1% compared to the previous year, but their value increased by 15.8% to Lm399.9 million. The primary factor behind the reduced volume continued to be the increased use of the direct credit system. The number of direct credit payments rose from 1.5 million in 2005 to 1.6 million in 2006, with their value rising by 18.0% to Lm352.7 million. Government salaries account for over half of the value of these payments.

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. Most cross-border foreign exchange transactions are carried out through SWIFT transfers, which is a standardised service for transferring payments between banks and other financial institutions around the world. The value of foreign exchange receipts processed by the Bank on behalf of the Government and public corporations rose from Lm74.8 million in 2005 to Lm293.5 million in 2006, with the rise reflecting privatisation receipts and taxes paid by international companies registered in Malta. Foreign exchange payments also increased to Lm177.8 million, driven by tax refunds.[1]

The Bank continued to be responsible for effecting payments in relation to the Government's external debt servicing. In 2006 capital payments totalled Lm9.9 million, up from Lm3.3 million in 2005. Meanwhile, interest payments on outstanding foreign loans fell marginally to Lm2.8 million. An additional Lm6.9 million was transferred to Government sinking funds earmarked for foreign debt servicing.

Banker to the banking system

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

The Bank continued to act as investment manager for the Depositor Compensation Scheme and the Investor Compensation Scheme, providing financial, accounting and other related services.[3] As the designated custodian of assets under the Insurance Business Act of 1998, the Bank also kept in its name, on behalf of insurance companies, certain specified assets backing funds guaranteed by the latter.

[1] The Bank also continued to manage the Foreign Pension Subsidy Scheme on behalf of the Government. The amount paid under this scheme fell to Lm6,477 in 2006 from Lm7,778 in 2005.

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

[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.

Payments 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 related settlement and payment finality. In this regard, the Bank is responsible for and controls the day-to-day business operations of the settlement accounts. During 2006, 49,826 interbank payments were processed by MaRIS for a total value of Lm20.0 billion. Compared with 2005, the volume and value of the interbank payments processed by MaRIS rose by 9% and 71%, respectively, mainly reflecting an increase in the amount of liquidity absorbed by the Bank through open market operations.

The Bank continued to oversee domestic payment and securities settlement systems. In March 2006, in terms of its statutory responsibilities related to the oversight of domestic payment systems, the Bank approved the establishment of Malta Clear, which is the main securities settlement system operated by the MSE.

The Bank also continued to manage the Malta Clearing House, through which most cheques issued in Malta are settled. While the amount of cheques cleared fell by 5% to 6.1 million in 2006, their value increased by 8% to Lm3.0 billion. The daily average number and value of cheques processed during the year amounted to 24,566 and Lm11.3 million, respectively.

The Bank kept abreast of progress achieved in the development and implementation of the Single European Payments Area (SEPA) in the euro area. 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

In 2006 the Bank continued to meet the Maltese currency requirements of the banking sector. It took in currency notes and coins surplus to requirements and issued them in line with the demand from the banks. It also examined notes and coins regularly to ensure that a high quality standard was maintained. Notes and coins that were deemed unfit for circulation were destroyed.

Circulation of banknotes and coins

The stock of currency notes and coins issued and outstanding at the end of 2006 stood at Lm504.0

Table 3.1

CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE BANK IN 2006

Lm thousands

	Notes and coins			Issued and
	Issued	Paid in	Net issue	outstanding[1]
January	25,581	33,329	-7,748	512,296
February	25,931	28,432	-2,501	509,795
March	31,970	30,905	1,065	510,860
April	31,513	31,646	-133	510,727
May	34,739	35,560	-821	509,906
June	30,925	28,872	2,053	511,959
July	30,337	30,305	32	511,991
August	31,393	33,776	-2,383	509,608
September	29,678	30,586	-908	508,700
October	28,787	31,982	-3,195	505,505
November	25,267	31,509	-6,242	499,263
December	30,914	26,201	4,713	503,976
2006	**357,035**	**373,103**	**-16,068**	**503,976**
2005	354,214	340,575	13,639	520,044

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

million, a fall of 3.1% since the end of 2005 (see Table 3.1). As a result, by December 2006 the share of notes and coins in broad money fell to 15.8%, from 17.1% at the end of 2005.

During the second half of 2006 there was a noticeable downward trend in the amount of currency in issue. To a large extent, this reflected the private sector's preparations to start switching their Maltese lira currency holdings into euro ahead of the Government's target date for the euro changeover of 1 January 2008. Apart from this trend, currency in issue fell in January, in line with seasonal patterns, as credit institutions disposed of excess holdings accumulated during the festive season. In June, on the other hand, demand increased, coinciding with the beginning of the peak tourist season. Currency in issue also rose in December, as a result of the normal pick-up in the demand for cash over the Christmas period.

At the end of the year, the value of notes in issue totalled Lm483.1 million, a fall of Lm16.8 million, or 3.4%, from the previous year's level. Their composition remained broadly unchanged, with the Lm10 note accounting for 69.8% of the total value of notes in issue (see Chart 3.1). The Lm20 note remained the second most commonly used banknote, although the amount in circulation and its share in the total both fell.

The value of the outstanding stock of coins rose by Lm0.7 million, or 3.7%, to Lm20.9 million in 2006. The shares of the various denominations in the total remained broadly unchanged, with the Lm1 coin still recording the highest share by value, followed by the 50c coin (see Chart 3.2).

Chart 3.1
COMPOSITION OF CURRENCY NOTES ISSUED AND OUTSTANDING AS AT END-2006

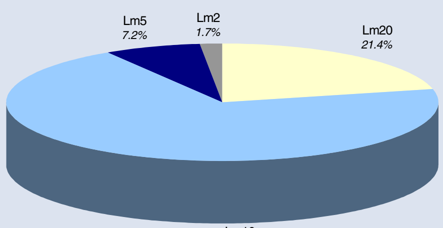
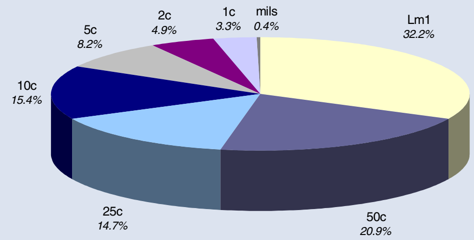


Chart 3.2
COMPOSITION OF COINS ISSUED AND OUTSTANDING AS AT END-2006



Commemorative coins

On 21 February the Bank announced the issue of a new decimal coin set dated 2006. The set consists of the seven current Maltese coins of the Second Series together with a three mils coin of the First Series. The coins were struck at the Royal Mint in the UK. The designs on the obverse and reverse sides of the coins remained unchanged.

On 15 September, the Bank, under the Europa Programme 2006 – Personalities, issued a coin commemorating the well-known Maltese scientist, archaeologist and writer, Sir Temistokle Zammit, who was born in 1864 and died in 1935. The emblem of Malta and the year of issue appear on the obverse of the coin, while the reverse depicts a likeliness of Sir Temistokle and the Europa Star, which is the official logo of the Programme. The coin was designed by the Maltese artist Noel Galea Bason. The silver proof coin, which is legal tender in Malta for the value of Lm5, was struck at the Royal Dutch Mint, with a minting limit of 15,000 coins.

Anti-counterfeit measures

During 2006, the Bank continued to examine local and foreign banknotes suspected of not being genuine. With regard to euro notes, the Bank continued to work closely with the ECB. Staff members also participated in a number of working groups specialising in the material examination of euro banknotes. Meanwhile, the Bank's Currency Surveillance Unit continued to act as the National Counterfeit 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 monetary policy decisions, which are the responsibility of the Governor.

At the end of 2006, the Board of Directors 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. Bernadette Muscat served as Secretary to the Board until February 2006, when she was replaced by Stephanie Sciberras. Over the year, eleven meetings were held.

Audit Committee

The Audit Committee, which is established in terms of the Central Bank of Malta Act, consists of three Board members. During 2006, it was composed of Joseph V. Gatt as Chairman, Charles J. Falzon and David A. Pullicino. The Committee reports and makes recommendations to the Board regarding financial reporting, internal audit and control, external audit and risk management.

The Audit Committee is required to meet and report to the Board at least four times a year, and to hold two meetings with the Bank's external auditors to discuss issues regarding the annual statutory audit of the Bank. The Committee held eight meetings in 2006, during which it discussed several issues including the appointment of the external auditors and the statutory audit of the financial statements. Additional topics included the annual internal audit plan, as well as internal control and risk management issues. The Audit Committee played an active role in ensuring that the accepted recommendations made by the external auditors in their Management Letter to the Bank for 2005 were implemented.

Management

The Executive Management Committee (EMC) is responsible for advising the Governor and Deputy Governor on administrative matters, including new policies and procedures. It is made up of the Governor as Chairman, the Deputy Governor, and the five Directors in charge of the divisions of the Bank. During 2006 the Committee held 48 meetings.

As part of the on-going restructuring process, the settlements function was transferred from Finance Office to Payment Systems Office. The responsibilities of the latter were broadened to include back office operations in connection with collateral management. In addition, the Monetary Operations Office changed its name to Monetary Operations and Collateral Management Office, in order to reflect its new responsibilities.

Throughout the year the ESCB Briefing Committee, which is chaired by the Governor and includes the Bank's representatives on the twelve committees of the ESCB, continued to co-ordinate ESCB-related work. This Committee held 16 meetings during the year.

Governor's official activities in Malta

In May the House of Representatives amended its standing orders to enable its Public Accounts Committee to discuss monetary policy and receive reports thereon from the Governor, in line with the provisions of the Central Bank of Malta Act. In this regard, the Governor appeared twice before the Public Accounts Committee, in May and November, to testify on the conduct of the Bank's monetary policy.

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

During 2006 the Governor addressed various conferences and seminars organised by constituted bodies and other organisations. These included the NECC, the Institute of Financial Services (Malta) and the Union Ħaddiema Magħqudin. He also gave various interviews to the local media. In May the Governor also delivered the keynote address at a seminar organised by Société Universitaire Européenne de Recherches Financières (SUERF) in conjunction with the Central Bank of Malta. The Governor's speeches focused on the Bank's assessment of the challenges facing the Maltese economy and on the country's preparations for the adoption of the euro.

Governor's official activities overseas

The Governor continued to attend the quarterly meetings of the General Council of the ECB. He also accompanied the Prime Minister and the Parliamentary Secretary at the Ministry of Finance to the informal ECOFIN meetings held in Vienna in April and in Helsinki in September. He also attended the Annual General Meeting of the BIS in June and the Annual Meetings of the IMF and the World Bank in Singapore in September.

