BANK ĊENTRALI TA' MALTA

EUROSISTEMA

CENTRAL BANK OF MALTA

FORTY-FIRST ANNUAL REPORT
AND
STATEMENT OF ACCOUNTS
2008

Address
Pjazza Kastilja
Valletta VLT 1060
Malta

Telephone
(+356) 2550 0000

Fax
(+356) 2550 2500

Website
http://www.centralbankmalta.org

E-mail
info@centralbankmalta.org

Printed by
Gutenberg Press Ltd
Gudja Road
Tarxien GXQ 2902
Malta

The cut-off date for information published in this Report is 27 February 2009 except where otherwise indicated. The cut-off date for data on GDP is 11 March 2009. Figures in tables may not add up due to rounding.

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

THE MISSION AND OBJECTIVES OF THE CENTRAL BANK OF MALTA

Our Mission

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

Our Objectives

We seek to achieve this mission by:-

Promoting price stability in the euro area

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

Contributing to the stability of the financial system

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

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

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

Supporting the development of financial markets

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

Providing and promoting efficient currency services

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

Optimising the returns on financial assets through prudent investment practices

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

Collecting, compiling, disseminating and publishing statistics

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

Advising the Government generally on financial and economic matters

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

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

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

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

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

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

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

BOARD OF DIRECTORS*

Michael C. Bonello
Governor

David A. Pullicino
Deputy Governor

Charles J. Falzon *Director*
Victor Busuttil *Director*
Antoinette Caruana *Director*

Executive Management Committee*

Michael C. Bonello
Governor & Chairman

David A. Pullicino
Deputy Governor

Alfred Demarco
Director
Economics and External Relations Division

Godfrey Huber
Director
Finance and Banking Division

René G. Saliba
Director
Financial Markets Division

Herbert Zammit LaFerla
Director
Financial Stability Division

John Agius
Director
Resource Management Division

Audit Committee*

Victor Busuttil
Chairman

David A. Pullicino
Member

Charles J. Falzon
Member

Investments Policy Committee*

Michael C. Bonello
Governor & Chairman

David A. Pullicino
Deputy Governor

Godfrey Huber
Director
Finance and Banking Division

René G. Saliba
Director
Financial Markets Division

Raymond Filletti
Senior Manager
Financial Control Department

Saviour Briffa
Senior Manager
Reserve Management Department

Stephen Attard
Manager
Middle Office

Mario Bugeja
Manager
Investments and Reserves Office

(as at 31 December 2008)

THE BOARD OF DIRECTORS

(as at 31 December 2008)

David A. Pullicino
(Deputy Governor)

Michael C. Bonello
(Governor & Chairman)

Charles J. Falzon
(Director)

Antoinette Caruana
(Director)

Stephanie Sciberras
(Secretary)

Victor Busuttil
(Director)

Antoinette Caruana was appointed for a period of five years with effect from 14 April 2008. She is currently a member of the Group Executive Board of Simonds Farsons Cisk plc and a tutor in management at the University of Malta.

Charles J. Falzon was appointed 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.

Victor Busuttil was appointed for a period of five years with effect from 1 January 2008. He is an economist and a retired senior official of the United Nations.

ORGANISATION CHART*

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

(as at 31 December 2008)

BANK ĊENTRALI TA' MALTA
Il-Gvernatur

CENTRAL BANK OF MALTA
The Governor

30 March 2009

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

Dear Minister

LETTER OF TRANSMITTAL

In terms of article 21 of the Central Bank of Malta Act (Cap 204), I have the honour to transmit to you, in your capacity as Minister responsible for finance, a copy of the Annual Report of the Bank for the financial year ended 31 December 2008.

Yours sincerely

Michael C Bonello

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
EEA	European Economic Area
EMU	Economic and Monetary Union
EONIA	Euro OverNight Index Average
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
EURIBOR	Euro Interbank Offered Rate
FI	fungibility issue
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
LFS	Labour Force Survey
MIGA	Multilateral Investment Guarantee Agency
MFEI	Ministry of Finance, the Economy and Investment
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
NCB	national central bank
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
OECD	Organisation for Economic Co-operation and Development
OMFI	Other Monetary Financial Institution
OPEC	Organisation of Petroleum Exporting Countries
RPI	Retail Price Index

GOVERNOR'S STATEMENT

The year 2008 was marked by the introduction of the euro, a major milestone in Malta's economic integration with the European Union and a turning point in the history of the Central Bank of Malta. The Bank is now a fully functioning member of the Eurosystem.

Malta's first year as a member of the euro area coincided with a global financial crisis of unprecedented proportions characterised by seized-up interbank markets, acute liquidity shortages, record high risk premiums, bank failures and a widespread loss of confidence. As the year progressed, a crisis that had its beginnings in a narrow segment of the housing market in the United States spread rapidly, accelerating after the collapse of Lehman Brothers in mid-September. As banks sought to restructure their balance sheets, the cost of financing rose and credit standards tightened such that borrowers found it increasingly hard to obtain finance. The resultant contraction in private consumption and investment produced a sharp decline in world trade. All these factors helped to push major economies, including that of the euro area, into recession. All along, central banks and governments used both conventional and novel methods in an attempt to contain the systemic risk posed by these developments. At the turn of the year, however, the situation remained tense and volatile, and its future evolution unpredictable.

These dramatic events have tested the expectation, which I expressed at this time last year, that membership of the euro area would strengthen the Maltese economy's capacity to withstand external shocks. It has certainly done so in one vital respect: euro adoption has meant that the economy has not been exposed to the risks inherent in managing a small, vulnerable currency such as the Maltese lira, and more so at a time of severe financial market turbulence.

The danger posed by the global crisis for the Maltese economy was also mitigated by the existence of a sound financial system. The banks at the heart of the system do not hold asset-backed securities associated with sub-prime loans, their investment portfolios are highly diversified and they follow prudent lending policies. Their funding model, moreover, is based on retail deposits and they have high liquidity and capital ratios. The latter have proved more than adequate to accommodate the valuation losses experienced as a result of the generalised decline in asset prices. Going forward, however, risks to the banking system are likely to develop, stemming from an expected weaker performance of key economic sectors, particularly the property market and those which are highly dependent on foreign demand such as tourism and manufacturing.

It was to be expected that Malta's trade-oriented economy would eventually be impacted by any contraction in external markets. The year started well, with real GDP expanding by 2.8% during the first half, broadly in line with the pattern seen in previous quarters. By mid-year, however, the impact of the global slowdown started to manifest itself, initially in a faster decline in exports of goods but, after the summer, also in decreasing tourist numbers. The annual growth rate slowed down. In the fourth quarter, the repercussions began to be felt more keenly in manufacturing sectors that were most exposed to reduced consumer spending abroad, notably in the electronics and automotive components industries. This contributed to a wider trade imbalance for the year as a whole, as an improved export performance in emerging service activities was insufficient to compensate for the deterioration in manufacturing and in tourism. At the same time, with investment spending also declining, growth in the final quarter turned negative. As a result, annual GDP growth more than halved from 3.6% in 2007 to 1.6% in 2008.

The sharp deceleration in global economic activity also brought about a reversal in inflation trends. While strong demand and supply constraints combined to push key commodity prices up to historical highs in the first half of the year, demand pressures eased thereafter and commodity prices turned down, sharply so in the case of oil. In the euro area, the year ended with an inflation rate of 1.6%.

Inflation developments in Malta did not fully mirror this pattern. Consumer prices rose steadily throughout the year, accelerating after the summer largely as a result of the delayed pass-through of higher international energy costs to consumer charges, but also because food prices failed to decline in line with trends abroad. This is a matter of concern, as it suggests the presence of market imperfections. At year end, the inflation rate stood at 5.0%.

As the threat of inflation receded, central banks worldwide adopted an easier monetary policy stance. In the euro area, the ECB reduced the interest rate on its main refinancing operations progressively from its peak level of 4.25% at the beginning of October to 1.5% in March this year. The rate reductions were largely passed on to bank borrowers in Malta, implying a considerable easing of domestic monetary conditions. Such a marked reduction in borrowing costs would have been unlikely had Malta not joined the euro area. Indeed, in some other EU countries, including those within ERM II, interest rates had to be raised to counter pressures on the exchange rate in the wake of rising tensions in currency markets.

Together with a domestic banking system which continues to respond to the demand for credit, lower interest rates should lend support to the economy in the context of the ongoing recession. The latter has indeed resulted in a downward revision of the Bank's growth projections for 2009. In real terms, GDP growth is now expected to range between 0.5% and 1.1% this year, driven by domestic demand, as the contribution of net exports is projected to be negative. It is then expected to recover to between 1.0% and 1.6% in 2010. These projections reflect the negative outlook for Malta's main trading partners. The degree of uncertainty surrounding the projections is exceptionally high and risks to GDP growth are assessed to be on the downside.

The global economic contraction has led to renewed interest in the use of fiscal policy to support aggregate demand. Several EU governments have announced large financial packages designed to bolster ailing financial institutions and to stimulate consumption and investment. The room for similar manoeuvres in Malta is limited by the relatively high budget deficit and debt levels. Fiscal prudence, moreover, remains necessary to safeguard both Malta's credit rating and investor confidence. Furthermore, an increased stimulus in the form of lower taxation or higher social benefits is not as cost effective as an increase in public investment expenditure. The latter is to be preferred since it tends to generate a smaller demand for imports, while raising the economy's potential output.

Malta's size and openness imply that consumption cannot be a reliable engine of growth. Sustainable economic expansion can only be based on a greater role for exports, thus allowing the economy to benefit from scale economies and keeping the current account deficit to reasonable proportions. In turn, this requires a process of continuous investment, particularly FDI in view of the associated technology transfer and access to markets.

In the current recessionary conditions, the only area where a case could be made for higher discretionary public outlays is in sectors, such as manufacturing and tourism, which are being increasingly impacted by the sharp contraction in foreign demand. Any support measures, however, must be targeted and be of a temporary nature. A number of constructive initiatives have already been taken in this direction. Going forward, it will be important to recognise that public funds should only be used to support activities that promise to be viable in the medium to long term.

The resources to finance these additional outlays, moreover, should be derived in part from savings elsewhere. Two areas which have already been identified as offering scope for efficiency gains are the education and healthcare systems. These together absorb more than 25% of general government expenditure, and are both characterised by relatively less efficient outcomes in terms of output compared with the EU average. The need to achieve savings in these areas is also accentuated by the growing fiscal burden of an ageing population.

However deep and protracted the current downturn proves to be, the global marketplace will be more competitive once growth revives. The challenge this implies for the Maltese economy is clear. There will be fewer, but more cost-efficient suppliers to satisfy a slow-growing demand; a large pool of unemployed labour around the world, implying downward pressures on wages; and a possibly increased tendency for investment to move away from relatively expensive locations. Standing still, therefore, is not an option. When the recovery arrives, it is necessary to be prepared with the products of tomorrow and at prices the market will bear.

The current period of economic dislocation, therefore, may well be the right time to re-examine certain features of the domestic market with a view to removing remaining rigidities and increasing competition, including in services, as well as the working of certain labour market institutions, notably the automatic indexation of wages to prices, and cost structures generally. At the same time, an investment strategy more focussed on products and markets where demand promises to grow faster in the years ahead should also pay dividends.

Bank policies and operations

The adoption of the euro has had a profound impact on the Bank as an institution, as well as on its policies and operations. Today, the Bank forms an integral part of the Eurosystem, and is represented on the ECB's Governing Council, its highest decision-taking body. Bank officials also contribute to the Eurosystem through their participation in the work of the various committees and working groups.

The Bank is now responsible for the implementation in Malta of the Governing Council's monetary policy decisions. In this regard, the Bank regularly conducted open market operations with eligible domestic banks during 2008, offered them standing deposit and lending facilities and ensured that they maintained reserve requirements at the level set by the Eurosystem.

In managing its portfolio of assets, which includes both foreign and domestic financial assets, the Bank conformed to the rules of the Eurosystem. In January, it transferred a portion of its US dollar and gold reserves, calculated on the basis of its share in the ECB's capital, to the ECB. It also took responsibility for managing, on the behalf of the ECB, a part of the latter's reserves in conjunction with the Central Bank and Financial Services Authority of Ireland.

As the institution responsible for ensuring the stability of the financial system in Malta, the Central Bank of Malta works closely with the MFSA, which is responsible for prudential regulation and supervision, and the Ministry of Finance, the Economy and Investment. The three authorities maintained regular contact as the global financial crisis intensified during the year, to be able to react should the crisis have a direct impact on the domestic financial system. In this respect, in October the Government announced that coverage under the Deposit Guarantee Scheme would be raised to EUR 100,000 from EUR 20,000. This ensured that domestic depositors would enjoy the same level of protection as those elsewhere in the EU.

The currency changeover itself was a major operational challenge at the start of 2008. The Bank was responsible for the withdrawal and disposal of Maltese lira banknotes and coins and for ensuring that the supply of euro banknotes and coins met the needs of the public. The changeover process went smoothly, supported by an intensive communications campaign. Over 25 million Maltese lira banknotes and 270 tons of coins were collected, while the value of euro currency issued and outstanding at the end of the year exceeded EUR 715 million.

Another euro area-related development concerned the payment system. Here the Bank was actively involved in the preparations leading to the launch of the Single Euro Payments Area (SEPA) project at the beginning of the year. This initiative aims to increase the efficiency of electronic payments for the benefit of individuals and businesses across the euro area. The use of SEPA payments in Malta is spreading rapidly with the co-operation of the banks and the public sector.

The entry into the euro area also implied that the Bank became subject to the requirement to compile and transmit statistics on the basis of guidelines laid down by the ECB. The changeover itself entailed major revisions to statistical concepts underlying key economic, monetary and financial data used by the Bank and reported in its publications. At the same time, the Bank's analytical and research work was undertaken from a euro area perspective to a greater degree than before.

Finally, the adoption of the euro also necessitated substantial changes to the Bank's accounting system, which are explained in the financial statements that form part of this *Report*. The Bank's operating profit for the year amounted to EUR 48.6 million, as against EUR 28.7 million in 2007.

On behalf of the Board of Directors, I would like to thank the Bank's staff for their dedication and hard work during a major transformational phase in the institution's history.

Michael C Bonello

PART I

FINANCIAL AND ECONOMIC DEVELOPMENTS

1. DEVELOPMENTS IN THE INTERNATIONAL AND EURO AREA ECONOMY

In 2008 economic activity in the major industrialised countries slowed down significantly as the negative impact of the financial crisis spilled over onto the real economy. While remaining relatively buoyant, activity in the main emerging market economies also decelerated. High international commodity prices exacerbated inflationary pressures in the first half of the year, but inflation eased thereafter in response to lower commodity prices and falling global demand.

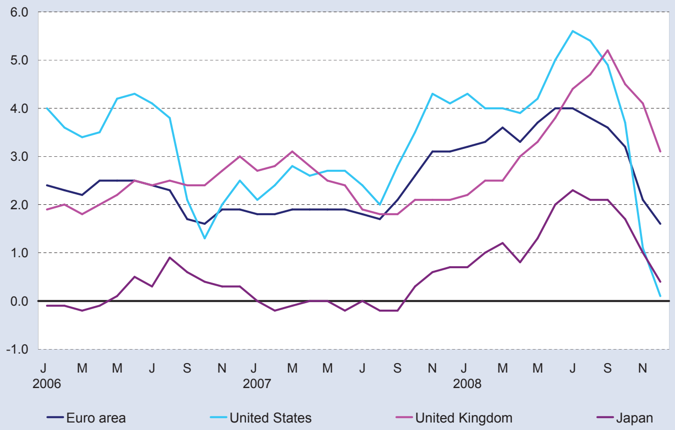
In the euro area, real GDP grew at a slower pace than in 2007, while inflation receded after reaching a historical peak in July. After leaving official interest rates unchanged in the first half of 2008, the ECB raised its minimum bid rate by 25 basis points to 4.25% on 3 July. In the fourth quarter of the year, however, the ECB cut the interest rate on the main refinancing operations on three occasions, for a cumulative drop of 175 basis points, bringing it down to 2.50%.[1]

The international economy

United States

Real GDP growth in the United States slowed down significantly in the course of 2008, as the economy entered a recession. In the first half of the year, output growth remained relatively stable compared with the corresponding period of the previous year. In the second half of the year, however, annual GDP growth slowed down sharply and in the last quarter of the year the economy contracted. Hence, over 2008 as a whole, real GDP growth decelerated to 1.1% from 2.0% in 2007 (see Table 1.1). This mainly reflected a rapid decline of private investment, principally resulting from the continued fall in residential investment amidst a slump in house prices. Personal consumption and exports grew at a slower pace, while government consumption rose more rapidly. In line with the deterioration in economic performance, the unemployment rate rose to an average of 5.8% in 2008 from 4.6% in 2007. Inflationary pressures remained elevated during the first

Chart 1.1
CONSUMER PRICE INFLATION
(annual percentage changes)



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

Table 1.1
REAL GDP GROWTH
Annual percentage changes; seasonally adjusted data

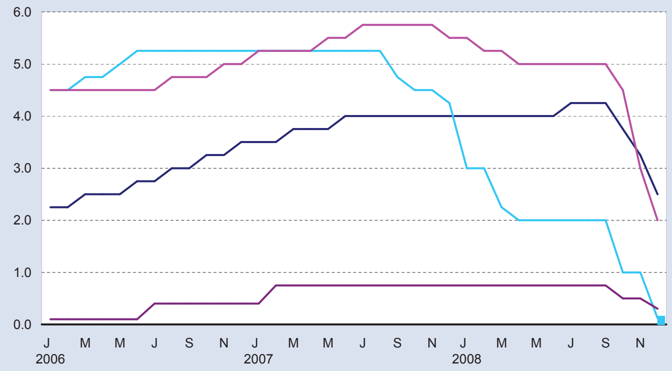
	2006	2007	2008	2008			
				Q1	Q2	Q3	Q4
United States	2.8	2.0	1.1	2.5	2.1	0.7	-0.8
Euro area	2.9	2.6	0.8	2.1	1.4	0.6	-1.3
United Kingdom	2.8	3.0	0.7	2.6	1.7	0.2	-1.9
Japan	2.0	2.4	-0.7	1.4	0.6	-0.2	-4.6

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

[1] For much of the year, the key ECB interest rate was the minimum bid rate on its main refinancing operations, which were conducted through variable rate tenders. As from 15 October 2008, the ECB began conducting its main refinancing operations at a fixed rate, set by the Governing Council, with full allotment. This implies that there is no longer a minimum bid rate.

half of the year, with the annual change in the consumer price index reaching a seventeen-year high of 5.6% in July. Subsequently, however, as energy prices receded, US inflation eased rapidly, ending the year at 0.1% (see Chart 1.1).

Chart 1.2
OFFICIAL INTEREST RATES
(percentages per annum; end of month)



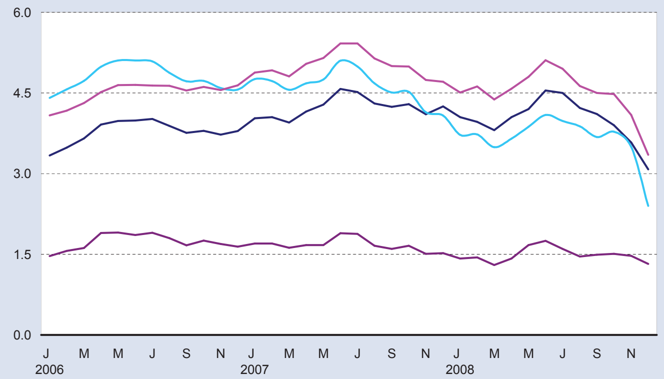
Sources: ECB; Federal Reserve; Bank of England; Bank of Japan.

Against a background of deteriorating economic conditions and turmoil in financial markets, the Federal Reserve eased its monetary policy stance considerably during the four months to April, lowering its target for the federal funds rate on four occasions for a cumulative reduction of 225 basis points to 2.00% (see Chart 1.2). Then, between May and September the target rate was kept unchanged. But following the collapse of Lehman Brothers in mid-September, the financial crisis worsened. In response, on 8 October, in a concerted action with other major central banks, the Federal Reserve lowered its target rate by 50 basis points to 1.50% and on 29 October it cut it by an additional 50 points to 1.00%. In addition, on 16 December, the Federal Reserve established a target range for the federal funds rate of between zero and 0.25%.

Apart from reducing interest rates, the Federal Reserve announced various measures to boost liquidity conditions. These included increases in the size of the Term Auction Facility, an expansion of the collateral that could be pledged in the Term Securities Lending Facility and increases in the amounts provided through temporary reciprocal currency agreements with the ECB and the Swiss National Bank.

In the first quarter of the year ten-year US government bond yields fell before recovering somewhat between April and June as expectations of further interest rates cuts receded (see Chart 1.3). Subsequently, and in particular towards the end of the year, ten-year yields fell again as the economic outlook deteriorated and the Federal Reserve lowered its target rate substantially, announcing that interest rates would probably be kept low for a long period of time. In addition, the financial market turmoil also favoured investment in Treasury securities, which were perceived to be less risky, resulting in lower yields on them.

Chart 1.3
LONG-TERM INTEREST RATES[1]
(percentages per annum; monthly averages)



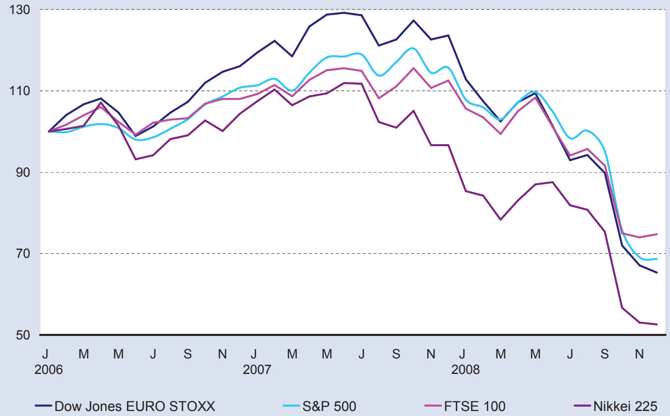
[1] Yields on ten-year government bonds.
Source: Reuters.

US stock prices generally declined throughout the year, except for a short interval between April and May (see Chart 1.4). The fall was more pronounced in the latter part of the year as concerns about the economic outlook intensified and the bankruptcy of Lehman Brothers and its aftermath increased investors' risk aversion. Thus, equity prices, as measured by the Standard & Poor's 500 index, fell by 38.5% over the year.

United Kingdom

In the United Kingdom, output contracted during the second half of the year and the economy entered recession. The annual rate of real GDP growth slowed down sharply, falling to 0.7% from 3.0% in 2007. Investment contracted as house prices fell sharply, while household expenditure grew at a slower pace. Meanwhile, government expenditure rose more rapidly. In the course of the year, as the economic situation deteriorated further, the jobless rate followed an upward path, exceeding 6% towards the end of the year. Inflation accelerated during the first three quarters of the year, reaching a peak of 5.2% in September, but price pressures decreased somewhat in the final quarter, and inflation ended the year at 3.1%.

Chart 1.4
STOCK PRICE INDICES
(index of monthly averages; Jan. 2006=100)



Source: Reuters.

After lowering the official Bank Rate paid on commercial bank reserves by 25 basis points twice, in February and April, the Bank of England kept rates on hold until September. Then, in October, in conjunction with other central banks, the Bank cut the Bank Rate by 50 basis points, while in November, as the economic environment deteriorated rapidly and inflation forecasts were revised downwards, it lowered it by an unprecedented one-and-a-half percentage points to 3.00%. In December the Bank Rate was reduced again, by one percentage point, to 2.00%.

Long-term government bond yields in the United Kingdom broadly followed a similar course to those in the United States, and generally fell except between April and June. In line with developments worldwide, equity prices also declined, with the FTSE 100 shedding around 32% during the year.