In January the Governor participated in a Euro-Mediterranean seminar organised jointly by the ECB and the Bank of Greece. During a seminar organised by FT Business in conjunction with the MFSA held in London in April, the Governor delivered a presentation on macroeconomic and financial stability as prerequisites for sustained growth in a Maltese context. In June the Governor travelled to London to address the 6th Annual Global Banking and Finance Forum organised by the Commonwealth Business Forum and to take part in a symposium organised by the Bank of England. In October the Governor was invited by the central bank of Slovenia to deliver a presentation on Malta's economy and to exchange views on preparations for euro adoption.

Economic analysis and research

The Bank continued to analyse 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 business perceptions surveys that are specifically undertaken for the Bank. The Bank publishes its analysis in its *Quarterly Review* and the *Annual Report.*

The Bank also prepared reports and forecasts in connection with the ECB and European Commission biannual exercises. During 2006 special focus was placed on labour cost developments in Malta and the impact of energy prices on inflation, as part of the ECB's bi-annual monetary policy co-ordination exercise. The Bank continued to analyse the development of house prices in Malta and is in the process of refining its property price indicators.

During the year the Bank also continued to prepare forecasts of the main macroeconomic variables for the Maltese economy by means of its econometric model, which is based on quarterly data. The model was developed further to enable the Bank to fulfil its present ESCB requirements and those that are expected to arise upon Malta's eventual participation in the euro area. Further progress was also made on the development of a satellite model for the housing market in Malta. The Bank made projections of key fiscal variables as part of the work of the ESCB in this area and, together with the Ministry of Finance, also prepared additional forecasts focusing on indicators of real economic convergence.

Statistics

To enable it to fulfil its national and international obligations, the Bank continued to compile, disseminate and publish a wide variety of economic, financial and monetary statistics. During 2006 the Bank ensured that the collection of data would come in line with ECB guidelines before the euro adoption date.

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 obligations towards the ECB. Consequently, in the course of the year it continued to strengthen its information management systems so as to improve the efficiency, security and quality of data exchanges with the ESCB. In December 2006 the Bank connected to the ECB's Statistical Data Warehouse, which is a comprehensive database covering the euro area economy available to users from NCBs and the general public.

Meanwhile, Bank officials regularly participated in the work of ESCB committees and working groups on statistical issues, as well as the EU's Committee on Monetary, Financial and Balance of Payments Statistics.

During the year the Bank began to transmit monetary flow statistics to the ECB. Meanwhile, in co-operation with the MFSA, it continued to work on updating the Banking Directive that deals with the compilation of monetary statistics. Furthermore, in-depth work was undertaken to implement ECB requirements regarding interest rates applied by credit institutions on deposits and loans of households and firms. New reporting requirements for investment funds, to come in line with ECB requirements, were also discussed.

In the area of balance of payments (BOP) statistics, the direct reporting data collection system began to operate quarterly, while work continued on preparations for the submission of a monthly BOP statement to the ECB. During 2006, with the help of the central bank of the Netherlands, work was also undertaken on the collection of portfolio data on a security by security basis.

To enhance its information on capital flows effected by residents, the Bank continued to collect such data through reporting forms submitted by banks and other intermediaries in terms of the External Transactions Act. Furthermore, in early 2006, the Bank started to publish data on the official reserves and foreign currency liquidity on its website.

Work on the compilation of Malta's financial accounts in line with the ECB guideline gathered pace. 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 Government Finance Statistics Committee (GFSC), which was set up to improve standards in the compilation of government finance statistics and to compile the government deficit and debt data that are submitted to Eurostat twice yearly in terms of the Excessive Deficit Procedure. In addition, to enhance GFS reporting to the IMF as well, an expert from the statistics office of Iceland visited Malta in the spring to advise the Bank and the Ministry of Finance on the revised methodologies for the compilation of such statistics.

The Bank also regularly provided the Fund with monetary and financial data and continued to meet the requirements set by the Fund's General Data Dissemination System (GDDS).

Legal issues

In 2006 the Bank proposed amendments to the Central Bank of Malta Act to cater for its eventual integration with the Eurosystem. Minor amendments to the External Transactions Act were also proposed. Furthermore, the Bank revised Directive No 1 on Minimum Reserve Requirements to allow for more frequent reviews of exemptions granted to banks from holding reserve deposits.

A Working Group composed of officials from the Bank and the MFSA proposed further amendments to the Financial Collateral Arrangements Regulations 2004 to align them with EU Directive 2002/47/EC.

Data protection

In February the Bank appointed a new Data Protection Officer and the Data Protection Commissioner was notified accordingly.

Human resources

As at end-2006, the Bank employed 310 full-time staff and a further 16 employees on a part-time basis.[1] Over the year the Bank recruited five economics officers and eight clerks. Ten members of staff left the Bank: three retired on medical grounds, six resigned and one opted for voluntary severance.

As in previous years, the Bank offered temporary employment to a number of University of Malta students during the summer period. The Bank also participated in the Traineeship Scheme administered by STC Training, a provider of information technology and management training, and offered temporary work experience to one student. In addition, the Bank offered an internship to four students from the Malta College of Arts, Science & Technology.

The Bank renewed its agreement with the Richmond Foundation, which is a charity working in the area of community rehabilitation and support services. It also extended its subscription to the Employee Assistance Programme, which is operated with the help of Caritas Malta, for a further year.

Training and development

In the area of training and career development, the Bank offered a wide range of courses for its employees, which were either organised in-house or by local and foreign institutions (see Table 4.1).

Local courses and seminars were focused on information technology, on the adoption of the euro, on health & safety and on internal audit. The Bank also organised a course for managers on the process of change management. Furthermore, in November, the Bank held its annual strategic planning seminar to review the work done during the year and to set objectives for 2007.

Table 4.1
STAFF TRAINING

Type of Training	No. of Courses/Seminars	No. of participants
In-house	17	753
External	100	133
Local	60	89
Overseas	40	44

During the year, the Bank continued to provide staff with development opportunities through short-term assignments with the ECB and EU national central banks.

Academic and professional courses

Under its Development Scheme, which offers scholarships to staff to pursue postgraduate qualifications at foreign universities, a member of the staff was selected to read for a Masters Degree in Finance at the University of York.

An increasing number of employees continued to benefit from the Bank's other study schemes (see Table 4.2). Over the year, 18 staff members successfully completed their academic and professional studies, while 38 others were following approved courses on a part-time basis.

Gender equality and discrimination

The Bank continued to place emphasis on gender equality. During 2006, it continued to implement

Table 4.2
ACADEMIC AND PROFESSIONAL COURSES

	Number of employees	
Type of programme	Programmes completed	Programmes being pursued
Postgraduate courses	9	17
Honours first degree courses	7	16
Diploma courses	2	6

[1] After taking authorised absences into account, including those due to family-friendly measures or the pursuit of study abroad, the Bank's complement as at end-2006 was equivalent to 299 full-time staff.

measures aimed at avoiding any form of discrimination based on sex. It also sent representatives to attend seminars on new developments in this regard.

Women make up 37% of the Bank's full-time staff complement. They constitute 21% of the executive grade, half of the clerical employees and 11% of the non-clerical grades. Furthermore, half of the staff members involved in self-development programmes on a part-time basis were female. In addition, women accounted for over 42% of participants in internal courses, 36% of those attending local external courses and 23% of those following courses overseas.

Premises

The Bank started renovating part of the premises situated at St James' Counterguard. The main project involves the Polverista, a listed building which was used as an ammunition store up to the 19th century and which is to be turned into a conference and training centre. Prior to the commencement of works, an evaluation of its historical value was carried out. In this regard, other work on the access tunnel to the Bank's Annexe was expected to start in the ensuing year.

Information technology

In 2006 the Bank's core systems were reviewed and adjusted in preparation for the euro changeover. A number of applications related to risk management, investment operations and the money and banking statistical database were enhanced further. In this regard, advice was sought from the ECB and the Hungarian central bank. During the year, Bank officials assisted in the drawing up of guidelines for the ESCB systems' vulnerability testing.

During 2006 officials from the Libyan and South African central banks visited the Bank to gather information on the accounting system and the implementation methodology used by the Bank with the intention of implementing a similar system in their respective institutions.

Internal audit

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

The Internal Audit Office continued to strengthen its approach through the introduction of a new internal document entitled *Audit Approach and Testing Methodology and Guidelines,* which represents a major operational development in the form of further standardisation of procedures and audit work.

In 2006 the Bank conducted its first Quality Self-Assessment of the Internal Audit Activity. One of the main objectives of the assessment was to determine the extent of internal audit compliance with the *International Standards for the Professional Practices of Internal Auditing (Standards)* and the *Code of Ethics* of the Institute of Internal Auditors. The aim was to identify opportunities to enhance management and work processes, as well as to add value to the other functions and governance of the Bank. The results were presented to the Audit Committee and the Board of Directors, while a summary report was also presented to the IAC of the ESCB in accordance with the provisions of its Audit Manual.

The Bank's internal auditors concluded twenty-two 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. Two of these audits were conducted on behalf of the ESCB. The coverage included audits on information security systems, financial issues, payment systems, currency issues, market operations and statistics. Several procedural audits were also undertaken, together with a number of follow-up audits to ensure the implementation of recommendations made.

Risk assessment

During 2006 the Bank continued to review the operations of business areas to ensure that potential exposures to risk are identified and assessed and appropriate controls implemented. It also implemented the Risk Matrix Database to consolidate its risk management framework. The Database enables senior management to access, monitor and report on risk management information.

In developing further its business continuity planning, the Bank developed a Pandemic Contingency Plan in view of the avian flu threat. In this regard, the Bank was instrumental in the setting up of a joint *Forum on Pandemic Preparedness in the Financial Services Sector* together with the MFSA. Several internal tests were also undertaken to ensure that the critical processes of the Bank would remain operative even under adverse conditions. Work on a formal crisis management plan was initiated to strengthen business continuity in case of a Bank-wide disaster.

Information and public relations

The Bank continued to communicate 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*, released a weekly money market report and a monthly update on monetary developments. The Bank also continued to participate in the translation into Maltese of ECB and European Commission documents.

The Bank was actively involved in the public consultation process for the choice of the designs for the national side of the Maltese euro coins. It also published euro cash changeover information on its website.