Japan

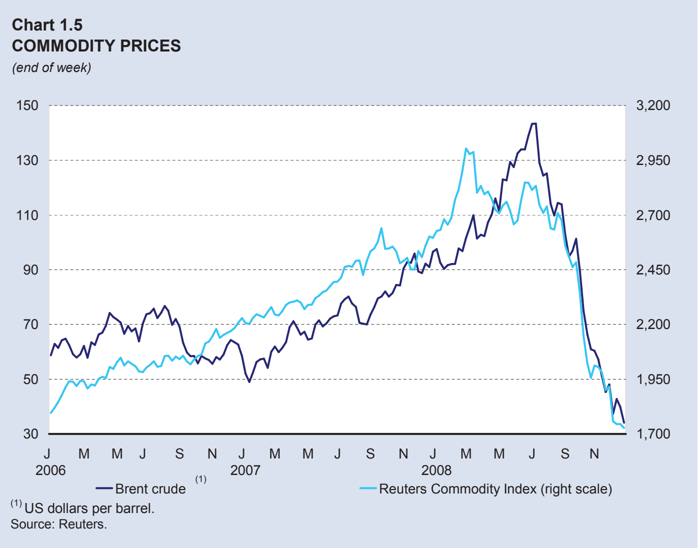
The Japanese economy contracted by 0.7% in 2008, after having expanded by 2.4% in the preceding year. Export growth slowed down sharply, while investment fell, dampening domestic demand. The unemployment rate averaged 4.0% during the year, up from 3.9% in 2007. Consumer prices increased for most of the year, with annual CPI inflation reaching a peak of 2.3% in July. Thereafter, price pressures cooled off rapidly, so that the inflation rate fell to 0.4% in December, reflecting lower prices of crude oil and other raw materials and a slowdown in economic activity.

In the first three quarters of the year the Bank of Japan kept the discount rate unchanged at 0.75%. In October, however, the rate was lowered to 0.50%. In December it was lowered further, to 0.30%, as economic prospects continued to deteriorate.

Movements in Japanese long-term bond yields broadly followed those in the other major economies, although they remained relatively low and stable. But equity prices, as measured by the Nikkei 225, fell sharply, ending the year around 42% below the level prevailing at the end of 2007.

Emerging Asia

While remaining relatively robust, economic activity in the main emerging Asian countries slowed down considerably, especially in the final quarter of the year when the global economic downturn reduced external demand. In China, GDP growth eased to 9.0% in 2008 from 11.8% in 2007, while in India it slowed to 7.1% from 9.0% in the previous year. Inflationary pressures in both countries also eased. In China, annual CPI inflation fell to 1.2% by the end of 2008, down from 6.5% in December 2007, while in India wholesale price inflation ended 2008 at 5.9%, after having reached double-digit values in the course of the year.



Commodities

Oil

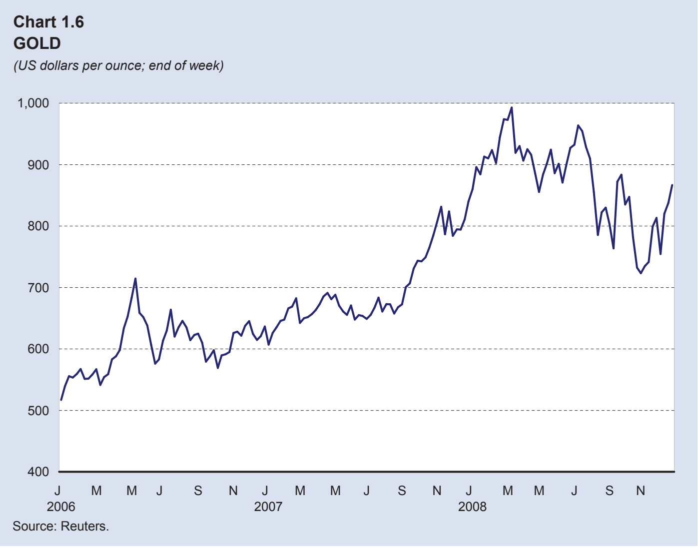
The first half of 2008 was characterised by an upward trend in oil prices as a result of political tensions in the Middle East, Nigeria and Venezuela, and strong demand from emerging economies. The price of Brent crude oil reached a peak of USD 143.6 per barrel on 3 July, before falling sharply for the rest of the year (see Chart 1.5). The factors behind the rapid decline in prices were the global economic slowdown, which reduced demand for oil, and the liquidation of positions in response to the financial market turmoil. Hence, the price of Brent crude oil ended the year at USD 36.17 per barrel, implying a 61.7% drop in US dollar terms over the year as a whole.

Other commodities

In the early part of the year the Reuters Commodity Index, which excludes gold and oil products, extended its upward trend, driven by rising prices of raw materials and food, as demand was robust while supply was negatively affected by adverse weather conditions.[2] In March, however, non-energy commodity prices fell as investors sought to cash in profits and cover losses made in other investments. During the following three months, non-energy commodity prices were volatile, but from July onwards prices generally fell as concerns over a global economic slowdown pushed food and metals prices down. Consequently, the Index fell by 32.6% during 2008, reaching levels last seen in late 2005 (see Chart 1.5).

Gold

The price of gold ended 2008 up by 5.4% from the end-2007 level, but this rise masked wide fluctuations in the course of the year (see Chart 1.6). In the first quarter of the year the gold price rose, propelled by the metal's safe haven status amid the financial market turbulence. It then fluctuated in a relatively wide range, before falling sharply after mid-July in response to an appreciation of the US dollar and despite wider concerns in financial markets that would normally have boosted demand for the metal. The gold price rebounded somewhat at the end of September, before falling



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

again till mid-November, after which it recovered its earlier losses as the US dollar weakened to end the year at USD 878.2 per ounce.

The euro area[3]

Real GDP and demand

The euro area economy grew at a markedly slower pace in 2008, with real GDP growth decelerating to 0.8% from 2.6% in 2007 (see Table 1.2). In the first quarter of the year euro area GDP grew at a sustained pace, before slowing down sharply through the remainder of the year, when negative quarter-on-quarter growth rates were registered. In fact, in the fourth quarter, output actually fell on an annual basis too. The sharp slowdown in economic activity was mainly due to a negative contribution from net exports and a deceleration in domestic demand.

The slowdown in domestic demand in 2008 was mainly driven by lower growth in private consumption. This fell to 0.5% during the year, contributing just 0.3 percentage points to the overall growth rate. Investment activity also weakened, while growth in government consumption was slower than in the previous year. Meanwhile, net exports failed to contribute to growth in the year under review, with both exports and imports expanding at a slower pace than in 2007.

Inflation

HICP inflation in the euro area averaged 3.3% in 2008, up from 2.1% in 2007. Inflationary pressures rose steadily during the first part of the year, with the annual inflation rate reaching a peak of 4.0% in July (see Chart 1.7). Rising international oil and food prices were the main driving forces behind the surge in inflation. Thereafter, however, inflationary pressures eased so that by December the year-on-year increase in the

Table 1.2
REAL GDP GROWTH IN THE EURO AREA
Seasonally adjusted

	2007	2008	2008			
			Q1	Q2	Q3	Q4
			Annual percentage changes			
Private consumption	1.6	0.5	1.6	0.8	0.4	-0.7
Government consumption	2.2	2.0	1.6	2.2	2.5	1.7
GFCF	4.4	0.4	3.3	2.0	0.4	-3.3
Domestic demand	**2.4**	**0.8**	**1.6**	**0.9**	**0.6**	**-0.2**
Exports	5.9	1.5	5.5	4.4	2.5	-5.6
Imports	5.3	1.5	4.3	3.2	2.5	-3.2
GDP	**2.6**	**0.8**	**2.1**	**1.4**	**0.6**	**-1.3**
			Percentage point contributions			
Private consumption	0.9	0.3	0.9	0.5	0.3	-0.4
Government consumption	0.5	0.4	0.3	0.4	0.5	0.3
GFCF	0.9	0.1	0.7	0.4	0.1	-0.7
Changes in inventories	0.1	-0.1	-0.4	-0.4	-0.3	0.6
Domestic demand	**2.3**	**0.7**	**1.6**	**0.9**	**0.6**	**-0.2**
Exports	2.4	0.7	2.3	1.8	1.0	-2.3
Imports	-2.1	-0.7	-1.7	-1.3	-1.0	1.3
Net exports	**0.3**	**0.0**	**0.6**	**0.6**	**0.0**	**-1.1**
GDP	**2.6**	**0.8**	**2.1**	**1.4**	**0.6**	**-1.3**

Source: Eurostat.

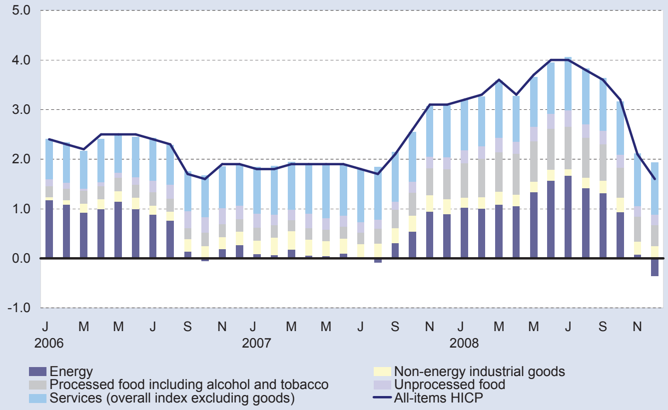
[3] This section includes statistical information up to 5 March 2009.

HICP stood at 1.6%. Most of this decline was attributable to a fall in energy prices and, to a lesser extent, in food prices.

The labour market

As economic activity slowed down, labour market conditions in the euro area also deteriorated in the course of 2008. By the third quarter, annual employment growth had slowed down to 0.8%, from 1.8% in the final quarter of 2007. Thus the decline in the unemployment rate seen in recent years was reversed as the number of the unemployed rose. In fact, the unemployment rate added 0.8 percentage points in the course of the year, to end December at 8.0% (see Chart 1.8).

Chart 1.7
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION
(percentage points; annual percentage change)



Source: Eurostat.

Monetary policy

After having left the minimum bid rate on the main refinancing operations unchanged at 4.00% in the first half of 2008, the Governing Council of the ECB raised the rate by 25 basis points on 3 July 2008. This decision was taken against a backdrop of increased concerns about second-round inflationary pressures and further evidence of upside risks to price stability over the medium-term. It then left official interest rates unchanged throughout the remainder of the third quarter of 2008.

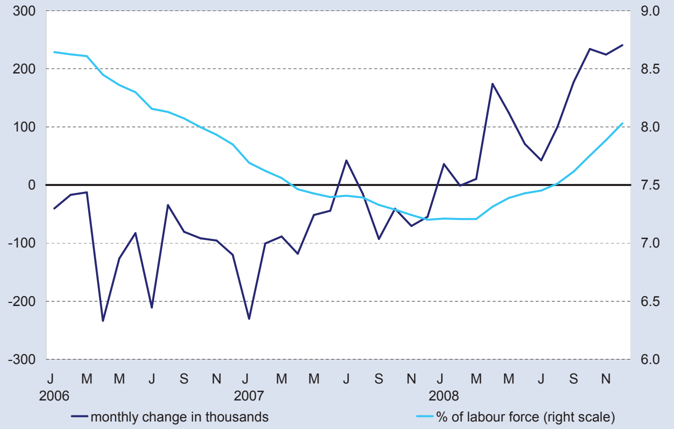
On 8 October, however, the ECB, in a coordinated action with other major central banks, reduced the interest rate on the main refinancing operations by 50 basis points to 3.75%. The rate was lowered again twice during the December quarter: by 50 basis points on 6 November and by 75 points on 4 December, so that it ended the year at 2.50%. These cuts were spurred by the intensification and broadening of the financial market turmoil, which was deemed likely to dampen demand for a prolonged period of time. Moreover, as a result, and also because of sharp falls in commodity prices, the outlook for price stability had improved.

Money and credit

The pace of monetary expansion in the euro area slowed down during 2008, with the annual growth rate of M3 declining to an average of 9.4% from 11.1% in the preceding year (see Table 1.3). This average masks a relatively rapid slowdown in the latter part of the year, however, with the annual rate of M3 growth dropping to 7.3% in December.

The annual growth of M1, a narrow measure of money that is closely linked to consumer transactions, fell sharply, to an average of 2.3% from 6.3% in 2007. After decelerating to 0.2% in August, the annual

Chart 1.8
UNEMPLOYMENT
(monthly data; seasonally adjusted)



Source: Eurostat.

Table 1.3
MONETARY AGGREGATES IN THE EURO AREA
Annual percentage changes; seasonally adjusted. Annual and quarterly data are averages.

	2007	2008	2008			
			Q1	Q2	Q3	Q4
M1	**6.3**	**2.3**	**3.6**	**2.0**	**0.6**	**3.0**
Currency in circulation	9.2	9.1	7.7	7.8	7.5	13.3
Overnight deposits	5.7	1.0	2.8	1.0	-0.8	1.1
M2-M1 (Other short-term deposits)	14.4	17.9	18.5	19.4	18.7	14.9
Deposits with an agreed maturity of up to two years	35.8	36.4	41.1	40.3	36.9	27.3
Deposits redeemable at notice of up to three months	-2.7	-1.9	-3.1	-2.2	-2.0	-0.5
M2	**9.9**	**9.5**	**10.3**	**10.0**	**9.0**	**8.7**
M3	**11.1**	**9.4**	**10.9**	**10.0**	**8.9**	**7.9**

Source: ECB.

growth rate of M1 rose somewhat in subsequent months, as the financial turmoil boosted demand for more liquid monetary assets.

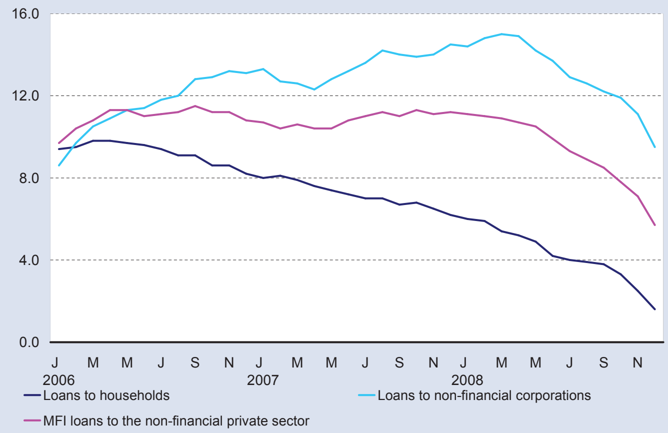
Short-term deposits other than overnight deposits accounted for most of the annual expansion in M3 during 2008, with growth in deposits with an agreed maturity of up to two years averaging 36.4%, up from 35.8% in 2007. The rise in short-term deposits reflected the flat yield curve, which increased the attractiveness of such deposits when compared to non-monetary assets outside M3.

On the counterparts side, credit growth decelerated during 2008, mainly as a result of tighter financing conditions and weaker economic activity (see Chart 1.9). The annual rate of growth of MFI loans to non-financial corporations fell to 9.5% from 14.4% in 2007, whereas the annual growth rate of MFI loans to households dropped to 1.6% from 6.2% the year before. The latter largely reflected a substantial drop in the annual growth rate of loans for house purchases, although growth of consumer credit and other lending to households also decreased.

The money market

Unsecured money market interest rates, as measured by EURIBOR, rose in the first three quarters of the year on increased expectations of higher ECB interest rates and mounting tensions in financial markets. The latter intensified after the collapse of Lehman Brothers, which pushed the three-month EURIBOR up to 5.39% (see Chart 1.10).[4] Starting from mid-October, unsecured money market interest rates fell sharply, mirroring the reductions in official interest rates and expectations of further policy easing. Thus, the three-month EURIBOR ended 2008 at 2.89%, down by 179 basis points from the level prevailing at end-2007. With the 12-month EURIBOR falling less

Chart 1.9
MFI LOANS TO THE NON-FINANCIAL PRIVATE SECTOR
(annual percentage changes)

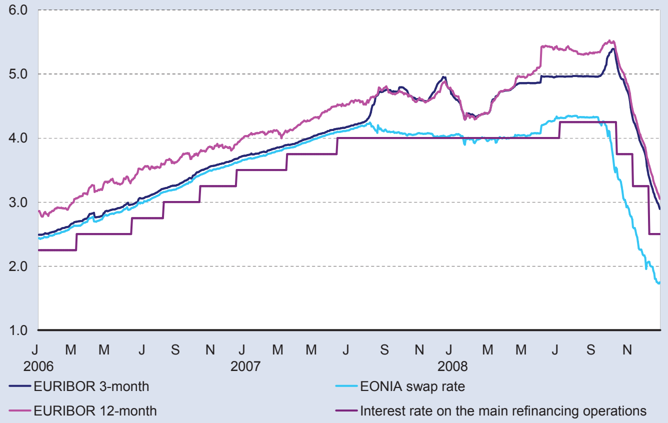


Source: ECB.

[4] EURIBOR refers to the rates at which a prime bank is willing to lend funds to another prime bank in euro on an unsecured basis.

sharply, the money market yield curve steepened.

Chart 1.10
KEY INTEREST RATES
(percentages per annum; daily data)



Sources: ECB; Reuters; Euribor FBE.

The spreads between EURIBOR and secured rates, such as those derived from the three-month EONIA swap rate, generally widened through 2008 as investors reassessed risk. By the end of December this spread had broadened to 114 basis points, compared to 64 basis points at the end of 2007.[5] Similarly, during the year, the spread between the ECB's interest rate on the main refinancing operations and the three-month EURIBOR generally widened, but the spread narrowed significantly towards the end of the year, particularly as the ECB injected significant amounts of liquidity at fixed interest rates to meet demand from the banking system.

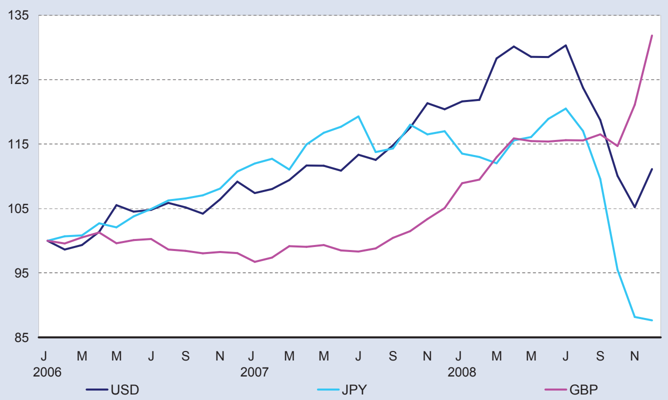
Equity prices

Developments in euro area stock prices broadly followed global trends during 2008. In the first quarter equity prices fell, reflecting increased risk aversion as market concerns regarding the implications of the US sub-prime mortgage crisis intensified. Between mid-March and May stock prices rebounded somewhat, but these gains were lost over the remainder of the year. The fall in prices gathered pace in the final quarter as the financial crisis deepened. Overall, euro area stock prices, as measured by the Dow Jones Euro STOXX index, fell by around 46% between end-2007 and end-2008.

Exchange rates

The euro continued to strengthen against the US dollar during the first seven months of the year, reaching a historical peak in July (see Chart 1.11). The appreciation of the European unit was linked to market perceptions of widening interest rate differentials in favour of the euro area. Then, starting from early August, the euro reversed course and began to depreciate sharply vis-à-vis the US currency on the back of a more pessimistic assessment of economic prospects for the euro area. The repatriation of foreign investments into the United States also contributed. In November, however, the euro broadly stabilised in dollar terms, before rebounding somewhat in December. Over the year as a whole, the euro shed 5.5% of its value against the US dollar.

Chart 1.11
EXCHANGE RATE MOVEMENTS OF THE EURO AGAINST OTHER MAJOR CURRENCIES
(index of average monthly rates; Jan. 2006=100; an increase in the index implies an appreciation of the euro)



Source: Eurostat.

[5] EONIA is a measure of the effective interest rate prevailing in the euro interbank overnight market. The EONIA swap rate is the fixed rate that banks are willing to pay in exchange for receiving the average EONIA rate over the lifetime of a swap contract.

In terms of the Japanese yen, the euro depreciated sharply from August onwards, as the attractiveness of borrowing and selling yen to finance investments in high-yielding currencies decreased. Thus, between end-2007 and end-2008, the euro depreciated by 23.5% against the yen.

In contrast, the euro strengthened by 29.9% against the pound sterling, extending the appreciation observed in 2007. The euro's appreciation against the UK currency was particularly strong in the last two months of the year as the Bank of England eased monetary policy significantly.

Chart 1.12
EURO NOMINAL EFFECTIVE EXCHANGE RATE
(index of daily effective exchange rate; Q1 1999=100)

Source: ECB.

In the first quarter of 2008, the nominal effective exchange rate of the euro as measured against the currencies of 22 of the euro area's most important trading partners appreciated, before broadly stabilising in the second quarter (see Chart 1.12). Throughout the second half of the year, however, the euro depreciated in nominal effective terms, mainly because it lost ground to the US dollar. Nonetheless, at the end of 2008 the euro stood 2.5% above its end-2007 level in nominal effective terms.

2. MONETARY AND FINANCIAL DEVELOPMENTS

Malta's entry into a currency union from 1 January 2008 had significant implications for the way monetary aggregates are measured and analysed. As from the adoption of the single currency, it was no longer possible to compile data for broad money (M3) covering Malta alone. Instead a partial measure of monetary statistics can be derived, reflecting the contribution that resident MFIs make to the monetary aggregates of the entire euro area.[1] Thus, in this analysis, comparison of monetary data compiled for the years 2007 and 2008 can only be made for selected components, namely residents' deposits and credit granted to them.[2]

Growth in residents' deposits slowed down considerably in 2008. At the same time, despite the slowdown in credit observed throughout the euro area, credit to residents accelerated further during the year. In line with developments abroad, however, increased demand for relatively safe Maltese government securities led to lower yields on Treasury bills and Malta Government Stocks, while equity prices fell sharply.

Residents' deposits

As stated above, the changeover to the euro led to significant changes in the compilation of monetary data, particularly on currency in circulation.[3] The latter cannot be measured directly; consequently, no reference to currency movements is made in this analysis. Furthermore, in measuring the Maltese contribution to euro area monetary aggregates both deposit liabilities belonging to residents of Malta and those belonging to other euro area residents are included. In contrast, domestic monetary aggregates covering the period until the end of 2007 only included Maltese residents' deposits.

The Maltese contribution to euro area M3 stood at EUR 8,686.1 million in December 2008, with the narrow money component amounting to EUR 3,857.0 million. This contribution increased slightly as the year progressed, rising by EUR 37.6 million from the end-January level. The remainder of this section, however, will focus on developments in residents' deposits only, where the euro changeover had no impact on definitions.

During 2008 overnight deposits grew at a much slower pace than in 2007, expanding by a mere EUR 9.9 million, or 0.3%, as opposed to the 11.7% growth recorded in the previous year (see Table 2.1). Growth in these deposits reflected an increase in balances belonging to insurance companies and households which were, however, partly offset by a drop in non-financial companies' deposits. Deposits redeemable at up to three months' notice rose only slightly in absolute terms, putting on EUR 8.9 million during the year. At the same time, deposits with an agreed maturity of up to two years increased quite strongly, rising by EUR 193.4 million, driven predominantly by funds belonging to households. Higher balances held by insurance companies and

Table 2.1
RESIDENTS' DEPOSITS[(1)]
Annual percentage change; EUR millions

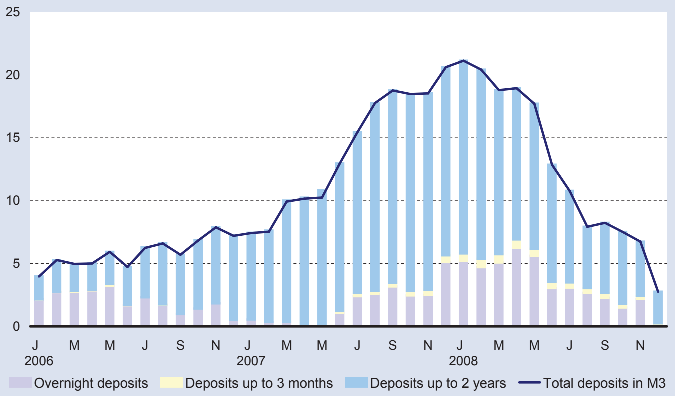
	2006	2007	2008	2008 Amount outstanding	2008 Absolute change
Overnight deposits	1.1	11.7	0.3	3,117.4	9.9
Deposits redeemable at notice up to 3 months	-2.0	46.8	8.5	114.2	8.9
Deposits with agreed maturity up to 2 years	12.8	27.1	4.3	4,668.0	193.4

(1) Data only include deposits belonging to residents of Malta.
Source: Central Bank of Malta.

1 For additional information on the presentation of Maltese monetary statistics following the adoption of the euro see Bull P. (2008), "Presentation of statistics relating to Malta following adoption of the euro", Central Bank of Malta *Quarterly Review*, 2008:1, pp 49-53.
2 Unless otherwise specified, 'residents' in this Chapter refers to residents of Malta only.
3 Prior to euro adoption, the amount of currency issued by the Central Bank of Malta, less amounts held by banks in Malta, was an exact measure of currency in circulation. Following the changeover, however, it is no longer possible to quantify the amount of currency in circulation since large amounts of euro coins and banknotes may be brought in by tourists and other visitors and taken out in the course of visits abroad.

non-bank financial intermediaries also contributed, though to a much lesser extent. The rise in such deposits may be partly attributed to the launch of new deposit schemes by resident credit institutions during the year. Nevertheless, the annual rate of growth of deposits with an agreed maturity of up to two years decelerated substantially, falling to 4.3% from the exceptionally rapid 27.1% growth rate of 2007.

Chart 2.1
CONTRIBUTION OF DEPOSIT CATEGORIES TO ANNUAL GROWTH IN RESIDENTS' DEPOSITS
(percentage points; annual percentage change)



Source: Central Bank of Malta.

Thus, despite increasing substantially in absolute terms, growth in total resident deposits decelerated throughout 2008, falling from a peak of 21.1% in January to 2.8% in December (see Chart 2.1). This slowdown is mainly attributable to two factors. First, a build-up in deposits during the final months of 2007, ahead of the currency changeover, had led to an acceleration in deposit growth rates, particularly during the second half of that year. Additionally, the reduction in bank interest rates during the last quarter of 2008 dampened residents' enthusiasm for deposits. Consequently, by the end of the year, the annual rate of deposit growth had returned to the levels observed prior to 2007.

For the year to December 2008, deposits with an agreed maturity of up to two years accounted for 91% of the overall increase in deposits, up from 73% in the previous year. Conversely, the contribution of overnight deposits to total deposit growth over the same period fell by 20 percentage points to 5%.

Table 2.2
MFI INTEREST RATES ON DEPOSITS BELONGING TO RESIDENTS OF MALTA[1]
Percentages per annum; weighted average rates for the period

	2007 Dec.	2008 Dec.
New business		
Households and NPISH		
Overnight deposits[2],[3]	1.10	0.57
Savings deposits redeemable at notice up to 3 months[2],[4]	3.55	2.09
Time deposits with agreed maturity		
Up to 1 year	3.88	3.06
Over 1 and up to 2 years	4.25	4.60
Over 2 years	3.49	4.77
Non-financial corporations		
Overnight deposits[2],[3]	1.46	0.64
Time deposits with agreed maturity	4.16	2.60

[1] Annualised agreed rates (AAR) on euro-denominated deposits belonging to households and non-financial corporations held with credit institutions resident in Malta (data before 2008 also include rates on business denominated in Maltese lira).

[2] For these instrument categories, interest rates are compiled on outstanding amounts but treated as new business indicators due to the large number of inflows and outflows.

[3] Overnight deposits include current accounts and savings withdrawable on demand.

[4] Households and non-financial corporations are merged, since deposits in this category held by non-financial corporations are negligible.

Source: Central Bank of Malta.

With regard to interest rates on deposits, MFIs responded promptly to the decline in the ECB's main refinancing rate by lowering rates on newly opened accounts. Thus, the rate on savings deposits redeemable at up to three months' notice fell by 146 basis points to 2.09% and that on time deposits with an agreed maturity of up to one year, which captures the bulk of outstanding time deposits, dropped by 82 basis points to 3.06% (see Table 2.2).[4] In contrast, interest rates on new deposits with longer maturities rose, reflecting innovative schemes offered by one bank.

Based on a weighted average over all deposits, the deposit rate was broadly stable during the first nine months of 2008. However, it followed a diminishing trend in the last quarter of the year, following the ECB's cuts. Consequently, over the year it fell by 43 basis points to 2.57% in December. Within the deposit categories, the average interest rate on savings balances fell by a significant 100 basis points to 0.73%, while that on time deposits declined moderately, to 3.74% from 3.97% twelve months earlier.[5] At the same time, the average interest rate on demand deposits dropped by 27 basis points to 0.51%.

Credit

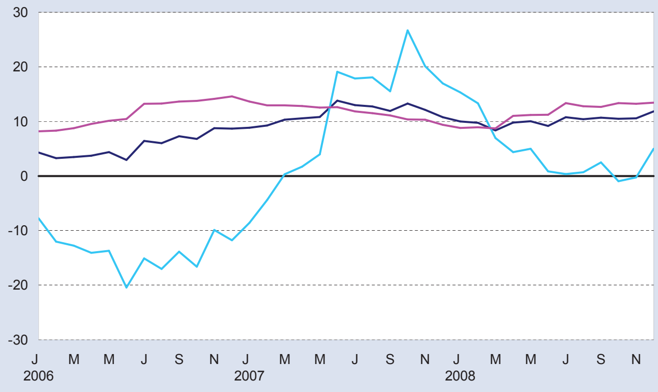
Prior to currency union the analysis of the counterparts to monetary growth used to focus on developments in domestic credit (i.e. credit extended by domestic credit institutions to residents of Malta) and the net foreign assets of the banking system. As a result of the introduction of the euro, data on credit aggregates incorporate credit extended by domestic MFIs to residents of the entire euro area. Furthermore, the data on net foreign assets no longer include claims on, and liabilities to, residents of other euro area members. Consequently, this figure is not comparable with that compiled until December 2007. This analysis will therefore focus on developments in credit to residents of Malta only, where the changeover had no impact on the compilation of data.

During 2008, credit to residents continued to expand, with the growth rate accelerating to 11.8% from 10.8% in 2007 (see Chart 2.2). Growth stemmed primarily from a substantial increase in credit to other residents, which mainly consists of lending to non-financial corporations and households, amounting to EUR 860.5 million. Meanwhile, a rise in credit to general government also contributed, though to a lesser extent (see Table 2.3).

Credit to general government slowed down during 2008, expanding by 5.0% as against the 17.0% growth rate of the previous year, when it was exceptionally strong. Growth in general government credit reflected an increase in the amount of MGS held by the banking sector which was, however, substantially counterbalanced by a contraction in the banks' Treasury bill portfolio.

Credit to other residents grew at a fast pace during 2008, expanding by 13.4%, as against 9.4% in 2007. Loans accounted for around 97% of total credit, with demand stemming

Chart 2.2
CREDIT TO RESIDENTS
(annual percentage changes)



Source: Central Bank of Malta.

[4] MFI interest rates (MIR) cover all interest rates that credit institutions apply to euro-denominated deposits and loans from/to households and non-financial corporations resident in euro area Member States. The household sector also includes non-profit institutions serving households (NPISH). Non-financial corporations include all enterprises except banks, insurance companies and other financial institutions. Hence, MIR statistics do not cover all institutional sectors, as is the case with weighted average deposit and lending rates.

[5] In this context, savings deposits include those that are withdrawable on demand. The latter are included with overnight deposits in MIR statistics.

Table 2.3
CREDIT TO MALTESE RESIDENTS
Annual percentage change; EUR millions

	2006	2007	2008	2008	
				Amount outstanding	Absolute change
Total credit	**8.7**	**10.8**	**11.8**	**8,863.8**	**936.4**
Credit to general government	-11.8	17.0	5.0	1,600.4	75.9
Credit to other residents	14.6	9.4	13.4	7,263.4	860.5

Source: Central Bank of Malta.

predominantly from the non-bank private sector (see Table 2.4). Loans to the latter expanded by 10.5%, mainly driven by credit to households for house purchases. Lending to the real estate, renting & business activities sector also rose notably. Meanwhile, a substantial expansion in lending to the transport, storage & communication sector was attributable to a large borrowing by a communications company in July. Running counter to the general trend, however, credit to the hotels & restaurants sector declined, as major capital investment projects were completed. Credit to the non-bank public sector increased robustly during 2008, mainly reflecting an exceptional rise in lending to the electricity, gas & water supply sector, which was for the purpose of repaying a foreign loan and to finance capital expenditure. Credit to public sector entities engaged in shipbuilding & ship repair and in the real estate sector also expanded.

Despite having slowed down during the twelve months to December, growth in mortgages remained the dominant purpose for bank borrowing by residents, with its contribution to overall private sector credit growth standing at 34%. At the same time, loans to the real estate, renting & business activities sector accounted for 27% of the overall annual increase, up from 18% in 2007. Meanwhile, the share of the ‘other’ category shown in Chart 2.3 was boosted by the exceptional loan extended to the transport, storage & communication sector. In absolute terms, bank lending to the private sector continued to be dominated by loans to house-

Table 2.4
CREDIT TO OTHER RESIDENTS[(1)]
Annual percentage change; EUR millions

	2006	2007	2008	2008	
				Amount outstanding	Absolute change
Total credit	**14.6**	**9.4**	**13.4**	**7,263.4**	**860.5**
Credit to the non-bank private sector	15.3	10.2	10.5	6,670.0	633.8
Credit to the non-bank public sector	4.7	-4.1	61.8	593.3	226.7
Total loans	**14.9**	**9.4**	**13.4**	**7,044.3**	**830.7**
Electricity, gas & water supply	32.7	4.1	69.4	333.1	136.5
Transport, storage & communication	18.7	-5.3	33.1	429.2	106.6
Agriculture & fishing	13.1	-2.4	15.4	25.8	3.4
Manufacturing	6.1	13.8	13.6	340.6	40.8
Construction	16.8	15.5	7.8	730.3	52.9
Hotels & restaurants	3.8	-3.8	-3.6	457.4	-16.9
Wholesale & retail trade; repairs	3.5	2.4	3.4	757.1	24.8
Real estate, renting & business activities	37.3	18.9	28.4	931.3	206.2
Households & individuals	15.5	14.5	10.8	2,862.7	278.6
Other[(2)]	13.3	-10.9	-1.2	176.8	-2.2

[(1)] Credit to other residents consists mainly of loans and holdings of securities, including equities, issued by the non-bank private sector and public non-financial companies, and financial derivatives. Interbank claims are excluded. Data only include credit to residents of Malta.
[(2)] Includes mining and quarrying, public administration, education, health and social work, community recreation and personal activities, extra-territorial organisations and bodies and non-bank financial institutions.
Source: Central Bank of Malta.

holds, which, together with loans to the real estate, renting & business activities sector and to the construction industry, make up more than two-thirds of the total.

Chart 2.3
CONTRIBUTION TO ANNUAL PRIVATE SECTOR LOAN GROWTH
(percentage points; annual percentage change)

Source: Central Bank of Malta.

The decline in interest rates charged by domestic credit institutions in the last three months of the year led to a fall in the weighted average interest rate on residents' loans. These dropped by 134 basis points during 2008, reaching 4.96% in December. Similarly, substantial decreases were registered in MFI interest rates on new loans to residents, particularly those related to lending for house purchases (see Table 2.5). Even rates charged on new lending to non-financial corporations, which had risen for much of the year, declined significantly during the final quarter, falling by 41 basis points over the year as a whole to 5.50% at end-December.

Developments in credit to residents appear to be consistent with the information disclosed by the quarterly Bank Lending Surveys (BLS) that were carried out during 2008.[6] Indeed, credit standards in respect

Table 2.5
MFI INTEREST RATES ON LOANS TO RESIDENTS OF MALTA[(1)]
Percentages per annum; weighted average rates for the period

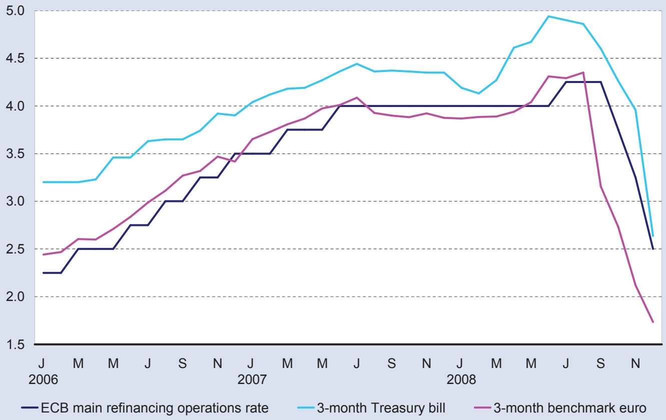
	2007 Dec.	2008 Dec.
New business		
Households and NPISH		
Overdrafts[(2)]	6.64	7.16
Loans		
Lending for house purchases	5.45	3.84
Consumer credit[(3)]	6.19	6.12
Other lending	6.34	6.44
Non-financial corporations		
Overdrafts[(2)]	5.27	5.30
Loans[(3)]	5.91	5.50
APRC for loans to households and NPISH[(4)]		
Lending for house purchases	5.36	4.35
Consumer credit[(3)]	6.21	6.25

[(1)] Annualised agreed rates (AAR) on euro-denominated loans taken up by households and non-financial corporations from credit institutions resident in Malta (data before 2008 also include rates on business denominated in Maltese lira).
[(2)] For these instrument categories, interest rates are compiled on outstanding amounts but treated as new business indicators due to the large number of inflows and outflows.
[(3)] Excludes bank overdrafts.
[(4)] The Annual Percentage Rate of Charge (APRC) covers the total cost of a loan, comprising the interest rate component and other (related) charges.
Source: Central Bank of Malta.

[6] The Bank Lending Survey gauges credit demand and supply conditions. The Central Bank of Malta began to survey a sample of Maltese banks in 2004. From January 2008 the Bank Lending Survey is being carried out as part of a quarterly exercise across the entire euro area.

of lending to enterprises and households remained unchanged throughout the year. This contrasts with developments in the euro area as a whole and elsewhere, where credit standards were tightened significantly against a background of volatile conditions in international financial markets. At the same time, although demand for bank borrowings slowed down in the first quarter as investors adopted a wait-and-see attitude ahead of the general elections in March, it picked up during the June quarter and remained generally stable throughout the second half of 2008.

Chart 2.4
MONEY MARKET INTEREST RATES
(percentages per annum; end of month)



Source: Central Bank of Malta.

The money market

The Treasury made less use of money market instruments to finance its operations during 2008. It issued EUR 1,032.6 million worth of bills as against EUR 1,110.7 million in 2007. Three-month bills made up almost three-fifths of the total issued, with six-month bills accounting for most of the remainder. Insurance companies and banks acquired around 46% and 34% of the bills, respectively, while households took up most of the remainder. During the first six months of the year, the three-month Treasury bill yield rose well above the end-December 2007 level, peaking at 4.94% in June (see Chart 2.4). During the final quarter of the year, however, following the cuts in official rates, the three-month yield dipped substantially, ending December at 3.65%.

Turnover in the secondary market for Treasury bills went up to EUR 168.4 million during 2008, from EUR 128.6 million in the preceding year. Almost all transactions involved the Central Bank of Malta in its role as market-maker, with the latter's purchases and sales amounting to EUR 140.4 million and EUR 20.6 million, respectively. In line with developments in the primary market, secondary market yields also fell significantly during the second half of the year. Indeed, they fell more markedly than primary market rates, with the yield on the three-month bill ending December at 2.64%. As can be seen from Chart 2.4, yields on euro area three-month government securities fell more sharply than three-month domestic yields. Consequently, the differential between the two widened to 90 basis points by year-end.[7]

The capital market

Net issues of long-term debt securities in the primary market increased to EUR 246.8 million in 2008, from EUR 238.6 million in the previous year (see Table 2.6). On a net basis, government issues rose by EUR 68.2 million to EUR 194.2 million, while securities issued by other residents declined by EUR 60.0 million to EUR 52.6 million.

The Government issued securities in June, August and October, with a combined value of EUR 287.4 million. Terms to maturity ranged from six to thirteen years, whereas coupon rates varied from 5% to 5.1%. Slightly more than three-fourths of the bonds issued were sold by auction. Of these, almost 90% were taken up by banks, with insurance companies acquiring most of the remainder. Meanwhile, bonds sold at fixed prices were purchased by retail investors, predominantly households.

At the same time, the value of debt securities issued by financial and non-financial corporations more than halved when compared to 2007. Three bonds were issued during 2008, with a combined value of EUR 62.0 million. Terms to maturity ranged between six and ten years and coupon rates varied between 5.9% and 7.5%.

[7] Short-term euro area rates refer to yields on three-month French government securities.

Table 2.6
ISSUES OF LONG-TERM DEBT SECURITIES[1]
EUR millions

	2006	2007	2008
Government			
Total issues[2]	103.1	289.1	287.4
Redemptions[3]	103.1	163.1	93.2
Net issues	0.0	126.0	194.2
Corporate sector			
Total issues	41.2	119.8	62.0
Redemptions[3]	26.1	7.3	9.4
Net issues	15.1	112.6	52.6
Total net issues	**15.1**	**238.6**	**246.8**

(1) Includes public issues of listed 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 Maltese liri. Banks, non-monetary financial institutions and public non-financial companies are included with corporate issuers. Long-term securities are those with an original term to maturity exceeding one year, and include preference shares.

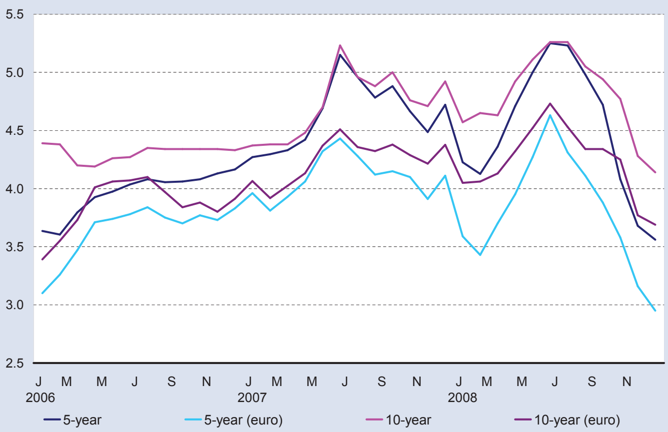
(2) Data exclude Malta Government Stocks that were issued directly to the Foundation for Church Schools. These amounted to EUR 3.5 million in 2006, EUR 11.0 million in 2007 and EUR 6.9 million in 2008.

(3) Redemptions include debt securities bought back by the issuer.

Sources: Central Bank of Malta; MSE; The Treasury.

Turnover in the secondary market for government bonds declined noticeably when compared to the previous year, falling from EUR 326.0 million to EUR 265.5 million (see Table 2.7). In 2007 it had increased significantly, reflecting a larger supply of fixed-interest securities in an environment of rising interest rates. During 2008, the Central Bank of Malta, acting as market-maker, continued to be a net buyer in the market, albeit to a lesser extent than in the previous year. It accounted for around 79% of the value traded. Trading was mainly undertaken in medium-term securities with maturities of between five and fifteen years. Yields on 5-year and 10-year government securities tended to decline in line with government bond yields in the euro area. Consequently, they fell by 116 basis points and 78 basis points, respectively, ending December at 3.56% and 4.14% (see Chart 2.5).[8] The drop in yields reflected increased risk-aversion by investors in unstable financial markets, which boosted the demand for safer government securities. Since euro area government bond yields declined at a slower pace than corresponding domestic yields, the spread between the two narrowed to 45 basis points by end-December, from 54 basis points twelve months earlier.

Chart 2.5
DOMESTIC AND FOREIGN LONG-TERM INTEREST RATES
(percentages per annum; end of month)



Sources: Central Bank of Malta; ECB.

Activity in the secondary market for corporate bonds expanded by EUR 14.0 million to EUR 26.4 million in 2008. Trading activity mostly involved seven major bonds out of a total of 35 listed securities. Transactions in these bonds made up more than three-fifths of total

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

Table 2.7
SECONDARY MARKET TRADING IN GOVERNMENT STOCKS
EUR millions

	2006	2007	2008
Central Bank of Malta purchases	70.2	205.7	141.9
Central Bank of Malta sales	17.7	45.2	67.4
Other deals[1]	70.6	75.0	56.2
Total	**158.5**	**326.0**	**265.5**

[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.

turnover. On average, corporate bond yields moved slightly upwards during the year.

In contrast, turnover in the equity market fell from EUR 64.7 million in 2007 to EUR 49.0 million in 2008. Transactions mostly involved the shares of banking institutions. It appears that the financial market turmoil overseas affected the domestic equity market, as shown in a significant drop in prices during the year. As a result, the MSE share index plummeted by 35% during the twelve months to December 2008, ending the year at 3208.22 (see Chart 2.6).

Chart 2.6
MSE SHARE INDEX
(end of month)

Source: MSE.

3. OUTPUT, EMPLOYMENT AND PRICES

Economic growth moderated in 2008 as both investment and exports contracted substantially. This notwithstanding, employment continued to increase over the first three quarters of the year, though there were indications of weaker labour market conditions in the last quarter. Meanwhile, the inflation rate accelerated, mainly due to the effects of higher food prices and a delayed pass through of increased energy costs.

Chart 3.1
REAL GDP GROWTH
(annual percentage changes)

Source: NSO.

At a sectoral level, manufacturing output declined over the year as external demand weakened, but the tourism industry was generally buoyant. Tourist activity slowed down in the last quarter, however, as tourist arrivals registered a year-on-year decline. Nevertheless, overall economic growth was underpinned by sustained gains in most other services sub-sectors.

Gross Domestic Product

The Maltese economy grew by 1.6% in 2008 as a deceleration in growth in the second and third quarters was followed by a negative outturn in the final quarter (see Chart 3.1). The overall slowdown stemmed from a sharp fall in investment and, to a lesser extent, in net exports. Strong expansion in private and public consumption, however, offset the negative impact of the decline in investment, so that domestic demand continued to contribute positively to GDP growth (see Table 3.1).

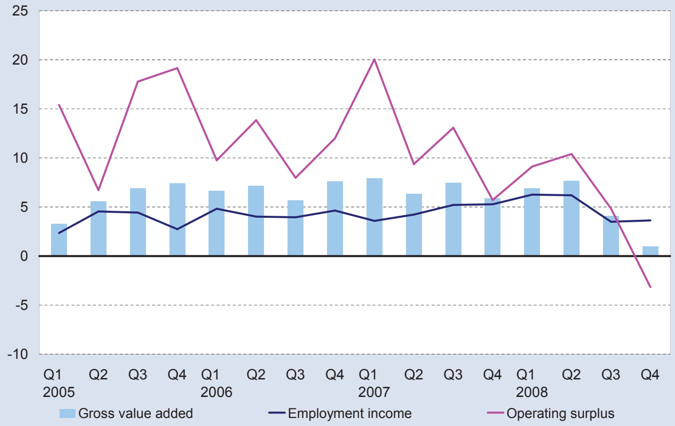
Table 3.1
GROSS DOMESTIC PRODUCT AT CONSTANT PRICES

	2005	2006	2007	2008
	Annual percentage changes			
Household final consumption expenditure	2.0	0.6	1.7	4.1
Government final consumption expenditure	-0.4	5.9	-0.8	8.3
Gross fixed capital formation	10.5	2.3	1.7	-19.7
Inventories as a % of GDP	1.4	2.4	3.1	4.4
Domestic demand	**6.2**	**2.8**	**1.9**	**1.6**
Exports of goods & services	0.6	10.5	3.3	-14.0
Imports of goods & services	3.4	9.5	1.5	-13.1
Gross domestic product	**3.7**	**3.2**	**3.6**	**1.6**
	Percentage point contributions			
Household final consumption expenditure	1.3	0.4	1.1	2.6
Government final consumption expenditure	-0.1	1.1	-0.2	1.5
Gross fixed capital formation	2.0	0.5	0.4	-3.9
Changes in inventories	3.3	1.0	0.8	1.4
Domestic demand	**6.5**	**3.0**	**2.1**	**1.7**
Exports of goods & services	0.6	9.4	3.1	-13.4
Imports of goods & services	-3.3	-9.3	-1.6	13.3
Net exports	**-2.8**	**0.1**	**1.5**	**-0.1**
Gross domestic product	**3.7**	**3.2**	**3.6**	**1.6**

Source: NSO.