Library

The Central Bank of Malta Library continued to be a leading source of information in the fields of economics, banking and finance. Apart from servicing the needs of the Bank's staff, the library also responded to requests from other public and private sector bodies and the general public, particularly students.

In line with its collection development policy, the Bank acquired new books, periodicals and specialised publications related to its functions and operations. Of particular significance during 2006 was the introduction of an electronic journal service.

The Bank also continued to serve as a depository for publications issued by international organisations, such as the IMF, the World Bank Group and the EBRD. During 2006, the Bank signed a Depository Library Memorandum of Agreement for Online Resources access with the World Bank.

Cultural and educational activities

In enhancing the collection in its currency museum, the Bank continued to acquire coins that circulated in Malta in past centuries. The Bank's coin collection consists of around 250 pieces, with coins dating back to the Punic-Roman period.

During the year, the Bank used the occasion of the International Museum Day to promote its museum with the general public. It also participated in the Malta International Trade Fair and displayed a selection of its coins to highlight the development of Maltese coinage over the centuries.

The Bank's museum also displayed memorabilia belonging to the well-known Maltese scientist Sir Temistokle Zammit following the issue of a silver coin as part of a European project commemorating prominent national figures.

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

5. International Relations

During 2006 the Central Bank of Malta continued to develop its ties with EU institutions, notably the ECB and the Commission, while building upon relations with international financial institutions, such as the IMF, the World Bank Group and the EBRD.

European System of Central Banks

As a member of the ESCB, the Bank continued to strengthen its relations with the ECB and the other NCBs of the EU, which collectively form the ESCB.

The Governor participated in the quarterly meetings of the General Council, while experts from different areas of the Bank took part in meetings of ESCB committees and working groups. In the meantime, the Bank continued to transmit information regularly on developments related to ERM II to the ECB.

During the year the Bank hosted two ESCB meetings in Malta. One was a meeting of the ESCB Banknote Committee, which included a euro accession workshop. The other involved the Working Group on Monetary and Exchange Rate Instruments and Procedures of the Monetary Operations Committee (WGME). On this occasion, the Chairman of the WGME delivered a presentation to Bank staff and representatives of Maltese credit institutions on the monetary policy framework of the Eurosystem.[1]

The Bank was invited to comment, together with the other NCBs, on the convergence reports prepared by the ECB prior to publication. This occurred for the report on Lithuania and Slovenia in the spring, and again when the regular biannual assessment for Malta and the other non-euro area countries was undertaken in the autumn. In the latter case, the Bank was actively involved in discussions with the ECB on the legal and economic aspects of the report, where these applied to Malta. This report was published in December.

During the year the Governor signed amendments to the ERM II Agreement of 1 September 1998 to provide for the entry of the NCBs of Bulgaria and Romania into the ESCB and the entry of the Slovenian NCB into the Eurosystem with effect from 1 January 2007. The amendments were endorsed by the Governing Council and the General Council of the ECB.

As in previous years, Bank officials continued to attend seminars and conferences organised by the ESCB and to benefit from the advice of experts from individual NCBs on various issues related to the adoption of the euro. Additional insights into the operational tasks of the Eurosystem were gained through participation in familiarisation visits organised by the ECB. Moreover, Bank staff benefited from short-term attachments with the central banks of Hungary and Slovakia on portfolio management, the methodology and IT infrastructure for financial accounts and the management of documents. The Bank also benefited from visits by experts from the central banks of Greece and the Netherlands in the field of balance of payments statistics, monetary operations and collateral management.

As part of the mutual collaboration between NCBs, during 2006 the Bank hosted the Supervisory Board of the Estonian central bank. The two central banks exchanged views on their experience during the first two years of EU membership. The Bank also received a visit from the Deputy Governor of the central bank of Slovakia to discuss matters related to the euro changeover. Officials from the central bank of Lithuania also visited the Bank to discuss common issues with the objective of strengthening the risk assessment process in both institutions.

In the course of the year, further progress was made in the preparations for eventual Eurosystem membership. More details are given in the Box on

[1] The Eurosystem comprises the ECB and the NCBs of those EU Member States that have adopted the euro.

the adoption of the euro which is annexed to this chapter.

European Commission

During the year the Governor attended two informal meetings of the EU Council of Ministers responsible for economic and financial affairs (ECOFIN). As in previous years, the Deputy Governor and other senior officials of the Bank participated in meetings of the Economic and Financial Committee (EFC) and its sub-committees when issues relevant to central banks, particularly international monetary issues, were discussed.

At the technical level, the Bank co-ordinated with the Ministry of Finance and the NSO on the EU's Excessive Deficit Procedure, the spring and autumn economic forecasts of the European Commission and the update of Malta's Convergence Programme.

Senior Bank officials continued to attend meetings and conferences of the European Anti-Fraud Office of the European Commission (OLAF).

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

International Monetary Fund

As the institution representing Malta at the IMF, the Bank, in consultation with the Ministry of Finance, voted on a number of resolutions in the course of the year, including the Resolution on Quota and Voice Reform in the IMF, which was adopted in September. The reform aims at achieving a better alignment of IMF quota shares with members' relative positions in the world economy and to enhance the participation of low-income countries in the Fund. In the meantime, the Bank continued to monitor the discussions on the ongoing IMF medium-term strategic review.

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 2005, at SDR61.7 million (around Lm30.3 million) and SDR40.3 million (around Lm19.7 million), respectively. Malta's SDR holdings, however, increased by SDR1.9 million to SDR34.0 million, mainly on account of interest earned on them.

As in previous years, the Bank also co-operated with other Maltese authorities with statistical responsibilities to ensure compliance with the IMF's General Data Dissemination System (GDDS). It also continued with its preparations for eventual participation in the Special Data Dissemination Standard (SDDS). In relation to the latter, a Mission from the IMF Statistics Department visited Malta to review the existing statistical systems, to advise the local authorities on the compilation of fiscal data in accordance with the latest IMF standards and to discuss technical assistance needs in the area of statistics.

In August the IMF published a Report on the Observance of Standards and Codes (ROSC) assessing Malta's macroeconomic statistics against the SDDS, the availability of Advance Release Calendars, and compliance with the IMF's Data Quality Assessment Framework. The Report concluded that Malta already meets the specifications for coverage, periodicity and timeliness for those SDDS data categories that are currently disseminated. It also noted that the quality of the macroeconomic statistics for Malta had improved significantly in recent years. Following a recommendation made by the Bank, the IMF agreed to provide technical assistance to the NSO regarding the compilation of producer price indices. The Bank, meanwhile, continued its active involvement in the initiative of the IMF to compile financial soundness indicators.

During the year the Bank also participated in IMF training seminars on monetary and financial statistics and on the Funds' financial programming approach. It was also represented at a seminar on business continuity measures and mitigation strategies against the potential negative economic effects of an avian flu pandemic, jointly organised by the BIS and IMF.

World Bank Group

The Bank continued to monitor relevant developments in the World Bank and its affiliates. As in past years, it co-operated with the Ministry of Finance on a number of resolutions proposed by the Executive Board of the IBRD, the MIGA and the IFC.

During the year the Bank also co-operated with the World Bank and with the Government to establish a Small States Network for Economic Development. The Government had proposed setting up the network, with a Secretariat in Malta, during the 2005 World Bank Small States Forum. The Forum formally adopted this proposal in September 2006. The network provides a mechanism for communication among small states, and between small states and donor organisations, with a particular emphasis on the exchange of expertise, best practice and technology.

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. The Bank examined a number of project proposals and resolutions that were presented during the year. In particular, the Maltese authorities approved a Resolution recognising the Republic of Montenegro as a member after the latter declared its independence.

In January the Bank hosted a meeting organised by the Austrian EBRD Director for the members of the constituency led by Austria and including Bosnia Herzegovina, Cyprus, Israel, Kazakhstan and Malta. The meeting was chaired by the Parliamentary Secretary at the Ministry of Finance as Governor for Malta on the EBRD, and was addressed by the Secretary General of the EBRD and the Austrian Director. It discussed recent developments and other matters of interest ahead of the Annual Meeting of the EBRD, which the Deputy Governor attended in London in May.

Bank for International Settlements

Although the Bank is not a member of the BIS, it took part, as in previous years, in seminars on financial stability related issues organised by the Financial Stability Institute, which is a joint institution of the BIS and the Basel Committee on Banking Supervision. In 2006 these seminars focused on advanced risk management practices. The Bank continued to monitor developments related to initiatives endorsed by the BIS.

Other

During the year, a senior Bank official continued to form part of the Maltese delegation to the Council of Europe Select Committee of Experts on the evaluation of Anti-Money Laundering Measures (MONEYVAL). He also participated in the meetings of the Bureau of the Committee and in the third round mutual evaluation of Lithuania as the evaluator for the financial sector.

In February the Bank hosted a meeting of the Committee on International Monetary Law of the International Law Association (MOCOMILA), a committee of the International Law Association that brings together experts from central banks and other institutions, together with academics and practitioners in the field, to discuss issues related to international monetary, banking and financial law.

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

Box 1: Preparing for the Adoption of the Euro

Upon joining the EU in 2004, Malta entered EMU with the status of a Member State with a derogation. This means that, provided the relevant convergence criteria are met, Malta will have to adopt the euro as its national currency. The convergence criteria, which are laid down in the Maastricht Treaty, cover developments regarding inflation, public finance, the exchange rate and the long-term interest rate. The Maltese authorities set 1 January 2008 as the target date for the adoption of the euro. In February 2007, the Government and the Central Bank of Malta formally requested a convergence assessment to be made by the ECB and the European Commission. If, on the basis of these assessments, the EU Council of Ministers, meeting in the composition of the Heads of State or Government, confirms that Malta has fulfilled the relevant conditions for entry, and euro area Member States are prepared to accept new members, then Malta would be able to adopt the euro as planned.

During 2006 the Bank stepped up preparations for the adoption of the euro across the whole range of its activities.

At a national level, the Bank continued to participate actively in the Steering Committee for the Euro Adoption through the Governor and in the NECC through the Deputy Governor, who also serves as the Deputy Chairperson of the Committee. The Bank also chairs the Financial Services Sectoral Committee (FSSC) through the Deputy Governor and is represented on the Training and IT Task Forces. The Bank also participated in a joint committee on communications set up with the NECC during 2006.

The FSSC met several times to discuss issues of interest to the financial services sector during the year. The sub-committee met in both "extended" format, where the representatives of all financial services providers are present, and in "restricted" composition, where only the Bank, the NECC, the MFSA, the MSE, the Malta Bankers' Association (MBA) and the Financial Intelligence Analysis Unit (FIAU) are present. The Bank prepared amendments to the relevant sections of the Euro Changeover Master Plan. The latest update was published early in 2007.