Private consumption grew by 4.1% in real terms in 2008, up from 1.7% in 2007, and added 2.6 percentage points to overall growth. It rose strongly in the second and third quarters, but decelerated to just under 2% in the fourth. In nominal terms, notable increases were recorded in expenditure on food & non-alcoholic beverages as well as on energy and transport-related items. Private consumption was supported by moderate growth in employee compensation and continued increases in consumer credit.

Chart 3.2
GROSS VALUE ADDED, EMPLOYMENT INCOME AND OPERATING SURPLUS
(annual percentage changes)



Source: NSO.

Meanwhile, government consumption also rose, by 8.3%, and added 1.5 percentage points to growth. Growth was particularly strong in the first half of the year, driven by expenditure on intermediate consumption.

Investment, or gross fixed capital formation (GFCF), contracted significantly in 2008 with the rate of decline becoming more pronounced as the year progressed. The overall drop of around a fifth mostly reflected a reduction in private sector investment in residential construction. The fall in public sector investment was mainly due to a base effect following the completion of the new state hospital in 2007. In nominal terms, investment in machinery fell by 10.5% while GFCF in construction declined by 21.5%. Meanwhile, there was an accumulation of inventories, which over the year accounted for 4.4% of GDP.

Net exports contributed negatively to GDP growth. In 2008 exports fell at a slightly faster pace than imports, shedding 14.0% and 13.1%, respectively. Nominal data on international trade point to a significant drop in exports of semi-conductors under the impact of weakening external demand.

An analysis of sectoral developments in GDP shows that gross value added expanded by 4.8% in nominal terms during 2008. While growth in value added was around 7% in the first half, it slowed down to 2.5% in the last six months of the year. This deceleration generally reflected a sharp decline in the operating surplus of firms and slower growth in employee compensation (see Chart 3.2).

From a sectoral point of view, economic growth in 2008 was sustained by further expansion of various types of services, especially business services. Thus, the real estate, renting & business activities category contributed one percentage point to nominal GDP growth as did the other community, social & personal services sub-sector, which includes gaming (see Table 3.2).

Another growth area was transport, storage & communication, which added 0.8 percentage points to growth, mainly driven by a higher operating surplus. The combined contribution of 1.3 points from health & social work, education and public administration reflected the impact of higher labour income as these three sub-sectors benefited from wage increases awarded under collective agreements. Meanwhile, the gross value added in the wholesale & retail trade expanded by 1.4%, buoyed in part by double-digit growth in profits recorded in the second quarter, though its contribution to overall growth was small.

On the other hand, gross value added of hotels & restaurants declined by 0.8%. As discussed in greater detail below, a positive performance in the first half of the year was outweighed by a decline in each of the last two quarters.

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

	2005	2006	2007	2008
Agriculture, hunting & forestry	0.0	0.1	-0.2	-0.1
Fishing	0.0	0.2	0.2	-0.1
Manufacturing	0.8	0.1	1.2	-0.2
Electricity, gas & water supply	-0.2	0.6	0.1	-0.2
Construction	0.1	0.3	-0.1	0.2
Wholesale & retail trade	0.9	0.0	0.3	0.1
Hotels & restaurants	0.0	-0.2	0.4	0.0
Transport, storage & communication	0.4	0.2	0.6	0.8
Financial intermediation	1.0	0.3	-0.3	0.3
Real estate, renting & business activities	0.8	1.7	1.1	1.0
Public administration	0.0	0.1	0.4	0.3
Education	0.2	0.1	0.2	0.3
Health & social work	0.2	0.3	0.3	0.7
Other community, social & personal services	1.1	1.9	1.8	1.0
Gross value added	**5.0**	**5.8**	**5.9**	**4.2**
Net taxation on products	**1.7**	**0.5**	**0.7**	**-0.2**
Annual nominal GDP growth (%)	**6.7**	**6.3**	**6.6**	**4.0**

Source: NSO.

In addition, overall growth was negatively affected by reduced value added in agriculture, fishing, manufacturing and energy. Together, these contributed to a contraction of 0.6 percentage points in the overall growth rate. In manufacturing, a decline of 1.1% in gross value added reflected a reduction of 6.6% in profits and 1.4% in the wage bill, as export-oriented firms came under pressure. The negative impact of the energy-related sector reflected the higher cost of oil.

Manufacturing

The slowdown in activity in the manufacturing sector persisted almost throughout the year, with sales for the first nine months contracting by 6.9% on a year earlier (see Table 3.3).[1]

In contrast to the modest gain reported in 2007, exports of manufactured goods declined by EUR 155.2 million, or 10.6%, largely due to a drop in turnover of firms in the radio, TV & telecommunications category. But even if the latter's results are excluded, exports fell by 2.7%, as higher sales by the pharmaceuticals and the publishing & printing sub-sectors were offset by lower sales by companies in the electrical machinery and the textiles & clothing industries.

On the other hand, domestic sales increased by EUR 32.0 million, or 9.8%, partly reversing the declines reported in previous years. The food & beverages sub-sector accounted for more than half of the overall gain, with sales rising in line with the increase in consumption of food and beverages over the same period. Moreover, higher local sales of fabricated metal products and other non-metallic minerals were reported. In contrast, the furniture sub-sector reported a fall in local sales, reflecting a further shift towards more competitively priced imported furniture.

The survey also found that investment undertaken during the first nine months of 2008 declined by EUR 37.8 million, equivalent to 27.2%, compared to the same period of the previous year. This was mainly due to reduced capital outlays by the printing & publishing and the food & beverages sub-sectors, though the decline was from elevated investment outlays recorded in both sub-sectors in 2007.

[1] These results are based on a quarterly survey of a sample of around 385 manufacturing enterprises conducted by the NSO.

Table 3.3
MANUFACTURING PERFORMANCE - SELECTED INDICATORS
EUR millions

	2006	2007	Jan.-Sep. 2007	Jan.-Sep. 2008
Total turnover	**2,431.4**	**2,382.1**	**1,795.7**	**1,672.5**
Change in exports	**267.5**	**-2.1**	**52.6**	**-155.2**
Radio, TV & telecommunications	257.8	-76.0	-23.0	-138.2
Pharmaceuticals	55.0	44.7	31.5	18.7
Electrical machinery	-26.7	29.6	26.4	-20.8
Printing & publishing	-2.5	13.0	12.4	14.2
Clothing, textiles & leather	-21.4	-14.3	-10.2	-11.4
Others	5.3	0.9	15.5	-17.7
Change in local sales	**-12.6**	**-47.3**	**-44.6**	**32.0**
Food, beverages & tobacco	-22.2	-49.6	-43.9	17.6
Other non-metallic minerals	2.3	-1.8	-1.5	5.6
Printing & publishing	1.6	5.0	3.5	0.1
Fabricated metal products	3.6	4.3	2.2	9.5
Furniture	2.6	-2.0	-1.6	-3.9
Others	-0.5	-3.2	-3.3	3.1
Change in investment	**22.7**	**37.6**	**28.3**	**-37.8**
Change in employment (1)	**-993**	**-419**	**-337**	**-653**
Change in wages per employee (%)	**5.9**	**4.5**	**4.0**	**2.4**

(1) Figures represent differences in average employment levels between the respective periods.

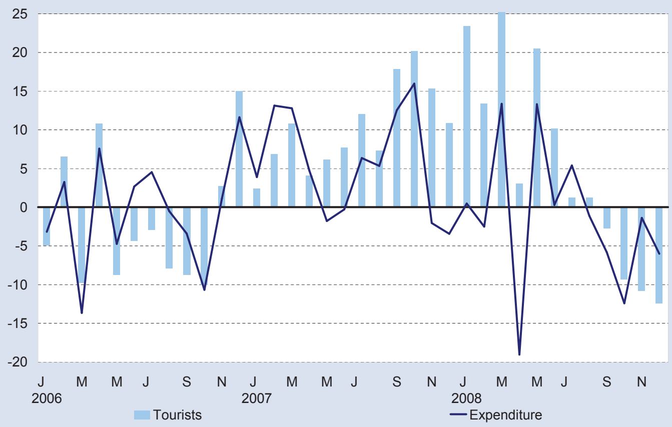
Source: NSO.

Over the same period, average employment levels in manufacturing declined by 653, or 3.6%, as layoffs in the clothing and the radio, TV & telecommunications sectors outweighed recruitment by pharmaceuticals companies. Meanwhile, wages per employee rose at a more modest pace of 2.4%, compared with 4.0% in 2007.

Tourism

The number of inbound tourists increased by 3.8% to just under 1.3 million in 2008. The overall gain, however, masked a weaker performance of the tourism industry in the second half of the year. Thus, reflecting the slowdown in Malta's major European markets, a notable increase in tourist numbers during the first half of 2008 was followed by a marginal rise in the third quarter and a decline in the fourth (see Chart 3.3).

Chart 3.3
TOURISM INDICATORS
(annual percentage changes)



Source: NSO.

Over the year tourist arrivals from Italy, Germany and Spain expanded at double-digit rates, of 27.1%, 16.0% and 32.2%, respectively. However, arrivals from the United

Table 3.4
DEPARTING TOURISTS BY COUNTRY OF RESIDENCE
Thousands

	2005	2006	2007	2008
Tourist departures by air & sea	**1,170.6**	**1,124.2**	**1,243.5**	**1,290.9**
UK	482.6	431.3	482.4	454.4
Germany	138.2	125.8	130.0	150.8
Italy	92.4	112.5	113.7	144.5
France	82.6	73.4	75.1	81.2
Others	374.8	381.1	442.3	460.1

Source: NSO.

Kingdom, which is Malta's main source market, dropped by 5.8% as the recessionary climate in that country took its toll on outbound travel (see Table 3.4).

Total nights stayed by tourists during the year were up by 2.2% to just under 11.3 million. On the other hand, the average length of stay declined slightly, continuing a trend which had been in evidence for some years. Thus, the average duration fell to 8.7 nights in 2008 from 8.9 nights in the previous year and 9.5 nights in 2006.

With regard to tourist expenditure, this decreased by just under 2%. This could be attributed to the shorter stays and a decline in spending on air fares as low-cost airlines expanded their operations. As in recent years, there was an increase in outlays on non-package holidays along with a reduction in spending on package holidays and in other expenditure.

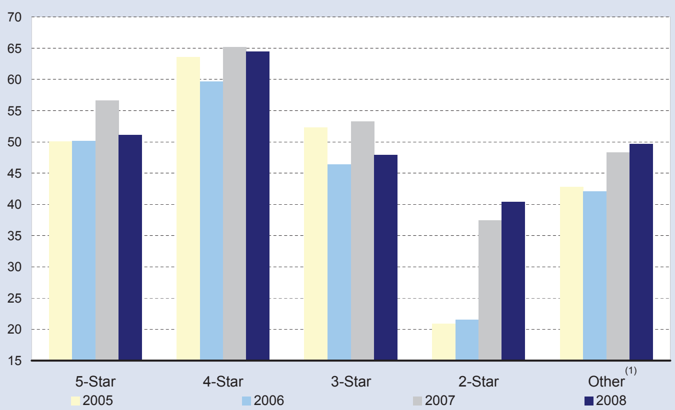
An analysis by purpose of visit and frequency shows that the number of leisure tourists and business travellers rose by 3.4% and 13.8%, respectively. Furthermore, the number of repeat visitors was up by 1.1% to 0.4 million, while the number of first-time tourists rose by 5.1% to just under 0.9 million.

An assessment of occupancy rates indicates that the higher-end hotel categories registered a decline. In particular, a substantial fall, of almost 6 percentage points, was recorded by the 5-star category. Meanwhile, the lower-end categories, that is, 2-star hotels and 'other' accommodation types experienced higher occupancy rates (see Chart 3.4). The general dilution in occupancy rates may in part be due to the 3% increase in bed capacity between end-2007 and end-2008.

The tourism sector continued to be boosted, to some extent, by further growth in the cruise liner industry. With the number of port calls by cruise ships rising by 28 during the year, to 397, the number of cruise passengers increased by around 13% to over 537,000. Compared with previous years there was a decline in the off-peak period but more pronounced growth during most of the peak period (see Chart 3.5).

The influx of cruise passengers from outside the EU, particularly the

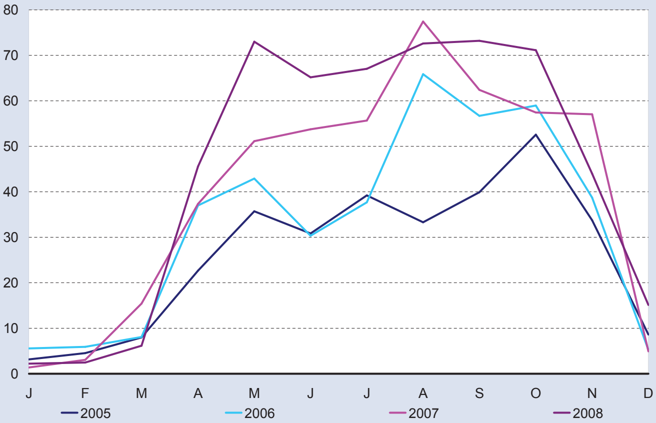
Chart 3.4
AVERAGE OCCUPANCY RATES
(percent)



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

United States, grew by almost two-thirds over 2007, while visitors from EU source markets rose by 2.8%. Within the latter group, The number of passengers from the United Kingdom and Spain rose by 71.8% and 13.0%, respectively. However, passenger numbers from France, Germany and Italy, on aggregate, declined by 18.3%.

Chart 3.5
CRUISE PASSENGERS
(in thousands)



Source: NSO.

Construction

Activity in the construction sector picked up in 2008 after having declined the year before. Gross value added rose by 5.1% and contributed 0.2 percentage points to nominal GDP growth.

In terms of income earned by the sector, it was the profit element which showed the largest gains, rising by a significant 10.6% following a drop of 12.3% in 2007. Employment compensation rose at a more moderate pace of 2.8%. In the first nine months of the year employment in the industry grew by 311, or 2.7%, compared with the same period of 2007 (see Table 3.5). Of these, three-quarters were employed by the private sector.

Data on gross fixed capital formation, on the other hand, show a drop of 21.5% in overall construction investment in 2008, particularly because the residential building component fell by 24.0%. The difference between the growing output of the sector and declining investment implies an increase in the stock of unsold dwellings. Investment in the non-residential category also contracted as a result of a drop in public sector activity, which mainly reflected a base effect: the completion in 2007 of the new state hospital. However, private sector investment in non-residential buildings showed a small rise.

During 2008 permits issued for the construction of dwellings dropped by 39.7% to 6,836 (see Table 3.6). The decline was spread across all major categories including flats, the predominant category, and mai-

Table 3.5
CONSTRUCTION ACTIVITY INDICATORS[(1)]

	2005	2006	2007	2008
Gross value added (EUR millions)	**160.7**	**172.7**	**167.4**	**176.0**
Share of gross value added in GDP (%)	3.3	3.4	3.1	3.1
Total employment	**10,565**	**11,212**	**11,525**	**11,836**
Private employment	7,625	8,168	8,436	8,668
Share of private sector in total construction employment (%)	72.2	72.9	73.2	73.2

[(1)] Employment data are averages for the first nine months of the year.
Source: NSO.

Table 3.6
PERMITS ISSUED FOR DWELLING UNITS (BY TYPE)

	2005	2006	2007	2008
Flats	7,539	8,961	10,252	6,184
Maisonettes	1,058	932	696	361
Terraced houses	363	375	257	164
Other	121	141	138	127
Total	**9,081**	**10,409**	**11,343**	**6,836**

Source: Malta Environment & Planning Authority.

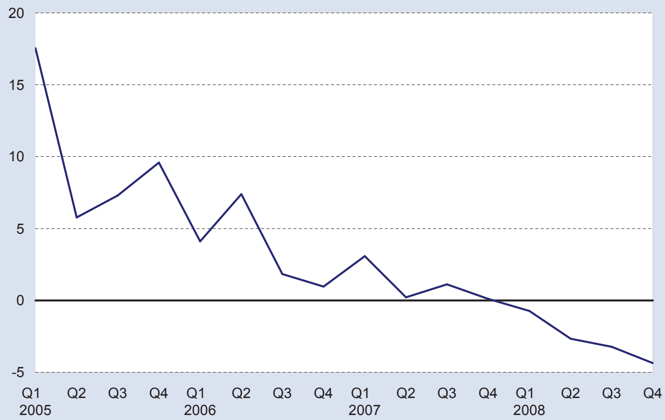
sonettes, which fell by 39.7% and 48.1%, respectively. Permits for the redevelopment of old houses into blocks of flats or maisonettes also declined, thus reversing the recent rising trend.

Residential property prices[2]

Following the deceleration observed in recent years, the Bank's index of advertised residential property prices indicated an average decline of 2.7% during 2008 (see Chart 3.6).

Disaggregated results show that the fall was spread across various property types. Asked prices for flats in shell form and in finished form, which together make up over half of the sample, were down by 2.0% and 5.4%, respectively, while those for villas and terraced houses declined by 3.7% and 1.8%.

Chart 3.6
RESIDENTIAL PROPERTY PRICES
(annual percentage changes)



Source: Central Bank of Malta.

On the other hand, higher prices were asked for two other categories. Prices of maisonettes in shell form were up by 2.6%, while those of town houses, which account for 5.4% of sampled properties and display a high degree of volatility, increased by 10.4%. Meanwhile, prices of finished maisonettes and houses of character remained roughly unchanged from 2007.

The labour market

Developments in the labour market in the first three quarters of 2008 were generally characterised by tight conditions as employment growth remained positive. Unemployment data for the second half of the year, however, indicated an easing in labour demand as the number of registered unemployed showed a persistent upward trend.

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

	2007 Jan.-Sep.	2008 Jan.-Sep.	Annual Change %
Labour force	**167,298**	**170,370**	**1.8**
Unemployed	11,101	10,168	-8.4
Employed	156,197	160,202	2.6
By type of employment:			
Full-time	139,153	141,757	1.9
Full-time with reduced hours	2,557	3,347	30.9
Part-time	14,487	15,098	4.2
By sector:			
Private	109,442	113,012	3.3
Public	46,755	47,190	0.9

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

[2] The Bank's property price index is derived from advertised real estate prices, using observations collected on a monthly basis, usually numbering in excess of 2,000. The index is divided into eight categories: finished and unfinished flats, finished and unfinished maisonettes, terraced houses, town houses, houses of character and villas. The index is a Fisher chained index, which is the geometric mean of the chained Laspeyres and chained Paasche indices.

Labour statistics based on the LFS revealed that during the nine months to September 2008 the number of persons at work increased on average by 2.6% over the same period of 2007. Meanwhile, the labour supply posted a smaller average gain, of 1.8% (see Table 3.7).[3] Full-time positions accounted for 65% of overall growth, even though the numbers of part-time employees and of full-time employees on reduced hours were also up. As in previous years, the private sector witnessed strong employment growth, averaging 3.3%, while the public sector posted a rise of 0.9%.

The overall employment rate, which measures the proportion of the working-age population in employment, increased significantly in 2008, rising by 0.7 percentage points to 55.3%, the largest recorded increase and the highest level since the inception of the survey in 2000. A gain of 2.2% was recorded in the female employment rate, while the male equivalent went down marginally, by 0.7%, narrowing the disparity between the genders. Furthermore, the participation rate, which tracks the labour force as a proportion of the working-age population, also rose, by 0.3 percentage points to an average of 58.9%.

Data based on administrative records maintained by the ETC also pointed to an expansion in employment and in the labour supply during the first nine months of 2008. The full-time gainfully occupied population increased by 2.2%, on average, while part-time employment rose by 5.7% on the corresponding period of 2007 (see Table 3.8).[4] A further indicator of market conditions, the ratio of placements to vacancies, increased by 2.2 percentage points to 30.7% in 2008. This reflected a decline in the number of vacancies that exceeded the fall in the number of placements compared to the levels recorded in 2007.

Administrative records also reveal a further contraction in public sector employment, while jobs in the private sector continued to increase. The public sector shed more than 500 jobs, although in part this reflected a reclassification effect: the major mail service provider was transferred to private ownership in September 2007.

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

	2007 Jan.-Sep.	2008 Jan.-Sep.	Annual Change %
Gainfully occupied	**141,408**	**144,583**	**2.2**
Public sector	**42,473**	**41,914**	**-1.3**
Private sector	**98,484**	**101,919**	**3.5**
Private direct production	**33,092**	**32,523**	**-1.7**
Manufacturing	22,012	21,206	-3.7
Construction	8,436	8,668	2.8
Private market services	**65,392**	**69,396**	**6.1**
Wholesale & retail trade	21,337	21,631	1.4
Hotels & restaurants	9,655	10,129	4.9
Transport, storage & communication	8,064	8,859	9.9
Financial intermediation	4,839	5,025	3.8
Real estate, renting & business activities	10,759	12,002	11.6
Other	10,738	11,750	9.4
Temporary employed	**451**	**749**	**66.1**
Part-time employees	**45,322**	**47,901**	**5.7**
Part-time as a primary job	25,371	27,002	6.4
Part-time holding a full-time job	19,951	20,899	4.8

(1) Figures are based on averages for the first nine months.
Source: NSO.

3 The LFS is a quarterly survey of the labour market conducted by the NSO using a random sample of 3,200 private households.
4 These statistics are compiled from the administrative records of the ETC.

Within the private sector, services continued to be the main growth area, with employment in this category rising by 6.1%. The largest gains were recorded in the business activities sub-sector, in the hotels & restaurants sub-sector and in the recreational, cultural & sporting activities sub-sector. In contrast, there were further job losses in manufacturing, particularly in the clothing and the radio, TV & communications sub-sectors. Administrative records also show gains in part-time employment. This rose by an average of 2,579, with 63% of the increase representing primary employment for the job holders.

Chart 3.7
UNEMPLOYMENT RATE
(seasonally adjusted; percent)

Source: Eurostat.

Unemployment

In line with the growth in employment, the LFS measure of unemployment for the first three quarters of 2008 showed a drop of 0.7 percentage points to a low of 5.9%, although there were general indications of a rising trend in unemployed persons in the second half of the year. Adjusted for seasonal variation, the unemployment rate for the entire year was estimated at 5.8%, 0.6 percentage points lower than in 2007 (see Chart 3.7).[5]

At 4.1% on average over the first nine months of 2008, the unemployment rate based on administrative records was 0.5 percentage points lower than a year earlier. The number of unemployed reached a low of 5,861 in June, but in subsequent months, through to November, it registered a persistent increase (see Chart 3.8). In December the number of unemployed persons was up by 3.3% on the year-ago level.

On average, however, during 2008 the number of unemployed declined to just over 6,200. Skilled workers accounted for around 95% of the drop, while the number of unskilled job seekers remained almost unchanged from 2007. In terms of duration, long-term unemployment fell, with persons registering for more than a year making up 70% of the total decrease. With regard to age classification, there was a reduction in the number seeking work across all age brackets, except in the over-45 category, which now accounts for 35% of job seekers.

Chart 3.8
REGISTERED UNEMPLOYED
(persons)

Source: NSO.

Prices

HICP

The annual average rate of HICP inflation rose to 4.7% in 2008, well

[5] Seasonal adjustment corrects the data for seasonal regularities and permits a wider range of inter-period comparisons.

above the rate of 0.7% recorded in 2007 (see Chart 3.9). Year-on-year inflation stood at 5.0% in December compared with 3.1% a year before. The sharp increase in inflation during 2008 was mainly due to accelerating food and energy prices (see Chart 3.10).

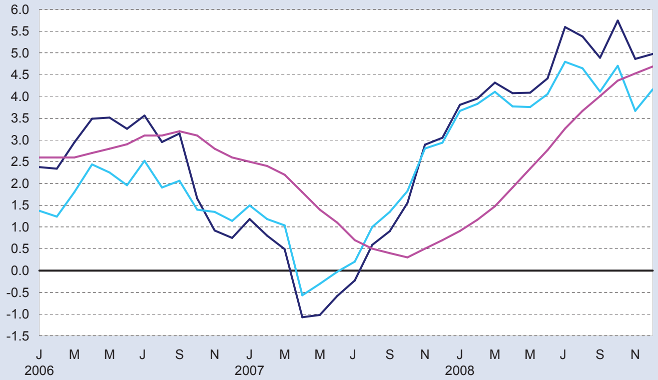
The food index, which accounts for 22.8% of the overall HICP basket, rose by an average of 6.6% during 2008, with major food categories, such as bread & cereals, meat, dairy products and vegetables, registering significant price increases (see Chart 3.11). The upward trend in food prices was most pronounced in the first quarter. This was followed by some moderation in subsequent quarters, but prices remained volatile until the end of the year.

The growth rate of energy prices, which was negative up to April 2008, gathered momentum during the year, ending December at 14.5% (see Chart 3.10). This stemmed mainly from the rise in the administratively-set surcharge on water and electricity bills that came into effect in the second quarter of the year.

The prices of services also rose at a faster pace in 2008, with the annual average increase in this component at 4.4%, substantially higher than the rate of 0.5% recorded in the previous year (see Chart 3.12). The acceleration was mainly attributable to higher prices of recreational activities, which account for almost 60% of the services component. In particular, prices of hotels & restaurants rose by 7.7% in the course of the year.

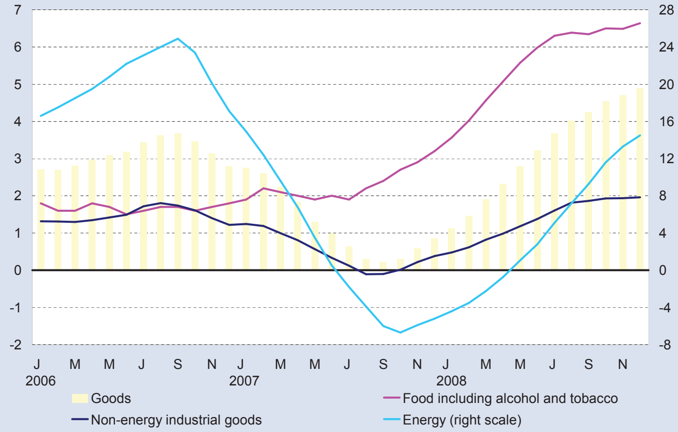
It is relevant to mention that, in contrast to developments in Malta, HICP inflation in the euro area fell from 3.1% in December 2007 to 1.6% a year later. The divergence

Chart 3.9
HICP INFLATION RATES
(annual percentage changes; annual average percentage changes)



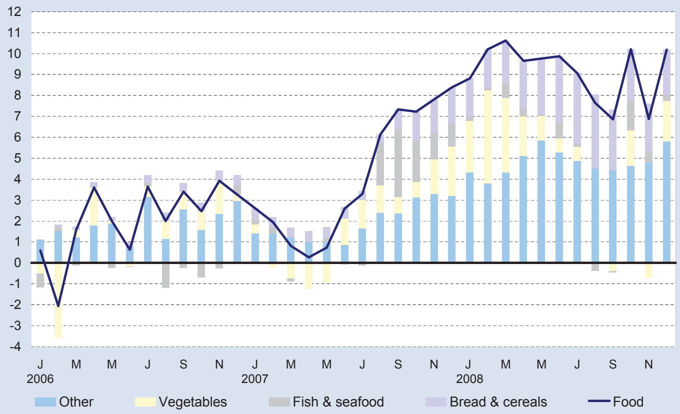
(1) Excludes "liquid fuels and lubricants for personal transport equipment" and "electricity, gas and other fuels"
Source: Eurostat.

Chart 3.10
INFLATION IN GOODS
(annual average percentage changes)



Source: Eurostat.

Chart 3.11
FOOD PRICES(1)
(contribution in percentage points; annual percentage changes)



(1) Excluding beverages and tobacco.
Source: Eurostat.

was mainly due to faster growth in energy and food prices in Malta (see Chart 3.13).

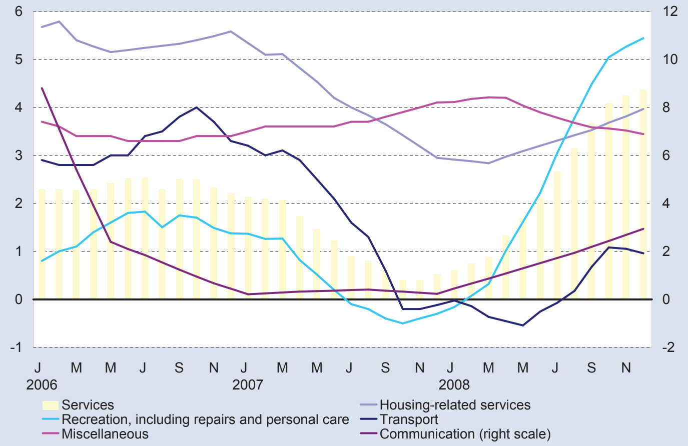
RPI and core inflation

The path followed by the RPI, the other measure of consumer price movements in Malta, mirrored that of its HICP-based counterpart. Food and energy prices contributed 1.9 and 1.1 percentage points, respectively, to the annual average RPI inflation rate, which rose to 4.3% over the year compared with 1.3% in 2007 (see Table 3.9 and Chart 3.14).[6]

Between January and July 2008, the RPI inflation rate was higher than the comparable HICP rate (Chart 3.15). This reflected the rapid increase in food prices over that period and the fact that food has a larger weight in the RPI than in the HICP. The divergence in the two inflation measures observed during the rest of the year, which was a departure from previous years, reflected the bigger HICP weight of the hotels & restaurants component. This exhibited a sharp increase in the latter part of 2008.

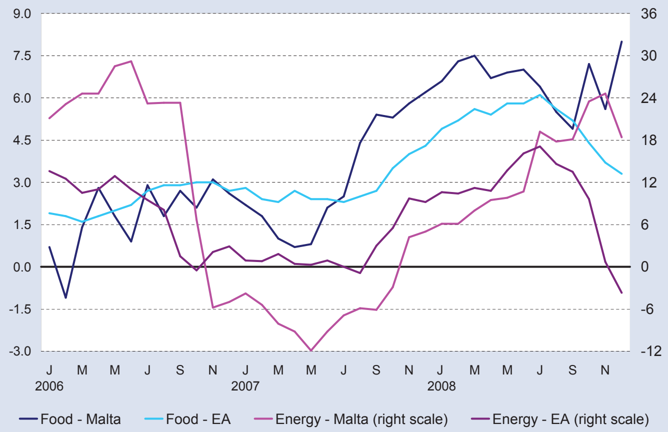
Core inflation stood at 1.7% at the end of 2008, 0.5 percentage points

Chart 3.12
INFLATION IN SERVICES
(annual average percentage changes)



Source: Eurostat.

Chart 3.13
FOOD AND ENERGY PRICES IN MALTA AND THE EURO AREA
(annual percentage changes)



Source: Eurostat.

Table 3.9
CONTRIBUTIONS TO RPI INFLATION
Percentage points

	Weights	2006	2007	2008
Food	23.82	0.5	1.0	1.9
Beverages & tobacco	6.11	0.1	0.1	0.2
Clothing & footwear	8.24	-0.1	0.0	0.4
Housing	7.57	0.4	0.2	0.3
Water, electricity, gas & fuels	2.25	0.6	-0.2	0.5
Household equipment & house maintenance costs	7.65	0.1	0.0	0.0
Transport & communications	23.13	0.8	-0.3	0.6
Personal care & health	6.22	0.2	0.1	0.1
Recreation & culture	8.84	0.0	0.1	0.1
Other goods & services	6.17	0.1	0.0	0.2
RPI	**100.00**	**2.8**	**1.3**	**4.3**

Source: NSO.

[6] Energy-related items are represented in two components of the RPI: water, electricity, gas & fuels and transport & communications.

more than at the end of 2007.[7] This was mostly attributable to higher prices of durable household goods and of educational & entertainment items.

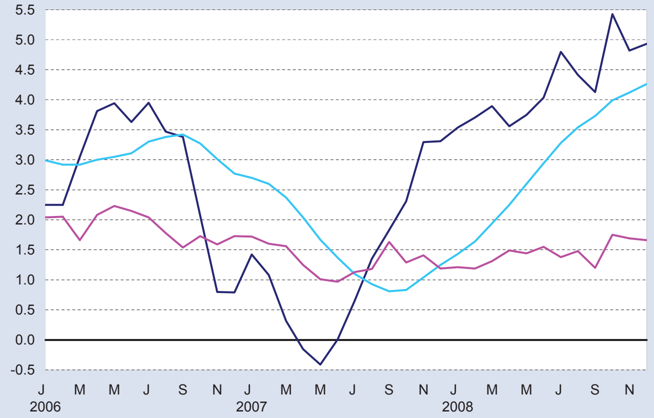
Costs and competitiveness

Labour cost developments

Buoyancy in the labour market translated into upward pressures on wages during 2008. In fact, estimates by the Central Bank of Malta on the basis of wage settlements through collective agreements suggest that wage inflation accelerated to 4.7% as against 4.1% in the previous year (see Table 3.10).[8] These settlements significantly exceeded the statutory increase designed to compensate employees for the rise in the cost of living.[9]

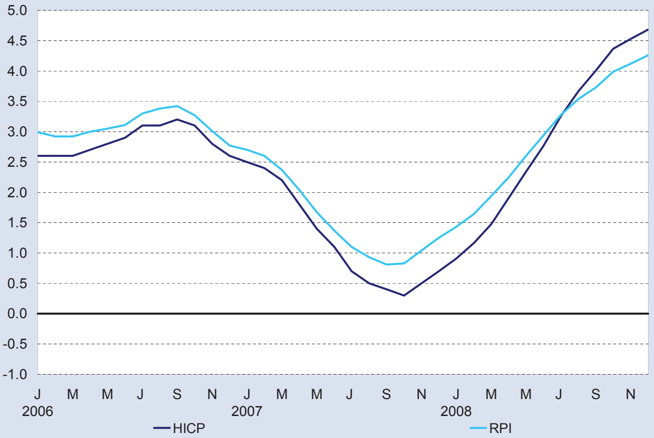
In the public sector, growth in average negotiated wages rose by a further 5.0% in 2008, after increasing by 3.5% a year before. The rise in average public sector wages reflected the back-loaded nature of the wage increases included in the collective agreement covering the civil service, which runs until 2010. It was also driven by wage drift, as the composition of the civil service contin-

Chart 3.14
RPI AND CORE INFLATION
(annual percentage changes; annual average percentage changes)



Sources: Central Bank of Malta estimates; NSO.

Chart 3.15
HICP AND RPI INFLATION RATES
(annual average percentage changes)



Sources: Eurostat; NSO.

Table 3.10
ESTIMATED CHANGE IN AVERAGE NEGOTIATED WAGES (1)
Annual percentage changes

	2005	2006	2007	2008
Private sector	4.1	4.0	4.4	4.7
Public sector	2.8	2.4	3.5	5.0
Overall	3.8	3.6	4.1	4.7

(1) The average wage is computed as a weighted mean of the minimum average wage and the maximum average wage.
Sources: Central Bank of Malta; Department of Employment & Industrial Relations; MFEI.

[7] The core inflation measure computed by the Bank excludes one-off fluctuations and reflects developments only in those sub-indices that show persistent price increases. The current divergence of the core measure from the RPI is due to the exclusion from the former of the fuel-related, food and clothing sub-indices.
[8] These figures include only unionised employees covered by collective agreements. Since such employment constitutes just under half of the gainfully occupied population, these estimates may not be representative of developments in the overall economy. Wage estimates incorporate cost-of-living adjustments but exclude overtime pay, production bonuses and all other allowances and income in kind.
[9] The latter is calculated as an absolute increase awarded to all employees on the basis of past increases in retail prices applied to a social wage.

ues to change with the recruitment of better qualified personnel in higher-paid positions. Similarly, growth in private sector wages picked up from 4.4% in the previous year to 4.7% in 2008, reflecting an increase across all categories.

Broader measures of labour cost developments also point to a pick-up in such costs during 2008, albeit to varying degrees. National accounts data indicate that average employment income per employee rose by 2.4% in 2008, after having increased by 1.5% in 2007.[10] Data obtained from the LFS, which tracks the change in remuneration across the entire employment market, showed an expansion in wages and salaries of 4.8% during the first nine months of 2008 compared to the corresponding period of 2007. This was driven by relatively rapid growth in various segments of the services sector, particularly health and other community, social & personal services, but also in manufacturing. Meanwhile, on the basis of Eurostat data on hourly labour costs, the wages component accelerated from 1.4% in 2007 to 1.8% a year later.[11]

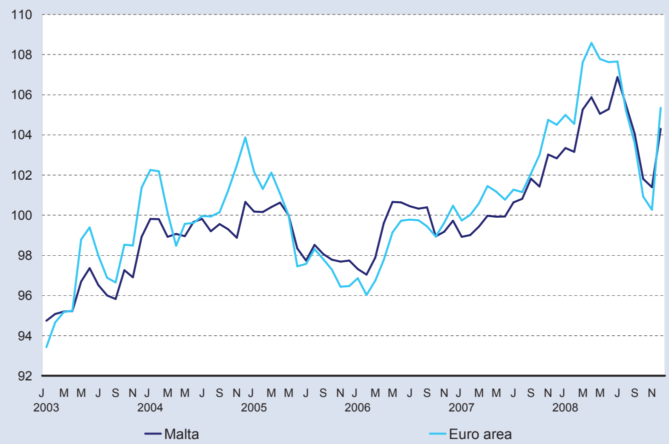
External competitiveness

Two key indicators of external competitiveness are the harmonised competitiveness indicator (HCI) and unit labour costs (ULC).

The HCI is a multilateral measure of international competitiveness that tracks price level and exchange rate changes relative to a country's trading partners. A higher (lower) score indicates a reduction (improvement) in a country's competitiveness. The HCI for Malta has two determinants. The first is Malta's inflation rate relative to that of its trading partners both inside and outside the euro area. The second consists of exchange rate changes against non-euro currencies. A limitation of the HCI is that it weights price and exchange rate changes by the direction of trade in manufactured goods only.

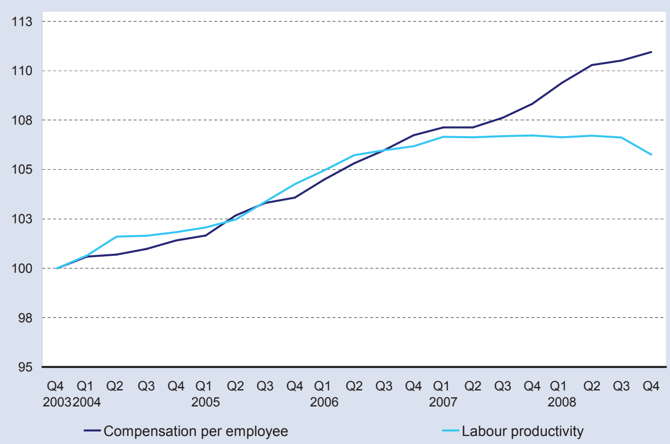
In the first half of 2008, the HCI for both the euro area and for Malta followed a rising path, partly mirroring the appreciation of the euro against the US dollar during the period (see Chart 3.16). Subsequently, however, both indices declined sharply through November, reflecting the decline in the exchange rate. Malta's HCI

Chart 3.16
HARMONISED COMPETITIVENESS INDICATORS
(May 2005 = 100)



Source: ECB.

Chart 3.17
COMPENSATION AND PRODUCTIVITY IN MALTA
(four-quarter moving sum indices; 2003 Q4= 100)



Source: ECB.

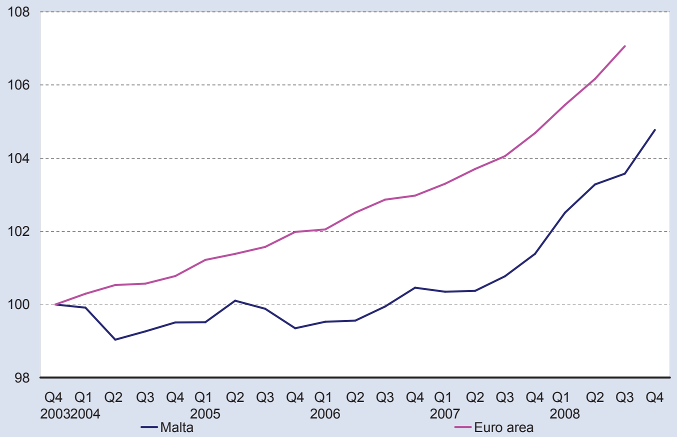
[10] Compensation of employees includes overtime payments.

[11] Eurostat's hourly labour cost index shows the development of hourly labour costs incurred by employers as a result of engaging labour. This index is made up of two components: wages & salaries and non-wage costs across manufacturing, construction and services. The wages and salaries component includes direct remuneration, bonuses and allowances paid by an employer in cash or in kind to an employee in return for work done. The non-wage element covers employers' social contributions plus net employment taxes.

was 1.4% higher in December 2008 than twelve months earlier, while that for the euro area also increased, but by 0.8 %.

Meanwhile, measured on a four-quarter moving sum basis, Malta's ULC during 2008 were up 3.3% on 2007.[12] This increase was propelled by a rise of 2.4% in compensation per employee and a decline of 0.9% in labour productivity (see Chart 3.17). However, Malta's ULC growth over the first three quarters of 2008 remained below that of the euro area (see Chart 3.18).

Chart 3.18
UNIT LABOUR COSTS IN MALTA AND IN THE EURO AREA
(four-quarter moving sum indices; 2003 Q4=100)



Source: ECB.

Economic projections for 2009 and 2010

The severe and unprecedented nature of the global crisis has made economic forecasting a more difficult exercise than usual. This is particularly true in the case of Malta which is exposed to developments in international market conditions. The projections presented below are, therefore, subject to an unusually high degree of uncertainty.

Assumptions

In preparing the forecasts a number of assumptions are made about key international indicators such as exchange rates, oil prices, interest rate spreads and external demand conditions.Thus, the US dollar and the pound sterling are assumed to remain constant against the euro at their mid–February levels throughout the forecast horizon. Meanwhile, on the basis of Brent crude oil futures, the price of oil per barrel is expected to fall from $98.00 to $48.80 in 2009, but to rise to $58.70 in 2010. As for interest rates, the spread between long-term bonds in Malta and the euro area is assumed to remain constant throughout the two-year period.

On external demand conditions, it is assumed that the larger euro area countries, the United Kingdom and the United States (Malta's major trading partners), will record a sharp contraction in trade and consumption volumes during 2009. In 2010 they are expected to experience a gradual and limited recovery. At the same time, inflation in these countries is expected to slow down markedly in 2009, as economic conditions continue to deteriorate and commodity prices remain at relatively low levels. Price inflation is expected to recover slightly in 2010 as economic activity begins to pick up. Similarly, export prices of Malta's major trading partners are envisaged to decline slightly in 2009 and rise only marginally in the following year, mostly reflecting the persistent weakness in global trade over the forecast horizon.

In a local perspective, it is assumed that inventory levels will remain constant at the same ratio of GDP as in 2008.

Economic growth

Reflecting the sharp downturn in global conditions, Malta's economic growth is expected to remain weak and below potential during the two-year forecast horizon. GDP is projected to grow at a modest rate of between 0.5% and 1.1% in 2009 before accelerating slightly to between 1.0% and 1.6% in 2010.

Growth in 2009 is expected to be driven mainly by domestic demand, with the contribution of net exports remaining negative. The decline in exports mainly reflects external demand conditions as consumption

[12] ULC measure the cost of employed labour per unit of output - more precisely, the ratio of nominal per-employee compensation to labour productivity. The latter is in turn defined as GDP at constant prices per person in employment. An increase (decrease) in ULC signals a drop (rise) in competitiveness.

Table 3.11
PROJECTIONS OF THE MAIN MACROECONOMIC AGGREGATES FOR MALTA
Percentage

	2008	2009[1]	2010[1]
Real Economic Activity (% change)			
GDP	1.6	0.5-1.1	1.0-1.6
Private consumption expenditure	4.1	0.1-1.1	0.4-1.4
Government consumption expenditure	8.6	1.8-2.8	1.4-2.4
Gross fixed capital formation	(19.7)	2.6-5.6	1.7-4.7
Inventories (% of GDP)	4.4	4.4	4.4
Exports of goods & services	(14.0)	(10.9) - (7.9)	(1.0) - 2.0
Imports of goods & services	(13.1)	(9.4) - (6.4)	(1.1) - 1.9
Balance of Payments (% of GDP)			
Goods & services balance	(3.6)	(2.4) - (3.4)	(2.4) - (3.4)
Current account balance[1]	(5.9)	(4.4) - (5.4)	(4.4) - (5.4)
Labour Market (% change)			
Total employment	2.5	0.4-0.8	0.6-1.0
Unemployment rate (% of labour supply)	5.8	6.2-6.6	6.7-7.2
Prices and Costs (% change)			
Overall HICP	4.7	0.6-1.2	1.0-1.6
HICP excluding energy	4.1	1.0-1.6	0.8-1.4
Retail price index	4.3	0.8-1.4	2.3-2.9
Compensation per employee	2.4	2.1-2.7	1.9-2.5
Unit labour cost	3.3	2.2-2.8	1.9-2.5
Public Finances (% of GDP)			
General government balance[1]	(3.9)	(2.4) - (2.6)	(2.8) - (3.0)
Government debt[1]	63.4	62.1-65.1	63.0-65.7
Technical Assumptions			
EUR/US$ exchange rate	1.471	1.289	1.286
Oil price (US$ per barrel)	98.0	48.8	58.7
10-year euro area bond yield	4.36	4.33	4.70

[1] Central Bank of Malta projections.
Brackets around figures denote a negative sign.

activity in Malta's main trading partners remains sluggish. To a lesser extent, the fall in exports is also expected to reflect an erosion of Malta's price competitiveness in overseas markets. These factors are expected to have a negative impact on both the major export-oriented sectors of the economy, more specifically manufacturing and tourism. Other export dependent sectors, such as those providing business and financial services, which recorded rapid rates of growth in recent years, are projected to expand at a decelerating pace as the external operating environment conducive to their growth continues to deteriorate. Reflecting the weakness in export markets and a dampening of consumption activity in Malta (as discussed below), imports are also projected to decline significantly in 2009. In 2010, both exports and imports are projected to grow marginally in response to a modest pick-up in external demand and private consumption.

The expansion in domestic demand in 2009 is expected to emanate mainly from investment activity as gross fixed capital formation by the Government rises sharply from the low level recorded in 2008. An increase in private-sector construction activity is also anticipated as work on the Smart City project gains momentum. These are expected to more than offset the impact of a further decline in investment in residential dwellings, the latter reflecting a weaker housing market. In 2010, however, investment growth is expected to decelerate as growth in gross fixed capital formation by the public sector falls below the exceptionally high rate projected for this year. In contrast, a recovery is expected in private sector investment, particularly that of residential dwellings, as the decline in house prices is expected to bottom out during the course of that year.

In 2009 private and public consumption are expected to grow at a less marked pace than in the previous year. The deceleration in public consumption expenditure reflects a return to a more normal rate of growth after the exceptionally high rate registered in 2008 in the light of a number of one-off factors. However, the growth rate of public consumption expenditure is expected to decline further in 2010 as the Government aims at tighter control on key expenditure items to keep the fiscal deficit within the limits set by the Stability and Growth Pact.

The slower growth in private consumption projected for 2009 is expected to reflect disposable income developments. The latter should increase marginally over the year as the labour market experiences only modest gains in employment and a higher rate of unemployment. Furthermore, private consumption is also expected to respond to negative wealth effects, while concerns about job security in certain sectors of the economy may act as an incentive for households to rebuild savings at the cost of lower consumption spending. In 2010, private consumption is projected to rise at a faster rate, underpinned by the gradual pick-up in employment growth.

The external account

In the external account, despite the increasingly negative contribution of net exports to GDP growth, the shortfall on the goods and services balance is expected to narrow in nominal terms in 2009. This is attributed to an improvement in the terms of trade, largely reflecting lower oil prices that are expected to persist throughout the year. In 2010, the goods and services balance is expected to remain unchanged, as a slight pick-up in real exports is outweighed by unfavourable movements in the terms of trade, the latter triggered by a recovery in commodity prices.