During 2006 the Bank participated actively in the work of the Public Administration Network Committee – PAN II, which is composed of government and central bank officials from EU Member States who share information on practical aspects of the euro changeover. Indeed, the Bank assisted in the drawing up of reports on the practical preparations for the future enlargement of the euro area. The Bank also continued to participate in meetings of the Directors of Communication established by the European Commission to co-ordinate communications activities related to EMU, including the euro changeover. At the ECB level, the Bank was an active participant in the Task Force on Euro Information Campaigns. In this regard, in consultation with the ECB, the Bank continued with its information campaign on the euro, which is expected to intensify in 2007 and 2008. In October an ECB delegation visited the Bank and the NECC to discuss issues related to this campaign.

The Bank took part in three conferences related to the euro changeover process held in Slovenia, Cyprus and Malta, respectively. The Deputy Governor formed part of the panel at the conference held in Malta, which was jointly organised by the European Commission and the NECC. In addition, the Bank attended meetings of the MBA Euro Adoption Sub-committee, which discussed issues related to the banks' information campaigns on the euro and the setting up of a code of good practice for them.

In the legislative area, the Bank reviewed the Central Bank of Malta Act to ensure that it was compatible with the Treaty establishing the European Community and the Statutes of the ESCB and the ECB. In May and November it launched separate consultation processes aimed at addressing the remaining legal differences through amendments to the Central Bank of Malta Act. As part of this procedure, the Bank requested the necessary legal opinions from the ECB and thereafter advised the Ministry of Finance on the implementation of the ECB's recommendations. In October, legal officials from the ECB visited the Bank to discuss developments related to the adoption of the euro, particularly in areas where the ECB may be consulted, including the planned implementation of legislation.

The Bank also assisted the NECC in formulating the necessary legal framework for the adoption of the euro, particularly the drafting and review of the Dual Display and Euro Pricing Regulations as well as guidelines for the rounding of Maltese lira amounts into euros and on the dual display of prices.

After the adoption of the euro, the Central Bank of Malta will contribute to the implementation of the ECB's monetary policy, as part of the Eurosystem, through open market operations, reserve deposits and standing facilities. In preparation for this role, the Bank reviewed the use of reserve deposits as an instrument of monetary policy and began discussions with the banking system on a gradual alignment of the domestic framework governing the operation of the minimum reserve system with that of the Eurosystem.

Further work was also carried out in the field of reserve management to ensure that, following euro adoption, the Bank will be in a position to manage, as its agent, part of the ECB's portfolio of foreign assets.

Plans covering all aspects of the actual cash changeover were also set in motion. The Bank will be responsible for the distribution of the euro notes and coins to the banking system, which will, in turn, distribute them to the public. At the same time, the Bank will also be responsible for collecting from the banking system all Maltese lira notes and coins, which will cease to be legal tender in Malta soon after the introduction of the euro. Besides, the Bank has been assigned the task of training particular trainers in cash handling, especially as regards the security features of the euro notes and coins.

Preparations for the cash changeover also involved the selection of the designs for the national side of the Maltese euro coins by the general public. In October, following their approval by the European Commission, the Bank, after an international invitation to tender, awarded the contract for the minting of euro coins bearing the Maltese national side to the French mint, the Monnaie de Paris.

With regard to logistical preparations for the cash changeover, the Bank leased land for the construction of a secure warehouse, which is expected to be completed by end-June 2007, to house the euro coins during the transitional phase. In addition, works were carried out on the Bank's premises to facilitate the processing of both euro and Maltese lira notes during the changeover period. A new currency processor, suitable for the sorting and authentication of both Maltese lira and euro banknotes, was bought.

In the area of payments systems, the Bank continued to prepare to ensure that, after euro adoption, payments can be effected smoothly between Malta and the other euro area Member States. Once Malta adopts the euro, the domestic MaRIS system will cease to operate, and the Bank and the MSE will join TARGET2 as direct participants.[1]

In 2006 the Bank's core IT systems were consolidated in preparation for the euro changeover, while a number of applications – particularly for risk management, investments and the statistical database – were enhanced further. Preparatory work was carried out on the upgrading of the Bank's core accounting system and other applications to cater for transactions in euro and to convert historical data into euro where necessary. In addition, other applications will be developed to facilitate statistical reporting, particularly to the ECB.

The Bank recognised the importance of ensuring that all its staff were familiar with key issues regarding the adoption of the euro and organised an internal training programme. A number of presentations about the principal elements of the institutional and statistical framework governing EMU, the implications of the euro for the Maltese economy and the Bank's own preparations in this regard were delivered.

[1] TARGET2 is the new payment system used by the Eurosystem for the settlement of central bank operations, large-value euro interbank transfers and other euro payments.

ECONOMIC & FINANCIAL POLICY CALENDAR 2006

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

5 January: ***National Euro Changeover Committee (NECC) publishes guidelines on dual display and pricing***

The NECC publishes guidelines for traders who opt to display prices in euro apart from the Maltese lira before a compulsory dual display period comes into effect. In such cases, the consumer is not obliged to pay in euro and a trader is not obliged to accept payment in euro. The price displayed in euro should be the price of the good or service in Maltese lira at the central parity rate of Lm0.4293 for every euro to the nearest euro cent.

12 January: ***NECC publishes guidelines for conversion of past data***

The NECC publishes guidelines for the conversion of past data related to the euro changeover process. These are intended to assist organisations in determining whether to convert past monetary and financial data, and if so, whether fully or in part.

14 January: ***Consultation process for selection of designs for Maltese euro coins announced***

The Government, in conjunction with the Central Bank of Malta and the NECC, announces a public consultation process for the selection of the designs for the Maltese euro coin set. The public is presented with twelve options divided into four themes and is asked to choose the preferred option to appear on the national side of the euro coins. On 2 February the Central Bank of Malta and the NECC announce the results.

24 January: ***European Commission assesses Malta's National Reform Programme***

The European Commission publishes its assessment of Malta's National Reform Programme for Growth and Jobs (NRP). According to the Commission, the NRP identifies and responds to the challenges facing Malta and is based on a good analysis of the current economic situation, with ambitious objectives and concrete measures.

The Commission encourages the Maltese authorities to strengthen competition and improve the quality of the regulatory system. It also calls for a reduction in the tax burden on labour and for work to be made more attractive through a comprehensive review of the tax and benefit system.

22 February: ***European Commission publishes assessment of Malta's updated convergence programme 2005 - 2008***

The European Commission publishes its assessment of the latest update of Malta's convergence programme. The budgetary strategy outlined in the update aims at reducing the deficit to below the 3% of GDP reference value in 2006 and sets a medium-term objective of a balanced budget.

28 February: ***NECC publishes guidelines on rounding and smoothing***

The NECC publishes a set of guidelines on the rounding and smoothing of Maltese lira amounts converted into euro. The guidelines aim to ensure fairness where conversion of monetary amounts from Maltese lira into euro necessitates the application of rounding and smoothing. Rounding rules in connection with the conversion of national currencies into euro are established in EU law.

14 March: ***ECOFIN Council gives opinion on Malta's convergence programme***

The ECOFIN Council invites Malta to implement with rigour the 2006 budget measures, to ensure the correction of the excessive deficit by the end of 2005. In addition, Malta is called upon to ensure that the debt ratio is declining towards the 60% of GDP reference value at a satisfactory pace from 2006 onwards.

23 March: ***NECC publishes guidelines on usage of the term "euro" in Maltese***

The NECC publishes a set of guidelines on the usage of the term "euro" in the Maltese language to ensure consistency in spelling and pronunciation. These guidelines apply to the spelling of the term "euro" in the Maltese language in legislation and legal instruments in any form whatsoever.

7 February – 24 March: The following regulations and amendments to existing regulations related to the financial services industry are issued through legal notices:-

7 February: Regulations governing the Depositor Compensation Scheme amended, through Legal Notice 35

The regulations governing the Depositor Compensation Scheme are amended so that any deposits in any currency of an EEA state are covered by the Scheme. Before the amendments, only deposits in Maltese lira were eligible for compensation.

7 February: Regulations governing the Investor Compensation Scheme amended, through Legal Notice 36

These amendments specifically provide that, in calculating the amount of compensation to be paid to an investor, all computations and payments are to be made in the currency of the investment.

21 February: Regulations on the prevention of money laundering amended, through Legal Notice 42

The amended regulations establish new, risk-based policies and procedures in relation to the acceptance of customers. These include the introduction of enhanced due diligence measures for higher-risk customers. They also introduce additional responsibilities with respect to the recording and independent verification of payment transactions and other obligations related to international correspondent banking and corporate relationships.

24 March: Special Funds (Regulation) Act (Cap. 450), European Passport Rights for Institutions for Occupational Retirement Provision) Regulations, 2006 published through Legal Notice 71

These regulations complete the transposition of the Pensions Directive 2003/41/EEC into Maltese law. Occupational retirement schemes that are set up in Malta, in any other EU Member State or in EEA States are defined as institutions for occupational retirement provision.

24 March: Special Funds regulations amended, through Legal Notice 72

These amendments provide for the exemption of asset managers established in other EU Member States, and who are already authorised to provide investment management services under the relevant EU Directives, from the registration requirement laid down in the Special Funds (Regulation) Act (Cap. 450).

24 March: Regulations governing the tax treatment of fringe benefits amended, through Legal Notice 76

The new regulations amend the tax treatment relating to fringe benefits in the form of loans advanced by financial institutions to their employees. The new benchmark rate is 0.25% higher than the central intervention rate set by the Central Bank of Malta and is to be reviewed at the end of each calendar year. These regulations came into force on 1 January 2006.

5 May: ***Government of Malta and European Commission sign agreement on funding of euro changeover information campaign***

The Government of Malta and the European Commission sign an agreement to fund an information campaign on the euro changeover to be carried out by the NECC. On 8 June the NECC officially launches its campaign, with the principal theme being '*The euro - in our common interest*'.

25 May: ***Central Bank of Malta raises central intervention rate***

The Central Bank of Malta raises its central intervention rate by 25 basis points, from 3.25% to 3.50%. The decision is taken in the light of an underlying downward trend in the Bank's external reserves that is associated with a narrowing of the interest rate differential in favour of the Maltese lira.