The labour market

In line with the projected slowdown in economic activity, employment growth is expected to decelerate while the unemployment rate continues to rise. Employment prospects are expected to turn negative in 2009, largely because of stagnating external demand and a much less buoyant residential construction sector. The employment outlook is expected to be more positive in 2010, as economic activity gains some momentum. However, with employment growth expected to remain below the growth rate of the labour force, the unemployment rate is forecast to rise to between 6.7% and 7.2% during the projection horizon.

Prices and costs

After peaking at 4.7% in 2008, HICP inflation is projected to ease significantly during 2009, to between 0.6% and 1.2%, largely reflecting the base effect of past increases in commodity prices, but also diminishing locally-generated inflation. In 2010 inflation is expected to range between 1.0% and 1.6%, mainly reflecting a rebound in energy and food commodity prices.

The impact of unit labour costs on inflation is expected to be weaker in 2009, as these are projected to ease to a range of 2.2% - 2.8%, from 3.3% in 2008. Enhanced productivity growth is expected to outpace a rise in compensation per employee, although wage settlements in certain sectors of general government may continue to put upward pressure on the overall average wage. In 2010, ULCs are projected to slow down further, partly on account of a further pick up in productivity levels and moderate growth in wages, particularly in the private sector, in the context of a generally soft labour market and increased competition in export markets.

Public finance

The general government deficit is expected to narrow to a range of 2.4% - 2.6% of GDP in 2009. Recurrent expenditure is expected to remain broadly stable as the impact of earlier one-off expenditures is reversed. Meanwhile, a projected pick-up in the government's capital expenditure programme should have only a minor impact on the deficit as this will be financed largely from EU funds. On the revenue side, inflows are expected to expand at a slightly faster pace than in the previous year as a result of base effects and the introduction of new indirect tax measures from 2009. However, the deficit ratio is projected to widen again in 2010, to between 2.8% and 3.0% of GDP, as expenditure on transfer payments accelerates notwithstanding slow growth in consumption-related expenditure.

The projected deficits are expected to be financed entirely by new borrowing. Consequently, the debt-to-GDP ratio is anticipated to rise from around 62% in 2007 to a range of between 63.0% and 65.7% by 2010.

Risk to the projections

The uncertainty surrounding the duration and depth of the global recession compounds the risks to the projections. These appear to be mainly on the downside, as recent international economic indicators point to the possibility of a more severe and protracted downturn in Malta's major trading partners. Other possible downside risks emerge from developments in the local economic environment, most notably the slack in the residential component of private construction investment and the growing tendency for household savings to increase at the cost of lower consumption expenditure.

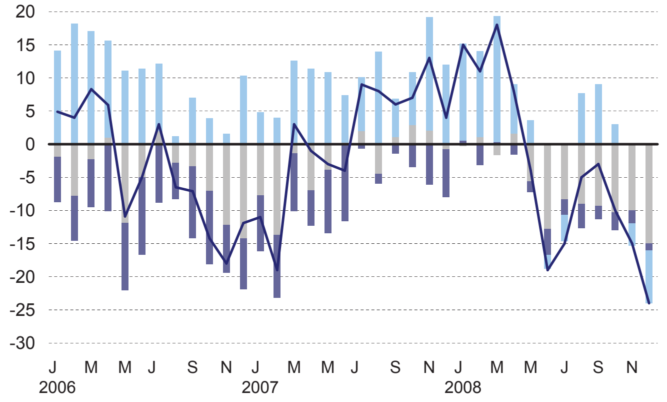
Risks to inflation are more balanced. Thus, while the baseline forecast already incorporates an upturn in commodity prices, there may be further upside risks if the assumption of a constant exchange rate is undermined by a possible depreciation of the euro against the US dollar. This upside risk to inflation may, however, be attenuated by downside risks to economic growth, which would exert downward pressure on prices, particularly wages, as capacity in the local economy is underutilised.

BOX 1: BUSINESS AND CONSUMER SURVEYS

Industrial confidence surveys

Industrial confidence weakened as the year progressed, implying a deteriorating business outlook for most sectors of manufacturing industry. The seasonally-adjusted industrial confidence indicator fluctuated in a positive range through April 2008, but dipped into negative territory thereafter, bottoming at -19 in June. Although confidence recovered over the following three months, it slid thereafter to -24 in December (see Chart 1A). Among the components of the indicator, stocks of finished goods were relatively stable throughout the year, while a contraction in both order books and production expectations was particularly evident in the last quarter.

Chart 1A
INDUSTRIAL CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

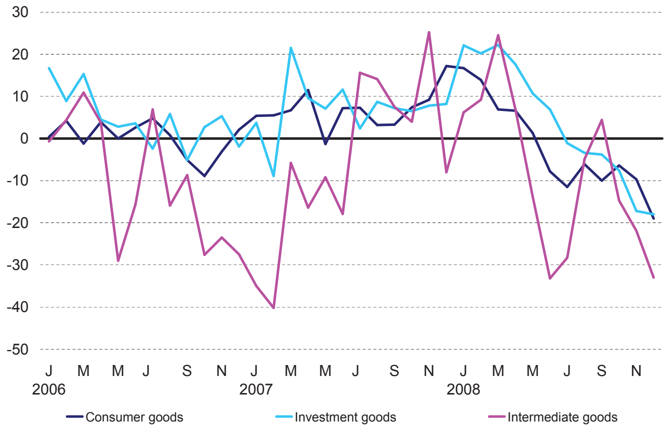
An analysis by main industrial groupings shows that sentiment weakened among producers of consumer and investment goods, both of which moved into negative territory in the latter half of 2008. In the consumer goods category, the drivers were lower order books and a slight build-up in stocks of finished goods, while production expectations turned negative only in the last two months of the year. Meanwhile, in the investment goods category, order books were in decline throughout the year, whereas the downturn in production expectations set in during the autumn months.

Sentiment in the intermediate goods category displayed its usual volatility and fluctuated mostly in negative territory after the first quarter. The main factors contributing to this development were a substantial deterioration in order books along with oscillations in stocks of finished goods and in production expectations. The latter turned negative in the last two months of the year (see Chart 1B).

Meanwhile, surveys commissioned by the Bank suggested a scaling down of expectations among construction firms and providers of services during the latter part of 2008.[1]

Improved expectations, on a year earlier, of turnover and employment were reported in the second quarter by respondents in the construction

Chart 1B
CONFIDENCE INDICATORS BY MAIN INDUSTRIAL GROUPINGS
(seasonally adjusted; percentage points)

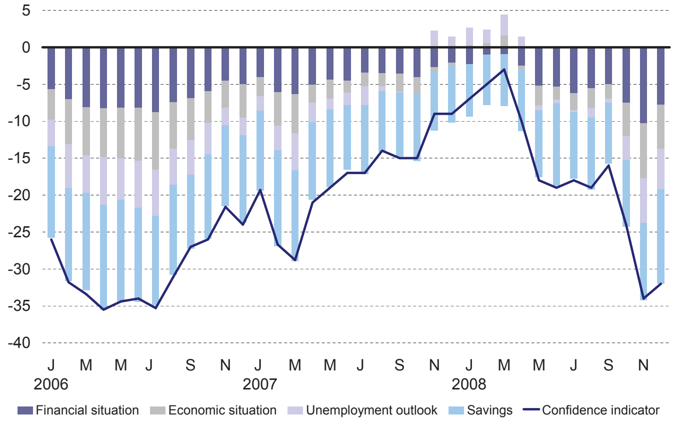


Source: European Commission.

[1] The data series is not seasonally adjusted and commences in the second quarter of 2007.

sector. However, this was followed by downward corrections in the third and last quarters. Similarly, expectations reported by service providers regarding turnover and employment were fairly close to year-ago levels in both the second and third quarters, but then dipped markedly in the fourth quarter. The downturn was common to most sub-sectors, with the exception of information technology and business services.

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



Source: European Commission.

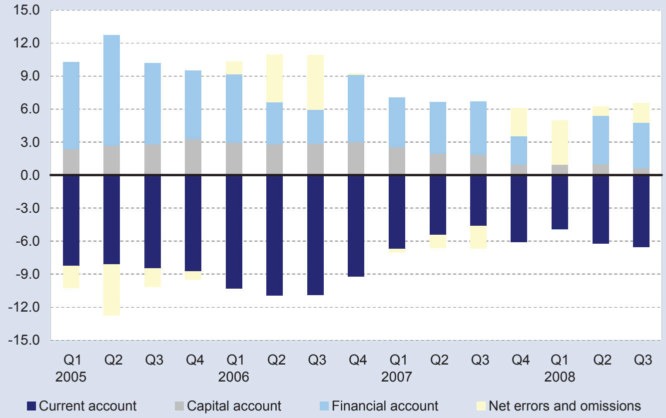
Consumer confidence surveys

Survey results show that the improvement in consumer sentiment observed in Malta during most of 2007 extended into the first quarter of 2008. However, sentiment generally deteriorated during the rest of the year, with the seasonally-adjusted indicator of consumer confidence ending December at -32 (see Chart 2). Consumers' appraisal of the general economy, particularly the labour market, worsened substantially as the year progressed, while their assessment of their own financial situation and their ability to save became considerably more negative during the second half of the year. Supplementary indicators show that respondents' spending intentions with regard to major purchases were higher on average in 2008 than in 2007.

4. BALANCE OF PAYMENTS

After having narrowed to 4.6% of GDP in the year to September 2007, the current account deficit rose to 6.5% of GDP in the twelve-month period to September 2008. During the same period net inflows on the capital and financial account as a percent of GDP fell by nearly two percentage points to 4.7% (see Chart 4.1). This was mainly attributable to developments on the capital account, which posted a smaller surplus, as official transfers from the EU and Italy declined. At the same time, net inflows on the financial account also fell. On a four-quarter cumulative basis, sizeable positive net errors and omissions were recorded.

Chart 4.1
COMPOSITION OF BALANCE OF PAYMENTS
(four-quarter moving sums; percentage of GDP)



Source: NSO.

The current account

During the first three quarters of 2008 the current account deficit widened to EUR 156.3 million, an increase of EUR 39.1 million when compared to the same period a year earlier (see Table 4.1). This reflected a wider merchandise trade gap and, to a lesser extent, higher net income outflows, which together offset a larger favourable balance on services. More recent GDP figures point to a widening of the deficit on external trade in goods and services during 2008 as a whole. This is attributable to a contraction in exports of EUR 274.8 million as against a drop of EUR 208.3 million in imports.

Merchandise trade

Balance of payments data for the first nine months of the year indicate that the merchandise trade deficit increased by EUR 214.4 million, or 30.4%, to EUR 920.7 million.[1] This reflected a EUR 171.7 million contraction in the value of exports and a EUR 42.7 million rise in imports.

Table 4.1
BALANCE OF PAYMENTS
EUR millions

	2005	2006	2007	2007 Q1-Q3	2008 Q1-Q3
Current account	**-420.4**	**-471.8**	**-330.6**	**-117.1**	**-156.3**
Goods	-904.4	-964.2	-986.0	-706.3	-920.7
Services	647.7	711.2	847.6	699.5	839.7
Transport	63.6	77.8	98.5	86.2	120.9
Travel	394.7	354.1	392.4	349.6	330.2
Other services	189.3	279.2	356.7	263.6	388.6
Income	-199.6	-212.5	-129.0	-136.6	-187.7
Current transfers	35.9	-6.4	-63.2	26.2	112.4
Capital and financial account	**455.7**	**466.3**	**191.7**	**122.8**	**198.6**
Capital account	155.7	153.1	51.4	33.5	17.6
Financial account	300.0	313.2	140.3	89.4	181.0
Errors and omissions	-35.4	5.5	138.9	-5.7	-42.3

Source: NSO.

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

As a result, on a four-quarter moving sum basis, the visible trade gap widened sharply when compared to the four quarters ending in September 2007 (see Chart 4.2). Although the upward trend in imports stabilised over the nine months to September 2008, the downward trend in exports in evidence since the last quarter of 2007 persisted.

Chart 4.2
GOODS BALANCE
(four-quarter moving sums; EUR millions)

Source: NSO.

Customs data for the entire year reveal that the merchandise trade gap rose by 4.2% in 2008, as against a 4.9% increase in the previous year. The expansion in the trade gap in 2008 reflected a sharp fall in exports, partly as a result of negative growth in external demand, which outweighed a contraction in imports. This contrasts with developments observed in the previous year, when the widening trade gap was attributable to faster growth in the value of imports than in that of exports (see Table 4.2).

During 2008 the value of exports contracted by EUR 252.5 million, or 11.0%. Exports of electrical machinery, principally semi-conductors, which declined by EUR 168.2 million, accounted for two-thirds of the fall, although a EUR 41.3 million drop in exports of fish farming products also contributed. Conversely, exports of pharmaceuticals extended their upward trend, rising by EUR 15.9 million over the year, while those of plastics and printed matter continued to register moderate rates of growth.

Imports were down by EUR 198.3 million, or 5.5%, on the previous year, mainly on account of significant falls in the purchases of industrial supplies and capital goods. As a consequence of the drop in exports of semi-conductors, imports of products within the electrical machinery category, which form the bulk of industrial supplies, fell by EUR 156.0 million. At the same time, imports of capital goods were also down. This mainly reflected lower purchases of aircraft by the national airline, which were exceptionally high in 2007, and of machinery and mechanical appliances, partly related to lower government expenditure on capital formation.[2]

Table 4.2
MERCHANDISE TRADE
EUR millions; annual percentage changes

	2006	2007	2008[(1)]	2007	2008
Imports	**3,487.5**	**3,578.2**	**3,379.9**	**2.6**	**-5.5**
Industrial supplies	1663.5	1610.3	1399.5	-3.2	-13.1
Capital goods & others	655.1	636.2	486.1	-2.9	-23.6
Consumer goods	863.8	913.8	932.9	5.8	2.1
Fuel & lubricants	305.1	417.8	561.3	36.9	34.3
Exports	**2,256.8**	**2,287.3**	**2,034.8**	**1.4**	**-11.0**
Trade deficit	**1,230.7**	**1,290.8**	**1,345.1**	**4.9**	**4.2**

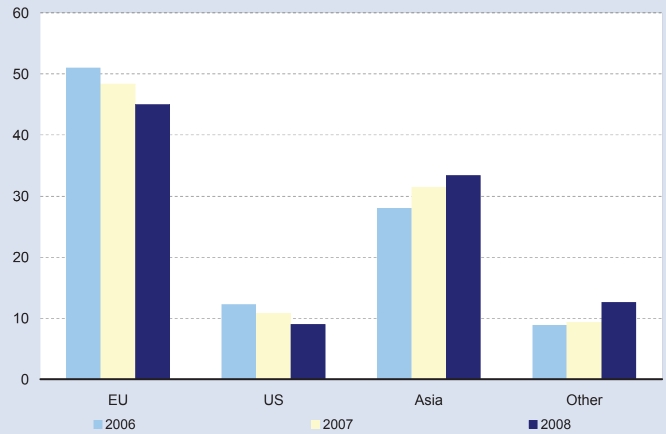
(1) Provisional
Source: NSO.

[2] In Customs data, aircraft leased by resident airlines and registered in Malta are being recorded as imports if they are leased for more than two years.

On the other hand, in response to the surge in international oil prices, the fuel import bill rose by 34.3%. Meanwhile, a marginal rise in the value of imports of consumer goods was driven by food imports, which in turn reflected higher global prices for key agricultural commodities, particularly cereals. In contrast, imports of durable consumer goods declined.

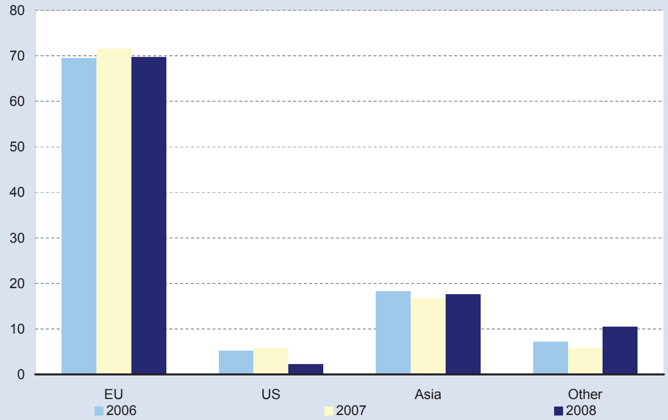
With respect to the geographical direction of trade, the EU remained Malta's most important trading partner, accounting for 69.7% of total imports and 45.1% of exports during 2008 (see Charts 4.3 and 4.4). Trade with the euro area alone accounted for 53.5% and 33.9% of Maltese imports and exports, respectively. Nonetheless, the magnitude of total trade flows to the EU declined, with the value of imports and exports falling by EUR 207.7 million and EUR 189.9 million, respectively, from the levels registered in 2007. In particular, imports from France and exports to the United Kingdom were both down significantly, the former reflecting lower imports of aircraft and electronic components and the latter being driven by a drop in re-exports of motor vehicles.

Chart 4.3
GEOGRAPHICAL DIRECTION OF EXPORTS
(percentage share of total)



Source: NSO.

Chart 4.4
GEOGRAPHICAL DIRECTION OF IMPORTS
(percentage share of total)



Source: NSO.

Similarly, during 2008 Malta's trade flows with the United States declined both in absolute terms and as a proportion of the total. At the same time, exports to Asia fell in absolute terms but their share in the total went up by 1.9 percentage points to 33.4%. On the other hand, the share of imports from the region rose to 17.6%.

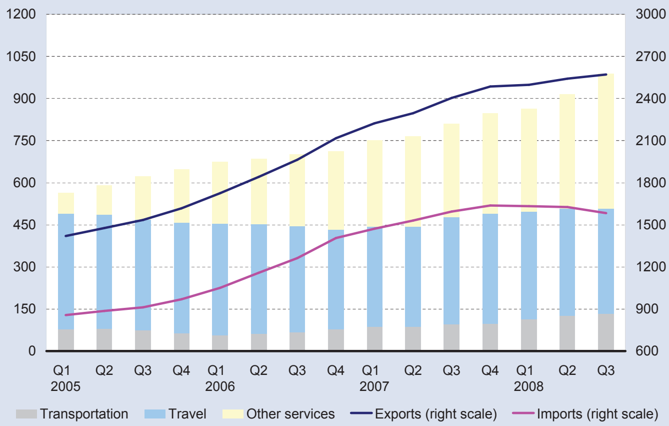
Services

The surplus on services continued to gain further momentum during the first three quarters of 2008, increasing by EUR 140.3 million, or 20.1%, on the comparable period a year earlier. This stemmed from a 4.5% increase in receipts and a 4.6% decline in payments.

The increase in the positive balance was mainly attributable to higher net inflows on 'other services', which expanded by EUR 125.0 million as a result of higher receipts from leasing and merchanting, although a decrease in payments for business, professional and technical services also contributed. These factors outweighed an increase in outflows on financial services. Net receipts on transport were also up. Travel receipts registered a slight drop, despite the higher number of inbound tourists. Together with higher spending by residents travelling abroad, this led to a marginal decline in the surplus on travel.

Likewise, during the twelve months to September 2008, the positive balance on services showed a rise of EUR 178.2 million, or 22.0%, on the comparable period a year ago (see Chart 4.5).

Chart 4.5
SERVICES BALANCE
(four-quarter moving sums; EUR millions)



Source: NSO.

Net outflows on the income account during the first nine months of 2008 were up by EUR 51.2 million, or 37.5%, compared with the same period a year earlier. This was mainly attributable to increased interest payments on foreign borrowings and a rise in profits earned by non-resident shareholders in domestic corporations. The latter have been on a general upward trend in recent years, reflecting steady inflows of foreign direct investment, though a significant proportion of these profits is subsequently reinvested in Malta. Furthermore, interest earned by residents on their portfolio investments abroad was marginally lower than in the same period of 2007. Hence, during the twelve months to September 2008, the negative balance on the income account also increased.

During the first three quarters of 2008, the positive balance on current transfers increased by EUR 86.2 million on the corresponding period of 2007. Thus, during the twelve months to September 2008 the surplus on current transfers increased by EUR 65.4 million. This was almost entirely due to higher tax receipts from companies engaged in international business.

The capital and financial account[3]

During the first three quarters of 2008, the capital and financial account posted net inflows of EUR 198.6 million, an increase over the EUR 122.8 million registered in the corresponding period of 2007 (see Table 4.1). The increase was entirely driven by movements in the financial account, which posted additional net inflows of EUR 91.7 million. Conversely, the surplus on the capital account fell to EUR 17.6 million, almost half the level recorded in the previous year. The decline was mainly due to lower receipts by way of grants under the Italy-Malta Financial Protocol and post-accession EU funds.

Over the first nine months of the year, net inflows on the financial account were mainly driven by the other investment component. Increases in currency and deposit liabilities to non-residents and additional borrowing by resident banks, particularly those predominantly involved in international operations, accounted for the greater part of these inflows. In contrast, the portfolio investment account recorded large net outflows as institutional investors increased their holdings of foreign equities and debt securities. Higher net outflows related to derivative instruments also impacted negatively on the financial account. During this period external reserve assets declined by EUR 18.9 million.

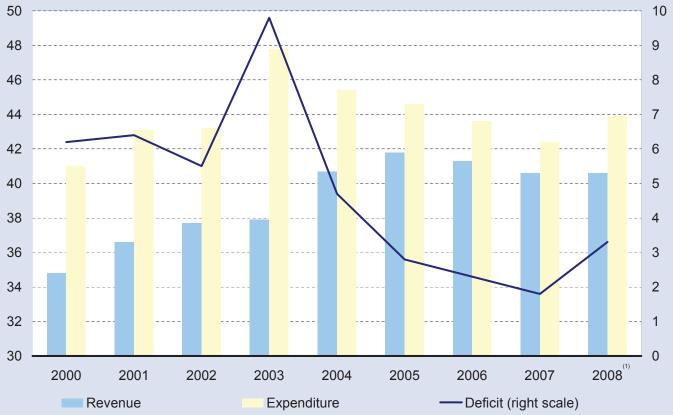
Meanwhile, a lower net surplus was recorded on direct investment. Inward flows during the first three quarters of 2008 were mainly boosted by injections of share capital in banks and re-invested earnings by private corporations. These inflows were partly offset by direct investment overseas by resident firms in the tourism and telecommunications sectors.

[3] Following Malta's entry into the euro area on 1 January 2008, assets that represent claims on other euro area residents, as well as all euro-denominated assets, whether representing claims on residents of the euro area or not, are no longer considered to form part of the country's external reserves. This also applies to a fraction of the Bank's reserve assets which, in line with Eurosystem membership obligations, was transferred to the ECB in exchange for a claim on the ECB. As a result, data related to reserve assets, portfolio investment, derivatives and other investment cannot be analysed with reference to pre-2008 figures.

5. GOVERNMENT FINANCE

The general government deficit was expected to rise to 3.3% of GDP in 2008 from 1.8% in the previous year, largely as a result of one-off expenditure items.[1] Consequently, the primary surplus, which is the difference between revenue and expenditure excluding interest payments, was expected to have dropped. At the same time, the negative balance in the Consolidated Fund is projected to have increased, with expenditure growing at a much faster pace than revenue, while the government debt-to-GDP ratio is set to have edged up to approximately 63%.

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



(1) Forecast
Sources: Eurostat; MFEI.

General government balance and debt[2]

The expected increase in the general government deficit-to-GDP ratio is solely explained by the rise in expenditure as a proportion of GDP, since the revenue ratio for 2008 is similar to that for 2007 (see Table 5.1 and Chart 5.1). During the year expenditure was boosted by two extraordinary outlays that together were estimated at around 1.7% of GDP. These were the early retirement schemes for shipyard workers in connection with the planned privatisation of the state-owned Malta Shipyards Ltd and the increased subsidy paid to the energy utility, Enemalta, a public sector corporation, to offset the impact of the surge in international oil prices on water and electricity rates charged to the consumer. As a result of the increase in the deficit, the debt-to-GDP ratio is expected to have added 0.6 percentage points in 2008, to 62.8% (see Chart 5.2). Relatively rapid nominal GDP growth is expected to have dampened the increase in the debt ratio.

Table 5.1
GENERAL GOVERNMENT FISCAL INDICATORS
As a percentage of GDP

	2007	2008
Total revenue	40.6	40.6
Total expenditure	42.4	43.9
Interest payments	3.4	3.3
Overall balance	-1.8	-3.3
Primary balance	1.6	0.0
Temporary measures (1)	0.6	0.3
Public debt	62.2	62.8

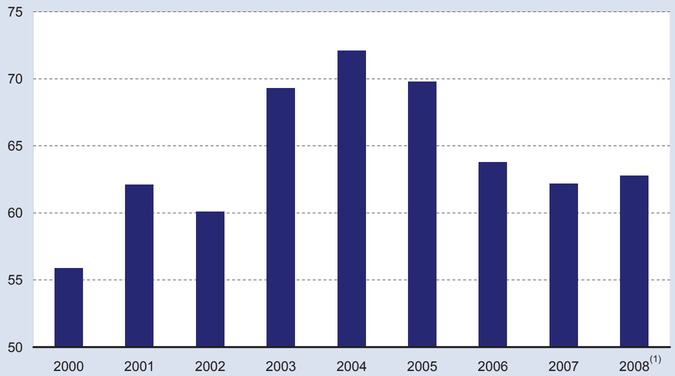
(1) As defined by the European Commission. A positive sign implies a deficit-reducing impact.
Source: *Malta: Update of Stability Programme 2008-2011,* MFEI.

[1] The source of the projections regarding general government developments in 2008 is *Malta: Update of Stability Programme 2008 – 2011*, published in December 2008 by the MFEI. This describes the Government's medium-term policy framework and includes forecasts of macroeconomic variables and budgetary objectives for the 2008-2011 period.

[2] The general government balance captures all transactions of the central government, including extra-budgetary units, and local government, on an accrual basis. In contrast, the Consolidated Fund captures most transactions of the central government, excluding extra-budgetary units, on a cash basis.

The general government deficit widened to EUR 230.9 million in the first three quarters of 2008, from EUR 108.0 million in the same period of 2007 (see Table 5.2). This was due to a substantial increase in expenditure, which grew more than twice as fast as revenue. This resulted in a primary deficit of EUR 97.2 million, as opposed to a surplus of EUR 22.3 million in the first three quarters of 2007.

Chart 5.2
GENERAL GOVERNMENT DEBT
(percentages of GDP)



(1) Forecast
Sources: Eurostat; MFEI.

The 5.6% growth in revenue on a year earlier was mainly due to higher receipts from taxes on income and wealth, which were up by 12.2%. Considerable increases were also observed in revenue from taxes on production & imports and social contributions, the latter reflecting the steady growth in employment. In contrast, the 'other revenue' item declined, mainly because of lower receipts by way of grants from the EU and Italy and a drop in yields from taxes on property transactions.

Expenditure expanded by almost 13% on a year earlier, with a surge in recurrent spending outweighing a drop in gross fixed capital formation. In absolute terms, intermediate consumption registered the largest increase, mostly as a result of high running costs involving the new state hospital, while outlays on social security benefits and compensation of employees continued to rise steadily. The 'other' expenditure item also increased significantly. However, this reflects the recording of a considerable one-off sale of land in 2007, which was netted from expenditure in that year.[3] Meanwhile, expenditure on subsidies rose by 42.6%,

Table 5.2
GENERAL GOVERNMENT BALANCE
EUR millions

	2007	2008(1)	2007 Q1-Q3	2008 Q1-Q3	Change Q1 - Q3 Amount	%
Revenue	**2,198.5**	**2,330.4**	**1,542.8**	**1,629.5**	**86.7**	**5.6**
Taxes on production and imports	800.2	832.3	580.0	610.4	30.4	5.2
Current taxes on income and wealth	726.0	780.6	470.4	527.8	57.4	12.2
Social contributions	398.3	424.8	294.3	312.3	18.0	6.1
Other	274.0	292.7	198.1	179.0	-19.1	-9.7
Expenditure	**2,296.0**	**2,519.8**	**1,650.8**	**1,860.5**	**209.7**	**12.7**
Intermediate consumption	290.6	321.4	189.7	260.0	70.3	37.1
Gross fixed capital formation	217.0	195.2	161.4	116.0	-45.4	-28.1
Compensation of employees	705.0	746.2	528.6	569.6	41.0	7.8
Subsidies	109.1	137.8	71.4	101.8	30.4	42.6
Interest	182.1	189.4	130.1	133.8	3.7	2.7
Social benefits	699.1	809.3	519.9	586.7	66.9	12.9
Other	93.1	120.5	49.6	92.6	43.0	86.7
Primary balance	**84.6**	**0.0**	**22.3**	**-97.2**	**-119.5**	**-**
General government balance	**-97.5**	**-189.4**	**-108.0**	**-230.9**	**-122.9**	**-**

(1) Data for 2008 are estimates taken from *Malta: Update of Stability Programme 2008-2011*.
Sources: MFEI; NSO.

[3] Disposals of non-financial and non-produced assets, such as sales of land, are recorded as negative expenditure in the general government accounts according to ESA 95 methodology.

Table 5.3
GOVERNMENT BUDGETARY OPERATIONS
EUR millions

	2007	2008[1]	2007 Jan-Nov	2008 Jan-Nov	Change Amount	Change %
Revenue	**2,064.4**	**2,210.7**	**1,740.7**	**1,812.8**	**72.1**	**4.1**
Direct tax	**983.6**	**1,078.4**	**772.7**	**867.3**	**94.5**	**12.2**
Income tax	663.4	738.8	499.9	579.3	79.5	15.9
Social security contributions[2]	320.2	339.6	272.9	287.9	15.1	5.5
Indirect tax	**838.4**	**868.5**	**753.6**	**772.8**	**19.3**	**2.6**
Value Added Tax	421.8	454.5	375.5	410.9	35.4	9.4
Customs and excise duties	185.0	185.3	168.3	161.7	-6.6	-3.9
Licences, taxes and fines	231.6	228.7	209.8	200.2	-9.6	-4.6
Non-tax[3]	**242.4**	**263.8**	**214.4**	**172.6**	**-41.7**	**-19.5**
Expenditure	**2,173.6**	**2,410.8**	**1,931.6**	**2,083.7**	**152.1**	**7.9**
Recurrent[2]	**1,915.7**	**2,135.6**	**1,724.0**	**1,889.2**	**165.2**	**9.6**
Personal emoluments	484.4	515.3	407.4	437.2	29.8	7.3
Programmes and other operational expenditure[4]	1,095.5	1,267.7	1,003.1	1,125.7	122.6	12.2
Contributions to entities	156.6	166.2	142.4	145.2	2.8	2.0
Interest payments	179.1	186.4	171.1	181.1	10.1	5.9
Capital	**257.9**	**275.2**	**207.6**	**194.5**	**-13.1**	**-6.3**
Primary balance[5]	**69.9**	**-13.7**	**-19.9**	**-89.8**	**-70.0**	**-**
Consolidated Fund balance	**-109.2**	**-200.1**	**-190.9**	**-271.0**	**-80.0**	**-**

[1] Data for 2008 are estimates, as shown in the *Financial Estimates 2009* and the *Budget Speech 2009* published in November 2008.

[2] Government contributions to the social security account in terms of the Social Security Act 1987 are excluded from both revenue and expenditure.

[3] Includes grants but excludes proceeds from sale of assets, sinking funds of converted loans and borrowings.

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

[5] Revenue less expenditure excluding interest payments.

Sources: MFEI; NSO.

largely reflecting the substantial payments to the energy corporation, as mentioned above. In contrast, gross fixed capital formation was down by 28.1%, mainly due to a base effect: in 2007 capital outlays on the new state hospital, which was completed in that year, were exceptionally high. However, expenditure on capital projects financed through official grants from overseas was also lower.

Consolidated Fund

The deficit on the Consolidated Fund for the first eleven months of 2008 was up by EUR 80.0 million compared with that for the same period a year earlier, reaching EUR 271.0 million (see Table 5.3). Similarly, the primary shortfall increased by EUR 70.0 million to EUR 89.8 million.

Revenue

As in 2007, revenue continued to grow through higher tax proceeds, particularly those from direct taxes. Likewise, during 2008 non-tax revenue declined at a rate similar to that registered in the previous year.

Revenue from direct taxes grew by 12.2% when compared to January-November 2007, with more than fourth-fifths of this stemming from income tax. Receipts from the latter were primarily boosted by higher proceeds from corporations. In addition, growth in employment income generated additional revenue from personal income tax, which offset the impact of the tax cutting measures introduced in the beginning of the year. Favourable labour market conditions were also reflected in the 5.5% increase in revenue from social security contributions.

Revenue from indirect taxes remained relatively stable, rising by 2.6% over the same period in 2007. VAT receipts were up by EUR 35.4 million, or 9.4%, reflecting strong growth in private consumption. The proceeds from customs & excise duties and licences, taxes & fines, on the other hand, decreased as excise duties on fuel fell significantly, while revenue from taxes related to real estate transactions also recorded a notable decline, brought about by the slowdown in the property market.

Non-tax revenue for the eleven months to November 2008 was down by 19.5% compared with the same period of 2007, falling to EUR 172.6 million, with just over two-thirds of the decrease being due to a reduction in receipts by way of grants from the EU and Italy. In addition, the fall in miscellaneous receipts was partly due to lower sales of land by the Government.

Expenditure

Expenditure rose by 7.9%, compared with a 1.9% increase in the period between January and November 2007, with higher recurrent outlays more than offsetting a reduction in capital expenditure.

Overall recurrent spending put on EUR 165.2 million, or 9.6%, on a year earlier. Although all recurrent items of expenditure increased considerably, three-fourths of the rise was due to programmes and other operational expenditure. The substantial expansion in this category of expenditure reflected higher subsidies to the energy sector, increased costs at the new hospital, and larger social security payments, particularly retirement pensions and children's allowances. In addition, the government wage bill expanded by 7.3% as a result of the annual increase in compensation to employees in terms of the existing collective agreement and additional increases to employees in the health sector under a new agreement. Meanwhile, interest payments on government debt rose by nearly 6%.

In contrast, capital expenditure during the eleven months to November was down by 6.3%, or EUR 13.1 million, compared with the same period of 2007. This resulted primarily from the base effect related to the completion of the new hospital a year earlier, though lower spending on projects financed by official grants also contributed. These factors were partly offset by increases in subventions to government entities, such as Malta Enterprise and the Malta Tourism Authority.

Gross government debt

The deficit on the Consolidated Fund during the first eleven months of 2008 was mostly financed by the issue of long-term bonds. As a result, gross government debt increased by EUR 222.6 million when compared to December 2007, reaching EUR 3,520.8 million.

Table 5.4

CHANGES IN GOVERNMENT DEBT

EUR millions

	2007	2007 Jan-Nov	2008 Jan-Nov
Gross government debt[1]	**120.3**	**137.0**	**222.6**
Euro coins issued in name of the Treasury[2]	8.3	-	22.0
Malta Government Stocks	137.0	137.0	201.1
Treasury bills	-18.9	5.2	3.6
Local loans	0.3	0.2	-0.2
Foreign loans	-6.5	-5.1	-3.9

[1] Excluding government debt held by Sinking Funds.

[2] Following euro adoption, Maltese euro coins issued are being considered as a currency liability pertaining to the Government. A number of such coins had been issued in December 2007 in starter packs to facilitate retail transactions after the changeover date.

Source: Central Bank of Malta.

The composition of the debt continued to shift towards longer maturities, with Malta Government Stocks making up 84.0% of the total outstanding and Treasury bills, which are short-term instruments, making up 10.2% (see Table 5.4). On the other hand, over the same period, foreign loans decreased by nearly EUR 4 million to make up 3.3% of gross government debt. A new category of government debt was created as a result of Malta's entry into the euro area. Under new arrangements, the Government is responsible for the issue of euro coins in Malta, which are classified as government liabilities and are therefore included in government debt. At the end of November euro coins issued amounted to EUR 30.3 million and represented 0.9% of the gross government debt.

PART II

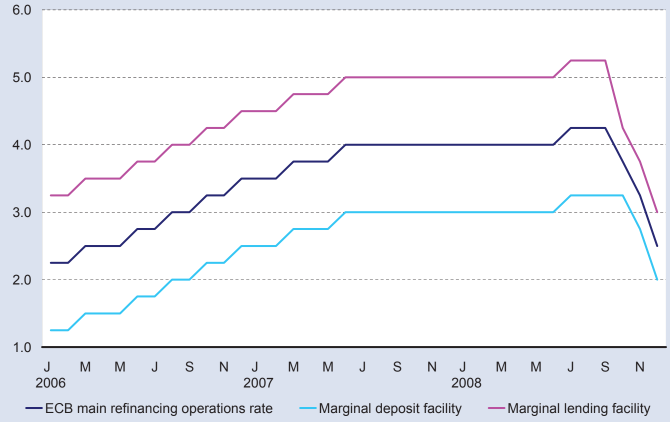
BANK POLICIES,

OPERATIONS AND ACTIVITIES

1. THE CONDUCT OF MONETARY POLICY

On 1 January 2008, Malta officially adopted the euro as its national currency and the Central Bank of Malta became a member of the Eurosystem, which comprises the ECB and the NCBs of the EU Member States that have adopted the euro. As a result, the Bank ceased to be directly responsible for monetary policy in Malta, but began to contribute to the formulation of monetary policy for the euro area through the Governor's participation in the Governing Council of the ECB. The Bank is responsible for the implementation of the Governing Council's monetary policy decisions in Malta.

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



Source: ECB.

As a member of the Eurosystem, the Bank's primary objective is the maintenance of price stability – defined as annual price increases in the euro area of below, but close to, 2% over the medium term. Price stability is widely seen as the proper goal of monetary policy, essential to encourage sustainable economic growth and a high level of employment.

During 2008 the Governing Council adjusted the interest rate on the main refinancing operations of the ECB, its main policy rate, on four occasions. During the first half of the year, the Governing Council noted that risks to price stability had risen and that inflation in the euro area was expected to remain high. Consequently, on 3 July, to counteract these inflation risks over the medium term and, at the same time, prevent broadly based second-round effects, the Governing Council increased the minimum bid rate on the main refinancing operations of the Eurosystem by 25 basis points to 4.25% (see Chart 1.1). Official rates then remained unchanged till end-September.

In October, however, following an intensification of financial market tensions and a moderation in inflationary pressures, the Governing Council, in a concerted action with other major central banks, cut the interest rate on its main refinancing operations by 50 basis points to 3.75%. Subsequently, the rate was cut by another 50 basis points to 3.25% in November and by a further 75 basis points to 2.50% in December.

Monetary policy operations

Following the adoption of the euro on 1 January 2008, the Central Bank of Malta started to implement the single monetary policy of the Eurosystem in accordance with the guidelines laid down by the ECB's Governing Council. In effect, the implementation of monetary policy in the euro area takes place in a decentralised manner, through the various NCBs of the Eurosystem.

Open market operations

Open market operations are the basic instrument used to manage the levels of liquidity in the market with a view to steering short-term interest rates close to the ECB's policy rate. The ECB has various types of open market operations at its disposal. It signals its monetary policy stance by changing the minimum bid rate on the main refinancing operations. The latter are liquidity-providing reverse transactions with a weekly frequency and a maturity, normally, of one week, which are executed according to a pre-specified calendar. Longer-term refinancing operations, aimed at providing banks with additional longer-term liquidity, are reverse transactions with a monthly frequency and a normal maturity of three months. These too are executed according to a pre-specified calendar. The Eurosystem also makes use of fine-tuning operations, which are non-regular operations to deal with unexpected liquidity fluctuations in the market. They can be either liquidity-providing or liquidity-absorbing.

During 2008, the ECB attempted to satisfy demand for longer-term liquidity through supplementary longer-term refinancing operations by providing additional three-month and six-month operations. This lengthened the average maturity of outstanding monetary policy operations. Furthermore, on 15 October, as the financial market turbulence intensified, the ECB responded by switching the auction procedure applied to its main refinancing operations to a fixed rate tender procedure with full allotment at the interest rate set on the main refinancing operations by the Governing Council. By shifting to a fixed rate tender and providing the full amounts bid, the ECB sought to ease tensions in the interbank market. At the same time, the Governing Council decided that all longer-term refinancing operations (LTROs) would be carried out through similar fixed rate tender procedures with full allotment and increased the frequency of such operations.

Over the course of 2008, the Central Bank of Malta regularly conducted open market operations, together with the other NCBs of the euro area, to implement the monetary policy decisions taken by the Governing Council.

The ECB conducted 53 main refinancing operations during the year. Maltese counterparties submitted a total of EUR 3.0 billion worth of bids, which were processed by the Bank according to the standard Eurosystem tender procedures (see Table 1.1). Of these, EUR 2.4 billion were accepted by the ECB. During the same period, the ECB carried out 28 longer-term refinancing operations, in which local counterparties submitted bids for EUR 0.7 billion and were allotted EUR 0.5 billion. During 2008, the Eurosystem also continued to offer liquidity in US dollars.[1] In the 56 dollar liquidity-providing operations conducted at various tenors, local counterparties bid for USD 3.7 billion and were allotted USD 1.2 billion. There was no participation from local counterparties in the Swiss franc liquidity-providing operations, also conducted by the Eurosystem during the year.

Table 1.1

PARTICIPATION OF RESIDENT CREDIT INSTITUTIONS IN EUROSYSTEM OPEN MARKET OPERATIONS

EUR billions

Type of operation	Amount bid	Amount allotted
Main refinancing operations	3.00	2.40
Longer-term refinancing operations		
3-month	0.46	0.30
6-month	0.17	0.12
Maintenance period	0.11	0.11
Liquidity-absorbing fine tuning operations	1.01	0.88
(TAF) Operations conducted in USD		
Overnight	0.02	0.02
7-day	0.05	0.05
28-day	1.38	0.43
84-day	1.12	0.34
USD FX Swap (7-day)	0.01	0.01

Source: Central Bank of Malta.

[1] Since December 2007, the Governing Council of the ECB had decided to take joint action with the US Federal Reserve by offering dollar funding to Eurosystem counterparties to facilitate the functioning of financial markets and to mitigate upward pressures on US dollar money market rates.

Additionally, the ECB conducted 17 liquidity-absorbing fine tuning operations and 8 liquidity-providing fine-tuning operations on an *ad hoc* basis, most of which were conducted on the last day of the maintenance period. Local counterparties only participated in liquidity-absorbing fine-tuning operations, bidding to place a total of EUR 1.0 billion in overnight deposits with the Bank and being allotted EUR 0.9 billion.

Standing facilities

During 2008 the Eurosystem also made use of standing facilities - another category of monetary policy instruments - to steer market rates, regulate liquidity in the banking system and signal the general stance of monetary policy. Standing facilities are administered in a decentralised manner by NCBs. The marginal lending facility is used to enable credit institutions to obtain overnight liquidity from the NCB at a pre-specified interest rate against eligible assets and is intended to satisfy their temporary liquidity needs. On the other hand, the deposit facility is used by credit institutions to make overnight deposits with the NCB, also at a pre-specified interest rate.

The amount deposited by resident credit institutions in the overnight deposit facility totalled EUR 8.2 billion during 2008. The build-up in deposits with the Bank was especially pronounced towards the end of the year, with EUR 5.8 billion being placed in December alone. It reflected increased risks in the interbank market, emanating from the global financial turbulence, which prompted banks to seek the safety of overnight deposits with the central bank.

At the same time, the marginal lending facility was utilised to the tune of EUR 1.0 million by the local credit institutions.

The interest rate on the marginal lending facility and on the deposit facility form the interest rate corridor, acting as the upper and lower boundaries, respectively, for the euro interbank overnight rate. While the interest rate charged on the marginal lending facility was set at 100 basis points above the minimum bid rate for most of 2008, that on the overnight deposit facility was 100 basis points below the minimum bid rate. On 9 October, however, to reduce volatility in money market rates, the ECB reduced the margin on each side of the main refinancing operations rate to 50 basis points. Both rates then moved in tandem with the main refinancing rate, ending the year at 3.00% and 2.00%, respectively.

All Eurosystem liquidity-providing operations have to be based on adequate collateral. In this regard, the Eurosystem accepts a wide range of marketable and non-marketable assets which can be used as collateral. However, to protect the Eurosystem from incurring losses in its monetary policy operations, and to ensure the equal treatment of counterparties and enhance operational efficiency and transparency, underlying assets have to meet certain criteria. In September 2008, the ECB reviewed its risk control measures to reflect the improvement in the methodological framework, the assessment of market and liquidity characteristics of eligible assets, the actual use of eligible assets by counterparties and new developments in financial instruments. The aim was to contain the risks being assumed by the Eurosystem. However, on 15 October, the ECB extended the list of assets eligible as collateral in Eurosystem credit operations to make it easier for banks to obtain liquidity.

As from 1 January 2008, the Central Bank of Malta started to implement the ECB's collateral management framework. The Bank is responsible for assessing the eligibility of assets and reporting newly issued domestic eligible securities for inclusion on the ECB's Eligible Assets Database. During 2008 the Bank assessed the eligibility of a wide range of collateral presented by domestic counterparties. As at end-December, the nominal outstanding value of eligible domestic marketable assets amounted to EUR 3.4 billion.

Following the adoption of the euro the number of banks operating in the domestic interbank market increased to 23, from six in 2007. Consequently, activity in the interbank market between domestic banks in 2008 involved a total of 212 deals, for a value of EUR 1.7 billion, as opposed to the 66 transactions worth EUR 0.3 billion which took place in 2007. More than four-fifths of the transactions which took place during 2008 were effected in the overnight tenor.

During 2008 the Central Bank of Malta contributed to the determination of the Eurosystem's liquidity needs through daily forecasts of the autonomous factors.[2]

Reserve requirements

The ECB requires credit institutions established in the euro area to hold reserve deposits with their respective NCBs. The Eurosystem's minimum reserve system aims at stabilising money market interest rates. It also contributes to the creation or enlargement of a structural liquidity shortage. The requirement for credit institutions to hold reserves with the NCBs increases the demand for central bank refinancing which, in turn, makes it easier for the ECB to steer money market rates through its open market operations.

Accordingly, each credit institution established in Malta is obliged to hold minimum reserve deposits with the Central Bank of Malta. The reserve requirement of each credit institution is determined as a proportion of its reserve base. Throughout 2007 the reserve requirement ratio amounted to 4% of the credit institutions' specified liabilities. As from the adoption of the euro, the reserve ratio applied to certain categories of deposits and debt securities issued by banks was lowered to 2%, while that on the remainder was reduced to zero. However, the minimum reserve framework of the Eurosystem enables credit institutions to make use of averaging provisions, such that compliance is determined on the basis of the average closing balances of reserve requirement accounts over the maintenance period, approximately one month. The remuneration rate paid on holdings of required reserves, which is linked to the interest rate charged on the main refinancing operations, stood at 2.00% at end-December 2008.

Reserve management

The Central Bank of Malta owns and manages reserve assets, as well as other foreign and domestic financial assets that are denominated in euro.[3] The reserve asset component, together with those of the ECB and the other NCBs of the euro area, forms part of the Eurosystem's reserves. The Bank's main investment objective is to maximise the return on its portfolio within the security and liquidity parameters approved by the Bank's Board of Directors and the Investment Policy Committee (IPC). As from 1 January 2008, the management of the Bank's reserves became subject to the accounting rules of the Eurosystem.

Furthermore, under the foreign currency specialisation framework, the Bank was responsible for managing an amount of US dollar reserves on behalf of the ECB by way of a pooling mechanism together with the Central Bank and Financial Services Authority of Ireland.[4] The value of assets transferred from the Bank to the ECB at the beginning of the year amounted to around USD 45.4 million and 10,000 troy ounces of gold. These assets form part of the pooled portfolio that is being managed by the two central banks.

Within the Bank, the management strategy relating to the Bank's own portfolio remained the competence of the IPC, which is chaired by the Governor and includes senior officials of the Bank. The IPC set investment parameters, monitored the performance of the Bank's financial assets, evaluated the implementation of investment strategies and reviewed the operational and risk framework of reserve management practices. The committee met on a monthly basis throughout 2008.