29 May: ***Final consultation process for selection of euro coin design launched***

The Central Bank of Malta and the NECC launch the final public consultation process for the selection of the designs for the national side of Malta's euro coin set. On 10 June the NECC announces that three designs had been selected, one representing the eight-pointed Maltese cross, the second the emblem of Malta and the third a neolithic temple altar.

29 May: ***MFSA publishes guidelines on the conversion of company share capital***

The MFSA, through the NECC, publishes the *Guidelines on the conversion of company share capital from the Maltese lira into euro*. These set out the manner in which company share capital denominated in Maltese lira is to be converted into euro.

29 May: ***MSE publishes guidelines on the redenomination of Maltese lira financial instruments***

The MSE, through the NECC, publishes the *Guidelines on the redenomination and renominalisation of Maltese lira denominated listed financial instruments converted into euro*. These guidelines set overall principles and direction on the redenomination of listed financial instruments denominated in Maltese lira into euro.

11 April – 26 May: The following legislation related to banking and finance is enacted:-

4 April: Rome Convention on Contractual Obligations (Ratification) Act (Cap. 482)

Through this Act Malta accedes to the 1980 Rome Convention on the law applicable to contractual obligations. The convention stipulates the manner in which the law is to be applied in cases where more than one jurisdiction is concerned and the governing law is not specified.

11 April: Securitisation Act (Cap. 484)

This Act provides a framework for the securitisation of assets, that is the conversion of receivables or other assets into securities that can be placed and traded in capital markets. The law provides that issued securities collateralised by a pool of assets can be transferred to a separate entity, the special purpose vehicle (SPV). The SPV can take the form of an investment company, a partnership, a trust and any other legal structure permitted by law. Investors in an SPV enjoy a first-ranking privilege over the securitised assets and their proceeds.

26 May: Insurance Business Act (Cap 403), Insurance Business (Long Term Business Contract Statutory Notice) (Amendment) Regulations, published through Legal Notice 115

These regulations amend Legal Notice 106 of 2000 by extending the 'cooling-off period' in respect of long-term insurance contracts from 15 days to 30 days. The amendments are to come into force on 1 August 2006.

26 May: Investment Services Act (Cap. 370), Investment Services Act (Linked Long Term Contracts of Insurance Statutory Notice) (Amendment) Regulations, 2006 published through Legal Notice 117

These regulations amend Legal Notice 354 of 2002 and extend the 'cooling-off period' applicable in the case of linked long-term insurance contracts from 15 days to 30 days. The amendments also clarify that "linked long term contracts of insurance" exclude distance contracts. The amended regulations are to come into force on 1 August 2006.

26 May: Malta Financial Services Authority (Cap. 330), Distance Selling (Retail Financial Services) (Amendment) Regulations, 2006 published through Legal Notice 116

These regulations amend Legal Notice 36 of 2005. For the purposes of EC Regulation 2006/2004 on consumer protection co-operation, the MFSA is established as the national competent authority responsible to enforce the laws that protect consumers' interests in the field of financial services. The regulations are to come into force on 1 August 2006.

19 May: ***Maltacom privatisation completed***

The Government of Malta sells its 60% shareholding in Maltacom p.l.c, a telecommunications company, to Emirates International Telecommunications (Malta) Limited, a company which forms part of the Tecom Investments group, for the price of Lm94.4 million, or Lm1.554 per share.

9 June: ***Master plan for euro changeover updated***

The NECC publishes the *Second Updated Master Plan for the Euro Changeover in Malta*. This relates to the management of the changeover, the timetable for euro adoption, the cash changeover and financial services as well as the communications strategy.

18 September: ***Maltese proposal to set up small states network for economic development adopted at Small States Forum: Malta to host permanent secretariat***

Representatives of small developing countries that are members of the World Bank meet in Singapore for the 2006 Small States Forum. Among other things, the Forum discusses a proposal by the Government of Malta, first made in 2005, for the establishment of a Small States Network for Economic Development (SSNED). The proposal, which was enthusiastically supported by the other members of the Forum, is formally adopted, and it is agreed that Malta should host the network's permanent secretariat.

25 July: ***Euro Adoption Act (Cap. 485) enacted***

This Act provides for measures connected with, and ancillary to, the adoption of the euro as the currency of Malta. It grants to the Minister responsible for Finance the power to issue regulations for facilitating the adoption of the euro. It also grants to the Prime Minister the power to amend any other law for the purposes of ensuring that this properly reflects the adoption of the euro as the currency of Malta, and that Malta's treaty and international obligations related to, or arising out of, the adoption of the euro as the currency of Malta are implemented.

23 August: ***MFSA extends licences held by credit and financial institutions to act as intermediaries in certain classes of insurance***

The MFSA announces that it is extending the operational licences held by credit and financial institutions to allow them to act as tied insurance intermediaries in the classes of general insurance where this covers export credit contracts and payment protection contracts of insurance issued in relation to loan repayments.

31 October: ***Central Bank of Malta raises interest rates***

The Bank, responding to an increase in euro area interest rates and amid expectations of a continued tightening of monetary policy abroad, raises its central intervention rate by 25 basis points to 3.75%.

1 December: Malta submits update of Convergence Programme 2006-2009

Malta submits an Update of its Convergence Programme for 2006-2009 to the European Commission. This document sets out the Government's objectives for macroeconomic and monetary and exchange rate policy and the medium-term projections of the main macroeconomic variables.

5 December: ***ECB/EU Commission publish Convergence Reports***

The European Commission and the ECB publish their respective 2006 Convergence Reports. These reports, which are prepared once every two years, monitor the progress made by Member States outside the euro-area (except the UK and Denmark) with respect to the fulfilment of their obligations regarding the achievement of economic and monetary union.

With respect to Malta both entities make broadly similar remarks, namely that Malta fulfills the long-term interest rates criterion but at this stage (autumn 2006) does not fulfil the other Maastricht criteria. Malta's inflation rate is above the reference value while fiscal data for 2005, the latest available, show levels above the stipulated benchmarks. In addition, Malta did not fulfil the exchange rate criterion because the period requirement of two years in ERM II had not yet been completed.

24 October: ***Implementation Report on National Reform Programme made public***

Malta's First Annual Implementation Report on the National Reform Programme submitted to the EU Commission is made public. The Report focuses on the initiatives taken by the Maltese Government to achieve the targets set in the Lisbon Agenda.

In its assessment of the Report published on 12 December 2006, the European Commission observes that Malta was making good progress in implementing its National Reform Programme (NRP) in most key areas. These include the sustainability of public finances and the implementation of significant measures in the environmental, education and training areas. More modest progress had been made in improving the business environment and on research and development and innovation.

18 October: ***Measures introduced in the Budget for 2007***

The Prime Minister and Minister of Finance presents the Budget for 2007 to Parliament.

The main measures include:

- The income tax thresholds for low and middle-income earners are raised, while a husband and/or wife working in a family enterprise can be considered as employees for tax purposes.
- Part-timers working more than eight hours a week may opt for a 10 per cent social security contribution rate, although this would entail an eventual proportionate reduction in their pension.
- The airport departure tax is to be halved to Lm10 as from June 2007.
- Tax relief of up to Lm400 for children in licensed childcare. In addition, childcare services at the workplace are no longer to be considered a fringe benefit and will no longer be taxed.
- A cost of living increase of Lm2.25, which includes the Lm0.50 already announced in 2005. There are changes also to taxes relating to the inheritance of property.
- Moreover, in order to boost the number of properties offered for rent to social cases, a preferential tax rate of 5 per cent on the rental income from such properties is to be applied for a 10-year period.
- Tax relief for parents of children attending private schools is doubled, while students following full-time courses in private institutions will get the same stipends as students at the University or the Malta College of

Arts, Science and Technology (MCAST).

- Lm900,000 are earmarked for the setting up of a Venture Capital Fund.

7 December: ***Social Security Act amended to provide for pension reform***

Parliament enacts Act No. XIX of 2006 to further amend the Social Security Act so as to provide for the gradual raising of the pension age to 65 years, for changes to the method by which the two-thirds pension is to be calculated, and for the possibility of having additional pensions.

7 December: ***Malta Venture Capital plc set up***

Malta Venture Capital plc is set up with an authorised capital of Lm10 million. The Government allocates Lm900,000 to the company as initial capital. Private investors are also expected to contribute to the capital subscription. The company's aim is to enable entrepreneurs to find the required finance to embark on projects not easily financed by local financial institutions. The new company is expected to assist the private sector in higher risk ventures, especially where innovative processes and new technologies are involved.

7 December: ***NECC launches initiative on fair pricing agreements***

The NECC issues a publication entitled *Fit for Fair! Fair-Pricing Agreements in Retailing*. The publication explains what fair pricing agreements in retailing (FAIR) are and how businesses can participate in such agreements. FAIR thus aims at ensuring fairness and transparency in pricing. This initiative is managed and monitored by the Euro Observatory on behalf of the Ministry of Finance.

13 October – 19 December: The following are the main new regulations and amendments to existing regulations related to the financial services industry issued through legal notices:-

13 October: Regulations governing performance fees paid by collective investment schemes published, through Legal Notice 239

These regulations prescribe the basis on which performance fees may be paid by collective investment schemes available to retail investors and specify a number of disclosure requirements.

13 October: Regulations governing insurance companies' accounts amended, through Legal Notice 240

This amendment provides that if a provision of these regulations is not compatible with the International Financial Reporting Standards, an insurance company's accounts are to be drawn up so as to give a true and fair view.

13 October: Regulations governing SICAVs published, through Legal Notice 241

These regulations describe the operations and structure of SICAVs and set out the rules governing them. They replace the previous regulations published through Legal Notice 102 of 1996.

15 – 19 December: Legal Notices 319-322, 324 and 326 of 2006 governing insurance business published

These legal notices cover various aspects of the insurance business in Malta. They refer to the Insurance Intermediaries (Transitional Provisions) Regulations, 2006, the Repeal of Investment Services Act (Linked Long-Term Contracts of Insurance Statutory Notice) Regulations, 2006, the Insurance Business (Long-Term Business Contract Statutory Notice) (Amendment) Regulations, 2006, the Investment Services Act (Licence and Other Fees) Regulations, 2006, the Insurance Business (Insurers' Assets and Liabilities) (Amendments) Regulations, 2006 and the Insurance Intermediaries (Exemptions) Regulations, 2006.

Part III

FINANCIAL STATEMENTS
FOR THE YEAR ENDED
31 DECEMBER 2006

Directors' report

The Directors present their report and the audited financial statements of the Bank for the year ended 31 December 2006.

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 59 to 78 respectively, give a detailed account of the Bank's activities and operations during 2006.

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 2006, and of its profit and its cash flows for the year then ended. The financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards issued by the International Accounting Standards Board and in accordance with the requirements of the Central Bank of Malta Act (Cap. 204) applicable for the financial period under review.

Financial results

The Bank's financial statements for the year ended 31 December 2006 are set out on pages A-7 to A-44 and disclose an operating profit of Lm11.2 million (2005: Lm10.8 million). The amount payable to Government is Lm10.9 million (2005: Lm10 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 Stephanie Sciberras was the Secretary to the Board.

Auditors

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

By order of the Board

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

Pjazza Kastilja
Valletta
Malta

20 March 2007

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 2006 and of the profit and cash flows for the year then ended. The Board of Directors is also responsible for ensuring that the financial statements are drawn up in accordance with the requirements of the Central Bank of Malta Act (Cap. 204) applicable for the financial period under review.

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

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

Independent auditors' report

To the Board of Directors of the Central Bank of Malta

We have audited the financial statements of Central Bank of Malta on pages A-7 to A-44 which comprise the balance sheet as at 31 December 2006 and the profit and loss account, statement of changes in equity and cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory notes.

Directors' Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Independent auditors' report - continued

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of the Bank as at 31 December 2006, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards and have been properly prepared in accordance with the requirements of the Central Bank of Malta Act (Cap. 204).

ERNST & YOUNG	PRICEWATERHOUSECOOPERS
Anthony P. Doublet (Partner) for and on behalf of	John B. Zarb (Partner) for and on behalf of
Malta	Malta
20 March 2007	20 March 2007

Profit and loss account

	Notes	**2006**	2005
		Year ended 31 December	
		Lm'000	Lm'000
Interest and similar income	3	**31,208**	24,831
Interest expense and similar charges	4	**(11,350)**	(7,564)
Net interest income		**19,858**	17,267
Net fee and commission expense		**(230)**	(237)
Net losses from foreign exchange activities	5	**(3,507)**	(2,283)
Other net trading gains	6	**7**	2
Gains less losses on disposal of available-for-sale financial assets	7	**109**	1,454
Other operating income		**107**	57
Administrative expenses	8	**(4,836)**	(4,690)
Depreciation on property, plant and equipment	20	**(255)**	(317)
Currency issue expenses	9	**(101)**	(457)
Profit for the financial year		**11,152**	10,796
Transfer to reserves for risks and contingencies	29	**(250)**	(795)
Payable to the Government of Malta in terms of Section 24(4) of the Central Bank of Malta Act (Cap. 204)		**10,902**	10,001

Balance sheet

	Notes	**2006**	2005
		As at 31 December	
		Lm'000	Lm'000
Assets			
Cash and balances with banks	10	**11,038**	6,305
Gold balances		**1,150**	664
Placements with banks	11	**341,984**	279,170
Investment securities:			
Available-for-sale	12	**527,175**	598,413
Held-to-maturity	12	**30,491**	-
Claims on the International Monetary Fund	13	**36,409**	37,514
Participating interest in the European Central Bank	14	**107**	107
Other foreign currency assets		**854**	865
Total external assets		**949,208**	923,038
Available-for-sale local assets:			
Treasury bills	16	**3,345**	1,865
Domestic debt securities	17	**26,924**	7,253
Derivative financial instruments	18	**1,118**	1,937
Other assets	19	**34,611**	35,771
Property, plant and equipment	20	**8,806**	8,754
Prepayments and accrued income		**12,968**	12,366
Total assets		**1,036,980**	990,984

Balance sheet - continued

	Notes	**As at 31 December** **2006** **Lm'000**	2005 Lm'000
Liabilities and equity			
Liabilities			
Notes and coins in circulation	21	**503,976**	520,044
Deposits by:			
Central banks	22	**15**	15
Banks	23	**283,649**	182,321
Government	24	**106,569**	147,461
Others	25	**17,594**	9,511
Profits payable to Government		**10,902**	10,001
Derivative financial instruments	18	**926**	575
Other liabilities	26	**33,212**	34,198
Accruals and deferred income		**2,174**	2,568
		959,017	906,694
Capital and reserves			
Capital	27	**5,000**	5,000
General reserve fund	28	**23,000**	23,000
Special reserve fund	28	**13,000**	13,000
Reserves for risks and contingencies	29	**44,995**	44,745
Fair value reserve	30	**(8,032)**	(1,455)
		77,963	84,290
Total liabilities and equity		**1,036,980**	990,984

The financial statements on pages A-7 to A-44 were approved for issue by the Board of Directors on 20 March 2007 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 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 expense recognised directly in equity	-	-	-	-	(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

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

Cash flow statement

	Notes	Year ended 31 December 2006 Lm'000	2005 Lm'000
Cash flows from operating activities			
Interest and similar income received		**36,212**	29,672
Interest and similar charges paid		**(11,242)**	(7,538)
Net fee and commission paid		**(230)**	(237)
Net trading and other expense		**(2,217)**	(4,305)
Cash payments mainly to employees and suppliers		**(5,437)**	(5,282)
Cash flows from operating profits before changes in operating assets and liabilities		**17,086**	12,310
Net changes in operating assets and liabilities:			
Placements with banks		**8,818**	(21,242)
Other foreign exchange assets		**630**	(2,632)
Treasury bills		**1,597**	6,898
Malta Government securities		**(20,372)**	5,936
Other assets		**1,160**	(1,531)
Currency in issue		**(16,068)**	13,639
Deposits		**41,155**	(9,580)
Other liabilities		**(986)**	1,566
Net cash from operating activities		**33,020**	5,364
Cash flows from investing activities			
Purchase of securities		**(256,894)**	(627,282)
Proceeds from sale and maturity of securities		**286,119**	447,674
Purchase of property, plant and equipment	20	**(307)**	(140)
Net cash from/(used in) investing activities		**28,918**	(179,748)
Cash flows from financing activities			
Payment to the Government under Section 24(4) of the Central Bank of Malta Act (Cap. 204)		**(10,001)**	(14,001)
Movement in cash and cash equivalents		**51,937**	(188,385)
Cash and cash equivalents at 1 January		**14,664**	203,049
Cash and cash equivalents at 31 December	31	**66,601**	14,664

Notes to the financial statements

1. Accounting policies

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

(a) Basis of preparation of financial statements

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

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

Standards, interpretations and amendments to published standards effective in 2006

In 2006, the Bank adopted new standards, amendments and interpretations to existing standards that are mandatory for the Bank's accounting period beginning on 1 January 2006. 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 accounting periods beginning after 1 January 2006 but which were not yet effective for the Bank's current accounting period beginning on 1 January 2006. The Bank has chosen not to early adopt 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.

(d) Foreign currency transactions and balances

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

1. Accounting policies - continued

(e) Demonetised currency notes and coins

(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.

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

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

1. Accounting policies - continued

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

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

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

(ii) Loans and receivables

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

(iii) Held-to-maturity

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

(iv) Available-for-sale

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

1. Accounting policies - continued

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

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

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

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

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

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

1. Accounting policies - continued

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

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.

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

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

1. Accounting policies - continued

(g) Derivative financial instruments

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

(h) Gold balances

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

(i) Claims on the International Monetary Fund

The International Monetary Fund Reserve Tranche Position and Special Drawing Rights are translated at the prevailing representative rate for the Maltese lira of SDR2.04061 to Lm1 as quoted by the Fund at the close of business on 31 December 2006. 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 2006. 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.

1. Accounting policies - continued

(k) Sale and repurchase agreements and lending of securities

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

(l) Financial guarantee contracts

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

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

(m) Other financial instruments

The Bank's other financial assets which have not been referred to in the accounting policies disclosed above, comprising principally placements with banks and other similar assets, are classified as loans and receivables in accordance with the requirements of IAS 39. The recognition and measurement rules applicable to loans and receivables are outlined in Note 1(f) to the financial statements. 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.

1. Accounting policies - continued

(m) Other financial instruments - continued

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

(n) Offsetting financial instruments

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

(o) Property, plant and equipment

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

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

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

Assets in the course of construction are not depreciated.

1. Accounting policies - continued

(o) Property, plant and equipment - continued

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

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

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

(p) Leases

Leases entered into by the Bank as 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.

(q) Cash and cash equivalents

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

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

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

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

3. Interest and similar income

	2006	2005
	Lm'000	Lm'000
Income from:		
Placements with banks	**9,306**	7,844
Available-for-sale investment securities	**18,996**	15,153
Held-to-maturity investment securities	**159**	-
Claims on the International Monetary Fund	**1,017**	727
Other foreign currency assets	**295**	432
External assets	**29,773**	24,156
Treasury bills and debt securities issued by the Government of Malta	**1,394**	538
Assets arising from monetary policy instruments	**-**	97
Other assets	**41**	40
	31,208	24,831

4. Interest expense and similar charges

	2006	2005
	Lm'000	Lm'000
Expense on:		
Bank deposits	**4,834**	4,128
Liabilities arising from monetary policy instruments	**4,054**	1,281
Government deposits	**2,408**	2,114
Other deposits	**54**	41
	11,350	7,564

5. Net losses from foreign exchange activities

	2006 **Lm'000**	2005 Lm'000
Amounts recognised in the profit and loss account	**(3,507)**	(2,283)

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 enters into foreign exchange transactions for the forward purchase of euro and simultaneous forward sale of sterling or US dollars for the purposes of hedging against foreign exchange movements (see Note 32 on 'Currency risk'). During the current year, the Bank incurred costs of Lm3.7 million (2005: 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

	2006 **Lm'000**	2005 Lm'000
Net fair value losses on held for trading foreign currency securities	**(6)**	(12)
Net fair value gains on other derivative contracts (Note 18)	**13**	14
	7	2

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

	2006 **Lm'000**	2005 Lm'000
Net gains/(losses) on disposal of:		
Foreign currency investment securities	**143**	1,419
Treasury bills and debt securities issued by the Government of Malta	**(34)**	35
	109	1,454

8. Administrative expenses

	2006	2005
	Lm'000	Lm'000
Staff costs	**3,105**	3,091
Training, welfare and other staff-related expenditure	**311**	262
Market information and communication expenses	**386**	440
Other administrative expenses	**1,034**	897
	4,836	4,690

Other administrative expenses mainly comprise maintenance expenditure, professional fees, travelling costs and other services or expense items which are incurred in the course of the Bank's operations. Auditors' remuneration for the current financial year amounted to Lm25,000 (2005: Lm16,000).

Compensation to the members of the Board of Directors for the financial year under review amounted to Lm88,130 (2005: Lm88,396). 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:

	2006	2005
	Number	Number
Governors	**2**	2
Divisional Directors	**5**	5
Heads and Executives	**75**	71
Supervisory and clerical staff	**199**	201
Non-clerical staff	**39**	40
	320	319

9. Currency issue expenses

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

10. Cash and balances with banks

	2006 **Lm'000**	2005 Lm'000
Cash in hand	**298**	224
Balances with banks - repayable on call and at short notice	**10,740**	6,081
Included in cash and cash equivalents (Note 31)	**11,038**	6,305

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.

11. Placements with banks

	2006 **Lm'000**	2005 Lm'000
Placements subject to fixed interest rates, by remaining maturity		
- One year or less but over three months	**12,879**	39,923
- Three months or less but over one month	**62,249**	51,943
- One month or less	**266,856**	187,304
	341,984	279,170

Placements with a contractual maturity of three months or less are included in cash equivalents for the purposes of the cash flow statement (Note 31).

12. Investment securities

	2006 **Lm'000**	2005 Lm'000
Available-for-sale investment securities – at fair value		
Debt securities principally subject to fixed interest rates, by remaining maturity		
- Over five years	**63,092**	57,175
- Five years or less but over two years	**137,919**	131,054
- Two years or less but over one year	**94,400**	162,530
- One year or less but over three months	**176,258**	191,401
- Three months or less	**55,506**	56,253
	527,175	598,413

12. Investment securities - continued

	2006	2005
	Lm'000	Lm'000
Held-to-maturity investment securities – at amortised cost		
Debt securities subject to fixed interest rates, by remaining maturity		
- Over five years	**10,946**	-
- Five years or less but over one year	**8,657**	-
- One year or less but over three months	**6,453**	-
- Three months or less	**4,435**	-
	30,491	-

The Bank's portfolio of investment securities is composed of listed foreign currency debt securities issued mainly by foreign governments and international financial institutions. As at 31 December 2006, 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 (2005: USD45 million or Lm16 million approximately). No amounts were borrowed under these facilities at the balance sheet dates. As at 31 December 2006, the fair value of held-to-maturity investment securities, based on quoted market prices, amounted to Lm30,282,000.

13. Claims on the International Monetary Fund

	2006	2005
	Lm'000	Lm'000
Reserve Tranche Position	**19,729**	20,871
Special Drawing Rights	**16,680**	16,643
	36,409	37,514

Malta's membership subscription to the International Monetary Fund amounts to SDR102,000,000 (2005: SDR102,000,000).

The Bank's position with the International Monetary Fund at 31 December 2006 is reflected in the balance sheet as follows:

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

13. Claims on the International Monetary Fund - continued

(b) Special Drawing Rights included above are equivalent to SDR34,036,755. These represent the Special Drawing Rights allocated to Malta amounting to SDR11,288,000, to which a corresponding liability exists in the form of a restricted demand deposit of the Government of Malta included under 'Other deposits' (see Note 25), together with other Special Drawing Rights acquired in accordance with International Monetary Fund requirements and procedures. Special Drawing Rights allocated to Malta cannot be withdrawn unless such advice is received from the Fund. Other Special Drawing Rights have no specified maturity.

(c) Currency Subscription included with 'Other assets' (see Note 19) is stated at Lm30,256,145 and represents the balance of the quota paid in Maltese liri. A corresponding liability included with 'Other liabilities' (see Note 26) exists in the form of IMF current accounts of Lm30,256,145 or SDR61,740,993.

The Reserve Tranche Position, Special Drawing Rights and SDR allocation (Note 25) are subject to floating interest rates determined by reference to the official rate quoted by the Fund on a weekly basis. The effective interest rate applicable to the interest-bearing instruments as at the balance sheet date was 4.07% (2005: 3.03%). The Currency Subscription and IMF current accounts are not subject to interest.

14. Participating interest in the European Central Bank

On 1 May 2004 Malta joined the European Union (EU) and consequently the Bank became a member of the European System of Central Banks (ESCB). In accordance with Article 28 of the Statute of the ESCB and the European Central Bank (ECB), the Bank became 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 29.1 of the ESCB Statute and which must be adjusted every five years and every time that a new member state joins the EU in accordance with Article 49.3. The share of Malta in the ECB's capital 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-45 and A-46 includes detailed disclosures of participating interests held by euro area and non-euro area National Central Banks (NCBs).

15. External reserve ratio

The ratio of external assets to notes and coins issued, excluding coins issued for numismatic purposes, and deposit liabilities is 104.10% (2005: 107.41%). In accordance with Section 19(1) of the Central Bank of Malta Act (Cap. 204), the minimum ratio in this respect is 60%.

16. Available-for-sale Treasury bills

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

	2006	2005
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**2**	1,406
- Three months or less but over one month	**2,441**	189
- One month or less	**902**	270
	3,345	1,865

The weighted average effective interest rate as at the balance sheet date was 3.79% (2005: 3.31%). Treasury bills with a contractual maturity of three months or less from the date of acquisition are included in cash equivalents (Note 31).

17. Available-for-sale domestic debt securities

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

	2006	2005
	Lm'000	Lm'000
By remaining maturity		
- Over five years	**1,251**	3,067
- Five years or less but over one year	**18,408**	2,576
- One year or less	**7,265**	1,610
	26,924	7,253

The weighted average effective interest rate as at the balance sheet date was 6.48% (2005: 6.07%).

18. Derivative financial instruments

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

	Assets	
	2006	2005
	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 EUR80 million (2005: EUR110.8 million) against USD	**553**	126
- forward purchase of EUR8 million against JPY	**70**	-
- forward purchase of EUR158 million (2005: EUR341.5 million) against GBP	**57**	1,290
Foreign exchange contract expiring in 2010		
- forward sale of EUR13.6 million (2005: EUR18.4 million) against Lm	**302**	368
Other derivative contracts maturing in 2009		
- cross-currency interest rate swaps with principal amounts of Lm10 million (2005: Lm10 million)	**136**	153
	1,118	1,937

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	
	2006	2005
	Lm'000	Lm'000
Foreign exchange and other derivatives held for trading:		
Foreign exchange contracts maturing within six months from the balance sheet date		
- forward purchase of EUR178.5 million against GBP	**508**	-
- forward purchase of EUR81.8 million (2005: EUR50 million) against USD	**208**	296
- forward purchase of EUR9.3 million against JPY	**-**	63
Other derivative contracts maturing in 2009		
- cross-currency interest rate swap with principal amount of Lm10 million (2005: Lm10 million)	**210**	216
	926	575

18. Derivative financial instruments - continued

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

19. Other assets

	2006 **Lm'000**	2005 Lm'000
International Monetary Fund Currency Subscription (see Note 13)	**30,256**	32,007
Others	**4,355**	3,764
	34,611	35,771

20. Property, plant and equipment

	Freehold property Lm'000	Leasehold property Lm'000	Assets in course of construction Lm'000	Others Lm'000	Total Lm'000
At 1 January 2005					
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

20. Property, plant and equipment - continued

	Freehold property Lm'000	Leasehold property Lm'000	Assets in course of construction Lm'000	Others Lm'000	Total Lm'000
Year ended 31 December 2006					
Opening net book amount	5,538	2,906	-	310	8,754
Additions	16	5	173	113	307
Depreciation charge for the year	(33)	(47)	-	(175)	(255)
Closing net book amount	**5,521**	**2,864**	**173**	**248**	**8,806**
At 31 December 2006					
Cost	5,658	3,196	173	2,821	11,848
Accumulated depreciation	(137)	(332)	-	(2,573)	(3,042)
Net book amount	**5,521**	**2,864**	**173**	**248**	**8,806**

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

21. Notes and coins in circulation

	2006 Lm'000	2005 Lm'000
Notes	**483,124**	499,934
Coins	**20,852**	20,110
	503,976	520,044

22. Central bank deposits

Deposits by central banks are denominated in Maltese lira, are repayable on demand and are included in cash equivalents (Note 31) accordingly.

23. Bank deposits

	2006 Lm'000	2005 Lm'000
Reserve deposits held in terms of Section 37 of the Central Bank of Malta Act (Cap. 204)	**176,930**	135,455
Other deposits from local banks	**19**	66
Liabilities arising from monetary policy instruments	**106,700**	46,800
	283,649	182,321

23. Bank deposits - continued

Reserve deposits held in terms of Section 37 of the Central Bank of Malta Act (Cap. 204), which are denominated in Maltese lira, are subject to variable interest rates linked to the Bank's Central Intervention Rate which at the financial year-end was 3.75% (2005: 3.25%). Reserve deposits denominated in euro are subject to floating interest rates linked to the ECB's minimum bid rate which at the balance sheet date was 3.5%. As at the balance sheet date, the effective interest rate applied to reserve deposits denominated in Maltese lira was 3.5% (2005: 3%), and the effective interest rate applied to reserve deposits denominated in euro was 3.25%. Other deposits from local banks are repayable on demand and are non interest-bearing. These other deposits are included in cash equivalents (Note 31).

Liabilities arising from monetary policy instruments mature within one month from the balance sheet date and are included in cash equivalents (Note 31). The weighted average interest rate applicable to these instruments, based on the Bank's Central Intervention Rate, was 3.7% (2005: 3.2%) as at the balance sheet date.

Amounts include:

	2006	2005
	Lm'000	Lm'000
By currency		
MTL	**270,279**	182,321
EUR	**13,370**	-
	283,649	182,321

24. Government deposits

Amounts include:

	2006	2005
	Lm'000	Lm'000
Current accounts by currency		
MTL	**62,346**	67,383
EUR	**14,658**	16,319
USD	**4,622**	5,987
GBP	**497**	386
Others	**403**	115
Sinking fund accounts by currency		
MTL	**16,859**	37,779
EUR	**5,224**	17,407
USD	**1,860**	1,972
Others	**100**	113
	106,569	147,461

Government deposits are repayable on demand and are included in cash equivalents (Note 31).

24. Government deposits - continued

Current accounts and sinking fund 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.

25. Other deposits

	2006 **Lm'000**	2005 Lm'000
Deposits by public sector corporations and similar entities:		
- Repayable on demand (included in cash equivalents - Note 31)	**2,509**	1,151
International Monetary Fund SDR allocation (see Note 13)	**5,532**	5,852
Others:		
- Repayable on demand (included in cash equivalents - Note 31)	**9,553**	2,508
	17,594	9,511

Amounts include:

	2006 **Lm'000**	2005 Lm'000
By currency		
MTL	**2,350**	2,688
EUR	**8,910**	806
SDR	**5,532**	5,852
Others	**802**	165
	17,594	9,511

Deposits by public sector corporations and similar entities denominated in Maltese lira, amounting to Lm1.63 million (2005: Lm0.86 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 Lm0.88 million (2005: Lm0.29 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.

26. Other liabilities

	2006 **Lm'000**	2005 Lm'000
International Monetary Fund current accounts (see Note 13)	**30,256**	32,007
Others	**2,956**	2,191
	33,212	34,198

27. 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.

28. 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.

29. 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.

30. Fair value reserve

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

30. Fair value reserve - continued

	Available-for-sale investment securities Lm'000	Available-for-sale local assets Lm'000
At 1 January 2005	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
Net losses from changes in fair value	(5,770)	(698)
Net (gains)/losses transferred to net profit on disposal	(143)	34
At 31 December 2006	**(7,442)**	**(590)**

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

31. Cash and cash equivalents

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

	2006 Lm'000	2005 Lm'000
Cash and balances with banks (Note 10)	**11,038**	6,305
Treasury bills maturing within three months (Note 16)	**3,339**	403
Placements with banks maturing within three months (Note 11)	**277,589**	205,957
Deposits maturing within three months (Notes 22, 23, 24 and 25)	**(225,365)**	(198,001)
	66,601	14,664

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.

32. 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 29 above. The Board considers credit risk and currency risk as the principal categories of risk faced by the Bank.

32. Financial instruments - continued

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 36 to these financial statements, whereas information relating to its liabilities is reflected in Notes 23, 24 and 25.

32. Financial instruments - 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:

	2006	2005
	%	%
EUR	**99.49**	99.84
GBP	**0.40**	0.04
USD	**(0.03)**	-
Others	**0.14**	0.12
	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 23, 24 and 25). 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.

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32. Financial instruments - 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**	**Held-to-maturity investment securities**	Current accounts	Sinking fund accounts	**Other deposits**
	%	%	%	%	%	%
MTL						
2006	**-**	**-**	**-**	**3.25**	**3.25**	**0.75**
2005	-	-	-	2.75	3.05	0.25
EUR						
2006	**3.49**	**3.03**	**3.69**	**2.75**	**3.00**	**2.75**
2005	2.26	2.50	-	1.51	1.76	1.51
GBP						
2006	**5.12**	**4.85**	**-**	**4.19**	**4.44**	**4.19**
2005	4.51	4.70	-	3.72	3.97	3.72
USD						
2006	**5.28**	**4.33**	**-**	**4.43**	**4.68**	**4.43**
2005	4.29	3.76	-	3.31	3.56	3.31

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.

32. 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 12, 16 and 17). Fair values for the Bank's derivative contracts are determined using forward exchange market rates at the balance sheet date for forward foreign exchange contracts and currency swaps (see Notes 5 and 18), and using valuation techniques, including discounted cash flow models, for other derivative contracts (see Notes 6 and 18). The valuation techniques used are supported by observable market prices or rates since their variables include only data from observable markets.

The following financial assets and liabilities include the main categories of instruments not presented on the Bank's balance sheet at their fair value: cash and balances with banks, balances with the International Monetary Fund, placements with banks, held-to-maturity investment securities together with deposits by banks, the Government of Malta, public sector corporations and other similar entities, and currency in circulation. The fair value of held-to-maturity financial assets, based on quoted market prices, is disclosed in Note 12 to the financial statements. The carrying amount of the other instruments referred to above approximates fair value due to their nature or short-term maturity. Deposits by banks mainly comprise reserve deposits. The face value of reserve deposits, balances with the International Monetary Fund and currency in circulation is essentially their fair value in view of the substance of the instruments or arrangements in place. Placements with banks mature 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.

33. Contingent liabilities and commitments

	2006	2005
	Lm'000	Lm'000
Contingent liabilities		
Guarantees and letters of credit	**25,606**	27,073
Financial commitments		
Repayment of foreign loans received by the Bank on behalf of the Government under Financial Conventions	**6,658**	8,609
Total	**32,264**	35,682

33. **Contingent liabilities and commitments** - continued

By remaining maturity:

Guarantees and letters of credit

	2006	2005
	Lm'000	Lm'000
- Five years or less but over one year	**66**	353
- One year or less but over three months	**1,342**	13,160
- Three months or less	**24,198**	13,560
	25,606	27,073

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

	2006	2005
	Lm'000	Lm'000
- Over five years	**621**	1,474
- Five years or less but over one year	**4,378**	5,385
- One year or less but over three months	**1,602**	1,604
- Three months or less	**57**	146
	6,658	8,609

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

In addition to the commitments disclosed in the tables above, at 31 December 2006 the Bank also had capital commitments in respect of property, plant and equipment amounting to Lm700,000. The Bank also has commitments in respect of recurrent expenditure which extend beyond the balance sheet date. In view of the nature and duration of these commitments, their impact on the Bank's financial results and on the assessment of the Bank's state of affairs was not deemed material for disclosure purposes.

34. 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 24 and 25 to the financial statements. The principal impact of banking transactions entered into with the Government and the entities referred to above, on the Bank's profit and loss account, is interest payable on deposits as disclosed in Note 4 to the financial statements. The Bank provides these entities with foreign exchange and related services, which do not have a significant impact on the Bank's profit and loss account. In this respect, the principal outstanding transactions as at the balance sheet date are reflected in Notes 18 and 33 to the financial statements. The Bank acts as market maker in Government securities and Treasury bills and ensures their liquidity in the secondary market by being ready to trade in such securities on the initiative of the market (see Notes 16 and 17). Income earned by the Bank from these assets is disclosed in Notes 3 and 7 to the financial statements.

The Bank's key management personnel are deemed to be the members of the Board of Directors. The Bank's transactions with key management personnel consist principally of compensation payable, which has been disclosed in Note 8 to the financial statements.

35. General

(a) Demonetised currency notes and coins

Demonetised currency notes

During 2006, demonetised currency notes presented for redemption amounted to Lm161,617 (2005: Lm190,689). At 31 December 2006, the value of unpresented demonetised currency notes amounted to Lm2,351,029 (2005: Lm2,512,646) analysed as follows:

	2006	2005
	Lm'000	Lm'000
Ten year period expires in:		
- 2008	**914**	930
- 2010	**1,437**	1,583
	2,351	2,513

35. General - continued

(b) Assets held in custody

At 31 December 2006, assets held in custody by the Bank in terms of the Insurance Business Act amounted to Lm19,531,000 (2005: Lm19,771,000).

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

During the preceding financial years, the Bank had been appointed as investment manager in respect of funds belonging to the Investor and Depositor Compensation Schemes. The Bank manages these funds on a discretionary basis but in accordance with the investment parameters set by the Management Committees of the respective Schemes. The amount of funds belonging to the Schemes, managed by the Bank, is adjusted by the amount of investments so effected. Accordingly as at 31 December 2006, the Investor and Depositor Compensation Schemes had interest-bearing deposits of Lm5,302 (2005: Lm11,714) and Lm5,120 (2005: Lm2,885) respectively, with the Bank.

36. 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.

36. Statement of the Bank's investments - continued

	EUR Lm'000	GBP Lm'000	USD Lm'000	Total Lm'000
Cash and balances with banks				11,038
Gold balances				1,150
Placements with banks by exposure country				
Belgium	45,076	9,591	-	54,667
France	25,758	-	-	25,758
Denmark	29,622	-	-	29,622
Ireland	21,465	-	-	21,465
Netherlands	21,465	-	6,515	27,980
Sweden	23,612	-	-	23,612
Switzerland	-	5,243	-	5,243
United Kingdom	124,669	6,394	22,574	153,637
	291,667	21,228	29,089	341,984
Available-for-sale investment securities by issuer category				
Government	79,675	-	3,731	83,406
Monetary financial institutions	234,877	80,185	19,381	334,443
Other financial institutions	29,882	24,945	3,076	57,903
Supranationals	23,473	6,981	5,446	35,900
Insurance sector	4,230	6,113	-	10,343
Non-financial institutions	5,180	-	-	5,180
	377,317	118,224	31,634	527,175
Held-to-maturity investment securities by issuer category				
Government	15,332	-	-	15,332
Monetary financial institutions	10,893	-	-	10,893
Supranationals	4,266	-	-	4,266
	30,491	-	-	30,491
Claims on the International Monetary Fund				36,409
Participating interest in the European Central Bank				107
Other foreign currency assets				854
Total external assets				**949,208**

Supplementary information to the financial statements:

Appendix 1

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

	From 1 May 2004 **%**
Nationale Bank van België/ Banque Nationale de Belgique	2.5502
Deutsche Bundesbank	21.1364
Bank of Greece	1.8974
Banco de España	7.7758
Banque de France	14.8712
Central Bank and Financial Services Authority of Ireland	0.9219
Banca d'Italia	13.0516
Banque centrale du Luxembourg	0.1568
De Nederlandsche Bank	3.9955
Oesterreichische Nationalbank	2.0800
Banco de Portugal	1.7653
Suomen Pankki-Finlands Bank	1.2887
Subtotal euro area NCBs	**71.4908**
Česká národní banka	1.4584
Danmarks Nationalbank	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	2.4133
Bank of England	14.3822
Subtotal non-euro area NCBs	**28.5092**
Total euro area and non-euro area NCBs	**100.0000**

Appendix 1 - continued

ESCB members' subscribed and paid-up capital

	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	141,910	141,910
Deutsche Bundesbank	1,176,171	1,176,171
Bank of Greece	105,584	105,584
Banco de España	432,698	432,698
Banque de France	827,533	827,533
Central Bank and Financial Services Authority of Ireland	51,301	51,301
Banca d'Italia	726,278	726,278
Banque centrale du Luxembourg	8,725	8,725
De Nederlandsche Bank	222,336	222,336
Oesterreichische Nationalbank	115,745	115,745
Banco de Portugal	98,233	98,233
Suomen Pankki-Finlands Bank	71,712	71,712
Subtotal euro area NCBs	**3,978,226**	**3,978,226**
Česká národní banka	81,155	5,681
Danmarks Nationalbank	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	134,292	9,400
Bank of England	800,322	56,023
Subtotal non-euro area NCBs	**1,586,443**	**111,051**
Total euro area and non-euro area NCBs	**5,564,669**	**4,089,277**