The Bank used extensive quantitative and qualitative techniques to ensure that the risk of possible losses arising from market and credit risk exposures were kept within the levels prescribed by the IPC and the Board, respectively. Against the background of the market turbulence and uncertainty that prevailed during 2008, the Bank took a series of precautionary measures. It first reduced credit exposures with a number of eligible debt issuers and bank counterparties. As the financial crisis worsened during the fourth quarter of 2008, the Bank implemented additional measures to limit its credit exposure to banks and issuers of debt instruments by lowering ceilings on amounts placed with counterparties and reducing terms to maturity.

---

[2] Autonomous factors are items on the Eurosystem's balance sheet which are not related to monetary policy instruments and are not normally under the direct control of the Eurosystem's liquidity management. These include banknotes in circulation, government deposits with the NCBs and net foreign assets.

[3] The Bank's reserve assets consist of claims on non-euro area residents denominated in foreign currency.

[4] The agreement between the two banks, which is formalised in a bilateral Memorandum of Understanding, builds upon a long-established relationship between the two institutions and certain operational similarities between them. Such arrangements to pool operational activities are contemplated in the relevant ECB guideline.

In terms of the ERM II agreement, the Bank may conduct interventions in those currencies participating in the ERM II regime.[5] No such interventions were necessary during 2008.

Following the adoption of the euro the Bank ceased to act as market maker for domestic credit and financial institutions in the foreign exchange market. Instead, these institutions traded euro for other currencies in the international currency markets. These foreign exchange transactions amounted to EUR 8.2 billion in 2008 and were mainly undertaken with credit institutions resident outside the euro area, corporations and households, and credit institutions in the rest of the euro area. Around two-fifths of the total transactions effected consisted of new swaps and other financial derivatives. While the former consisted mainly of deals with banks resident outside the euro area and cross-currency swaps, the latter were largely options in non-euro currencies carried out by a few banks with unrelated third parties. Meanwhile, foreign exchange transactions effected locally between domestic credit and financial institutions amounted to just EUR 30.7 million.

During 2008 the Bank continued to collect statistical data on foreign currency transactions and holdings for transmission to the ECB. Euro reference rates of exchange, as well as other rates of exchange, also continued to be made available to various users. During the year the Bank also provided advisory services on external financing and debt management to the Government and public corporations.

Market-making operations

In the year under review the Central Bank of Malta again acted as market-maker in the secondary market for Malta Government Stocks (MGS) and Treasury bills. In this way, the Bank provided adequate liquidity to the market and enhanced investor confidence in market trading. In line with the Central Bank of Malta Act, the Bank did not participate in the primary market for government securities and did not provide any other form of financing to the Government.

The Bank continued to publish daily opening bid prices and yields of all listed MGS, as well as daily buying and selling rates of Treasury bills. In addition, the Bank also quoted International Securities Market Association (ISMA) redemption yields on MGS on a daily basis.[6]

During 2008 the Central Bank of Malta continued to collect and analyse data on government debt so as to be able to fulfil better its role as advisor to the Government on debt management matters. Additionally, the working group on public debt management, consisting of officials from the Ministry of Finance, the Economy and Investment, the MSE and the Bank, held several meetings with international institutions in connection with preparatory arrangements regarding a review of the Government's debt management programme in the light of Malta's adoption of the euro. This included the possibility of an eventual launching of a government bond issue in European capital markets and a restructuring of the outstanding debt profile. The main objective is to ensure a smooth integration of the domestic securities market into that of the euro area.

The Financial Markets Committee (FMC), which provides a forum for the regular exchange of views and information between the Bank and all credit institutions operating in Malta on various market-related issues, met eight times during 2008. Discussions mainly revolved around the Eurosystem's monetary policy operational framework, including its collateral and risk control framework and measures taken to alleviate liquidity pressures in the euro area in the context of the international financial turmoil.

5 The European Exchange Rate Mechanism, ERM II, is an exchange arrangement that provides the framework for exchange rate policy co-operation between the euro area countries and those EU Member States that have not adopted the euro. Non-euro area Member States participating in ERM II peg their currencies to the euro at a central exchange rate, limiting exchange rate volatility. Malta ceased to be a member of ERM II upon the adoption of the euro.

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

BOX 2: THE ROLE OF THE CENTRAL BANK OF MALTA IN THE EUROSYSTEM

When Malta adopted the euro as its currency on 1 January 2008, the Central Bank of Malta automatically became a member of the Eurosystem. This event ushered in a new phase in the Bank's history, wherein the Bank, together with the other NCBs of the euro area, began to contribute to the attainment of the common goals of the Eurosystem. As a result, the Bank assumed new obligations related to the formulation of Eurosystem policies and the execution of Eurosystem tasks, while its operational framework became increasingly aligned with that of the Eurosystem.

These new responsibilities are additional to those conferred on the Bank when it became a member of the ESCB in 2004.[1]

Eurosystem objectives and tasks

Primary objective: price stability

The primary objective of the Eurosystem is to maintain price stability. This is defined as an annual rate of inflation below, but close, to 2% over the medium term. Apart from the implementation of monetary policy in the euro area, the Eurosystem is also entrusted with three additional basic tasks: the conduct of foreign exchange operations; the holding and management of the official foreign reserves of the Member States; and the promotion of the smooth operation of payment systems.

Other tasks of the Eurosystem

The Eurosystem also has the exclusive right to authorise the issuance of banknotes within the euro area and to collect the statistical information necessary for fulfilling its tasks. It is also responsible for contributing to the conduct of policies pursued by the competent authorities in charge of the prudential supervision of credit institutions and financial stability. The Eurosystem also co-operates with EU and multilateral institutions, as well as with other non-euro area NCBs, with a view to ensuring an environment conducive to financial and macroeconomic stability. Responsibility for the implementation of Eurosystem tasks is thus shared between the ECB and the NCBs.

The Central Bank of Malta's role in the Eurosystem

Participation of the Governor in the ECB Governing Council

A key responsibility that emanates from the Bank's membership of the Eurosystem is the Governor's participation in the decision-making bodies of the ECB. From 1 May 2004 until the end of 2007, the Governor only participated in the General Council of the ECB, whose members include the governors of all the EU NCBs. From 1 January 2008, the Governor also became a member of the Governing Council, which is the main decision-making body of the ECB. Apart from formulating the single monetary policy for the euro area, the Governing Council adopts guidelines and takes all the decisions necessary to ensure the performance of the tasks entrusted to the Eurosystem.

To enable the Governor to participate effectively in this decision-making process, the Bank established an internal structure that enables staff from different offices of the Bank, with expertise in specialised areas, to brief the Governor on issues presented to the Governing Council. The briefing relies on analyses conducted at the level of Eurosystem/ESCB committees and working groups (see below), as well as other information that staff obtain from other sources. Briefing sessions take place three days before each meeting of the Governing Council. Based on these internal exchanges, the Governor forms a personal view on the best way forward and communicates this during the deliberations of the bimonthly meetings of the Governing Council. This communication may also take place through written procedures in between meetings. Decisions taken by the Governing Council are generally elaborated further into policies and guidelines, setting common parameters for euro area NCBs in the execution of tasks on behalf of the ECB or the System.

[1] The ESCB is the central banking system of the EU. It comprises the ECB and the NCBs of all EU Member States. The Eurosystem is the central banking system of the euro area. It comprises the ECB and the NCBs of those EU Member States that have adopted the euro.

Participation in decision taking/advisory structures of the ESCB and the Eurosystem

The Bank directly contributes to the execution of ESCB and Eurosystem tasks through its participation in the deliberations of their internal structures. As stated above, the Governor participates in the Governing Council and in the quarterly meetings of the ESCB General Council. Bank officials also contribute to the work of a number of ESCB/Eurosystem Committees, Working Groups and Task Forces, which provide technical support and advice to the decision-making bodies.

Implementation of monetary policy

The Bank had completely aligned its monetary policy framework with that of the Eurosystem before euro entry. As a result, from 1 January 2008 domestic banks eligible to participate in Eurosystem monetary operations could do so through direct transactions with the Bank on the same terms and conditions that apply to other eligible counterparties in the euro area.

Management of foreign reserve assets

In relation to the management of foreign reserve assets, the Bank reached an agreement with the Central Bank and Financial Services Authority of Ireland for the joint management of that portion of its reserves that constituted its contribution to the foreign reserve assets of the ECB. The two authorities take collective decisions on the day-to-day foreign exchange operations that Eurosystem NCBs conduct as agents of the ECB, in accordance with the reserves management policy defined by the decision-making bodies of the ECB.

Currency issues: euro notes and coins

Upon the introduction of the euro, the Bank also assumed new obligations with regard to the issuance and analysis of euro coins and banknotes, including the detection of counterfeits. As a first step towards ensuring that the banking sector was adequately supplied with euro cash after the changeover, the Bank enhanced its forecasting techniques to estimate Malta's cash requirements and fed this information into cash production plans. The Bank also adapted the cash services it provides to the local banking community to bring them in line with the corresponding Eurosystem framework. Banks and other professional cash handlers in Malta are also required to comply with the ECB's Banknote Recycling Framework, which is intended to ensure that euro banknotes are checked for their fitness and authenticity before they are re-issued. The Bank is also responsible for examining counterfeit banknotes and coins and reporting relevant information to technical centres that report to the ECB (for counterfeit banknotes) and the European Commission (for counterfeit coins) on these matters.

Collection of monetary and financial statistics

A number of initiatives had also been pursued prior to euro entry to bring the Bank's statistical reporting up to the rigorous standards demanded by the ECB. In particular, the Bank had embarked on the compilation of additional monetary statistics and had invested in statistical databases and automated transmission systems to enable it to collect and transmit data in a more secure and efficient manner. Together with the NSO, the Bank had also developed a framework for a direct reporting data collection system based on statistical surveys and is now also working on the creation of an annual and quarterly set of financial accounts.

Payment and settlement systems

In the area of payment systems, the domestic MaRIS system was replaced by TARGET2. The latter consists of a single technical platform for payments in euro, and connects the euro area NCBs and other participants, such as financial institutions and stock exchanges, in payment and settlement systems. Apart from the Central Bank of Malta and the MSE, the main banks in Malta also participate in TARGET2. The migration to TARGET2 was completed successfully on 19 November 2007, well before Malta joined the euro area.

The Eurosystem also acts as a catalyst for change and innovation in the area of payment and settlement systems. Efforts in this area currently focus on three main projects: TARGET2-Securities (T2S), a system to improve the efficiency of Eurosystem collateral management (referred to as CCBM2) and the Single Euro Payments Area (SEPA). At the national level, the implementation of SEPA is being co-ordinated by the Bank and the MBA through the Payments System User Group, which also includes representatives of the banking community. The Bank continues to support and participate in all these initiatives endorsed by the ECB to enhance the efficiency and safety of payments and securities settlement systems.

Financial stability

The ongoing integration of European financial markets has strengthened the need for further co-operation at the EU level in the area of cross-border financial stability. Such co-operation takes place in terms of the 2008 Memorandum of Understanding (MoU) between the financial supervisory authorities, central banks and finance ministries of the EU on cross-border financial stability. The Central Bank of Malta, the MFEI and the MFSA are signatories to this MoU.

The Central Bank of Malta and the MFSA are also signatories to the 2003 MoU between the ECB, the NCBs and the supervisory authorities within the ESCB, which sets out guiding principles for co-operation in crisis situations, and the 2001 MoU on co-operation between payment systems overseers and banking supervisors.

Foreign exchange market

With the adoption of the euro, the role of the Bank as a market maker in the foreign exchange market came to an end as, unlike the Maltese lira, the euro is widely traded on international currency markets. Local banks can now access these overseas markets directly for their foreign exchange requirements. Indeed, as the euro's value against other currencies is determined by market forces without the intervention of the EU authorities, the Bank's role in relation to foreign exchange transactions has diminished considerably.

Other functions of the Bank in a local perspective

Eurosystem NCBs are also entrusted with their respective national responsibilities, as long as these do not interfere with the objectives and tasks of the ESCB. For instance, apart from participating in the operational management of the ECB's foreign reserves, the Bank continues to manage its own reserve portfolio in line with its own investment policy.

The Bank also continues to manage the Malta Clearing House, the mechanism through which cheques and other retail payments, such as money orders, are exchanged and cleared within the local banking system.

It also continues to collaborate with the MFSA to safeguard domestic financial stability. In fulfilling this shared responsibility, the Bank focuses on the overall systemic stability of the domestic financial sector, while the MFSA retains overall responsibility for the regulation and supervision of all individual credit and financial institutions. The two authorities also participate in a working group on domestic crisis management with the MFEI.

The Bank also retains its advisory role to government and continues to provide banking services to the public sector, subject to the statutory prohibition against the monetary financing of the sector.

Conclusion

Overall, membership of the Eurosystem has rendered the Bank's sphere of activities more complex and challenging. This provides it with a unique opportunity to enhance its expertise and to exploit the synergies between Eurosystem and other tasks.

2. FINANCIAL STABILITY

The Central Bank of Malta is responsible for ensuring the stability of the financial system in Malta. To this end, it works closely with the MFSA and the MFEI. In order to carry out this statutory responsibility, the Bank regularly monitors and assesses the soundness of the various components of the financial system, including the capital markets and the payments infrastructure. The Bank shares this assessment on a regular basis with the other relevant authorities.

The Bank analyses the developments and the performance of the financial sector, mainly credit institutions, in order to identify risk exposures which could make the financial system vulnerable to shocks. The analysis focuses in particular on those institutions and operations that are considered important for the domestic financial system, using both quantitative indicators and qualitative information. The Bank also analyses developments in the non-bank corporate sector and the household sector, primarily to highlight possible weaknesses that may negatively affect the financial sector. In addition, the Bank carries out periodic surveys on specific sectors, such as the real estate sector, that it deems to be of particular significance to the banks' loan portfolio. Moreover, the Bank performs stress tests to evaluate whether credit institutions have sufficient capital to withstand exceptional, but plausible, shocks. In the light of the current international financial crisis, the Bank also strengthened its stress-testing assessment of the liquidity profile of local banks. Furthermore, during the year, the Bank continued to enhance and refine its early warning indicators and its macro stress-testing capabilities.

As part of its on-going cooperation activity, the Bank discusses matters of mutual interest relating to financial stability with the MFSA in the regular meetings of the Standing Committee,[1] and with the MFSA and the MFEI within the ambit of the Domestic Standing Group[2] on matters related to the management of crisis situations. As the global financial crisis intensified, the three authorities were in continuous contact so as to monitor, evaluate and react as necessary should adverse developments have a direct impact on the domestic financial system. In this respect, and in conjunction with other EU countries, the Government, in the last quarter of the year, announced that coverage under the Deposit Guarantee Scheme would be raised to EUR 100,000 from EUR 20,000. This was in order to ensure that domestic depositors had the same level of protection as those in other EU countries.

Together with the other authorities, the Bank took steps to revise and strengthen the domestic framework for dealing with financial crisis situations in the light of the experiences gained from the current crisis. In this regard, the Bank is in the process of reviewing actions taken internationally to strengthen the financial stability infrastructure. These include the additional cross-border obligations arising from the signing, on 1 June 2008, by all EU Member States, of the Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability.

As part of its international obligations, the Bank, during 2008, continued to participate actively in the Banking Supervision Committee of the ESCB and its sub-structure. Moreover, as part of the Eurosystem, the Bank also participated in the High Level Task Force on financial crisis management and its technical working group. On the regulatory aspect, the Bank continued to be represented, together with the MFSA, on the EU Committee of European Banking Supervisors. It also continued to be actively involved in the IMF's project on financial stability indicators, which are an essential part of the Fund's Financial Sector Assessment Programme, now incorporated in the Fund's Article IV missions.

[1] The Standing Committee was established in terms of the Memorandum of Understanding (MoU) between the Bank and the MFSA signed in February 2003.

[2] The Domestic Standing Group (DSG) is chaired by the Deputy Governor of the Bank and includes a senior official from the Bank, the MFSA and the MFEI. The DSG forms part of the domestic structure under the crisis management framework.

3. CURRENCY, PAYMENT SYSTEMS AND BANKING SERVICES

Following the adoption of the euro, the Central Bank of Malta became responsible for circulating euro banknotes and for issuing euro coins on behalf of the Government. During 2008 the Bank played an active role in the cash changeover process. It was responsible for the withdrawal and disposal of Maltese lira banknotes and coins and for ensuring that the supply of euro banknotes and coins was sufficient to meet the needs of the public. It also remained responsible for ensuring that the new currency in circulation was fit for use and that any counterfeits were quickly detected.

As the authority responsible for the payment system, the Bank continued to develop the domestic payment and securities settlement infrastructure in order to enhance its efficiency. Meanwhile, as banker to the Government and to the rest of the domestic banking system, the Bank continued to provide banking services to the public sector and to credit and financial institutions in Malta.

Currency operations

The Bank was directly responsible for managing the migration to the euro and for the ensuing collection and disposal of banknotes and coins denominated in Maltese lira, the legacy currency. In addition, the Bank continued to issue currency in line with the demands of the banking system and to take in currency that was surplus to requirements. It also inspected euro banknotes and coins regularly to guarantee that a high quality standard was preserved. Banknotes and coins that were considered unfit for circulation were withdrawn.

Collection and disposal of the Maltese lira

During 2008 Maltese lira banknotes and coins continued to be collected to be destroyed. As from 1 February 2008, when the dual circulation period ended, all Maltese lira banknotes and coins were demonetised and ceased to be legal tender.[1] Legacy currency banknotes and coins were surrendered to the Bank, either through the banking system, or directly. This resulted in the collection of 25.7 million banknotes, with a face

Table 3.1

MALTESE LIRA CURRENCY COLLECTED AND OUTSTANDING

Lm thousands

	Lm20		Lm10		Lm5 & Lm 2		Coins(1)		Total	
	Coll.	O/S	Coll.	O/S	Coll.	O/S	Coll.	O/S	Coll.	O/S
Jan.	30,120.0	21,440	130,427.0	57,860	19,561.0	12,235	4,880.3	13,815	184,988.3	105,350
Feb.	8,671.3	12,768	24,481.4	33,379	2,588.0	9,647	1,432.9	12,382	37,173.7	68,176
Mar.	4,444.7	8,324	9,960.5	23,418	1,085.7	8,561	417.0	11,965	15,907.9	52,268
Apr.	2,395.2	5,929	4,780.1	18,638	783.1	7,778	360.6	11,604	8,319.0	43,949
May	155.0	5,774	573.8	18,064	69.9	7,708	30.1	11,574	828.8	43,120
June	193.8	5,580	684.2	17,380	95.8	7,612	17.8	11,557	991.6	42,129
July	165.7	5,414	437.0	16,943	62.4	7,550	17.8	11,539	682.9	41,446
Aug.	112.5	5,302	407.0	16,536	77.4	7,472	23.4	11,515	620.3	40,825
Sep.	101.5	5,200	350.7	16,185	40.7	7,432	21.4	11,494	514.3	40,311
Oct.	160.4	5,040	355.5	15,830	44.9	7,387	19.5	11,474	580.4	39,731
Nov.	109.5	4,930	356.1	15,474	45.4	7,342	12.9	11,458	524.0	39,204
Dec.	66.6	4,864	256.1	15,218	30.0	7,311	11.6	11,450	364.2	38,843
2008	**46,696.2**	**4,864**	**173,069.3**	**15,218**	**24,484.4**	**7,311**	**7,245.4**	**11,450**	**251,495.3**	**38,843**

(1) The denominations of coins consist of Lm1, 50c (cents), 25c, 10c, 5c, 2c, 1c, 5m (mils), 3m and 2m.

Source: Central Bank of Malta

[1] Maltese lira banknotes and coins will still be exchangeable at the Central Bank of Malta, free of charge, up to 1 February 2010 in the case of coins and up to 31 January 2018 in the case of banknotes. However, as from 16 June 2008, the fourth series of Lm2 and Lm5 banknotes, both issued on 17 March 1986, and which ceased to be legal tender on 15 June 1998, were no longer exchangeable at par at the Bank.

value of Lm244.2 million, which formed part of the 58.4 million banknotes, with a face value of Lm533.0 million, that were destroyed during the year. The amount destroyed also included banknotes that had been collected in 2007, ahead of the changeover. Furthermore, 270 tons of coins, with a face value of over Lm7 million, were collected and prepared for disposal. Altogether, the Bank collected Maltese lira banknotes and coins with a total value of Lm251.5 million, equivalent to EUR 585.8 million (see Table 3.1).

In addition, following euro adoption, statistics on currency in circulation were regularly collected and forwarded to the European Commission and the ECB. Early in the year, Flash Eurobarometer Reports were issued by the European Commission to monitor the cash changeover process and the use of the euro in everyday payments. These Reports were issued daily during the first week of January 2008, and weekly thereafter, until 26 January 2008. The full report – *"Dual circulation period in Cyprus and Malta - Daily summaries about the monitoring of the cash changeover process among the general public"* – was published in April 2008.

As at December 2008, Maltese legacy notes and coins that were still in circulation had a face value of Lm38.8 million, equivalent to EUR 90.5 million. The Lm10 banknote accounted for 39.2% of Maltese lira currency still in circulation, reflecting the fact that it was the most popular banknote. This was followed, at 29.5%, by coins, and, at 12.5%, by the Lm20 banknote, with the remaining amount being distributed among the two other banknotes in roughly equal proportions.

Circulation of notes and coins

The value of euro notes and coins which the Bank had frontloaded to the commercial banks prior to the changeover was formally recognised and shown on the Bank's balance sheet as a monetary liability on 1 January 2008. Starting with a net issue of EUR 456.9 million in January 2008, currency issued and outstanding increased by over 25% in the first four months of the year. Over the subsequent six months, however, the outstanding amount of currency issued stabilised, only to start picking up again in the last three months of the year, to reach EUR 715.1 million by the end of December (see Table 3.2).[2] The extraordinary inflow of notes to the Bank in January represented the return of excess banknotes that had been frontloaded to the banking system in 2007.

Table 3.2

CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE BANK IN 2008

EUR thousands

	Notes and coins			
	Issued	Paid in	Net issue	Issued and outstanding[(1)]
January	740,027	283,171	456,856	456,856
February	110,120	55,380	54,740	511,594
March	105,037	60,047	44,990	556,586
April	109,858	89,687	20,171	576,756
May	107,202	93,212	13,990	590,747
June	104,139	87,464	16,675	607,421
July	119,034	109,251	9,783	617,205
August	98,353	105,334	-6,981	610,210
September	110,273	109,201	1,072	611,282
October	130,923	98,791	32,132	643,413
November	103,535	83,429	20,106	663,519
December	146,939	95,378	51,561	715,080
2008	**1,985,440**	**1,270,345**	**715,095**	**715,080**

(1) Includes currency in circulation and currency held by the banking system.

Source: Central Bank of Malta

2 These data do not include the Maltese lira banknotes and coins that were still in circulation.

In the course of the year, the Bank signed a cooperation agreement with the central banks of Cyprus, Luxembourg, the Netherlands and Slovenia for the joint procurement of euro banknotes. By allowing for combined, larger orders of banknotes, this agreement offered the participating central banks scope for efficiency gains.

During the year the Bank examined a total volume of 83.9 million banknotes. These consisted of 35.0 million euro banknotes with a face value of EUR 574.7 million and 48.9 million Maltese legacy banknotes with a face value of Lm457.1 million. Nearly 13% of the euro banknotes examined were deemed to be unfit for re-issue and were destroyed, together with all the Maltese lira banknotes collected. In addition, approximately 67 million Maltese legacy coins and 11 million euro coins, with a total face value of around EUR 17 million, an amount which was roughly eleven times that of the previous year, were also examined in 2008. This substantial increase was mainly due to the fact that all the Maltese lira coins surrendered were processed in readiness for disposal and 11 million one cent coins, purchased in bulk, had to be processed before being issued.

Furthermore, the Bank took part in a regular Eurosystem-wide bank note quality exercise and undertook the first Eurosystem checking procedure to audit the quality of banknotes found suitable for re-issue.

Commemorative coins

A euro collector coin set issued in late 2007 continued to sell early in 2008. The set consisted of the 8 Maltese euro coins, bearing the Maltese national side, in bright uncirculated condition. Later in the year, a numismatic coin depicting the main entrance of the Auberge de Castille was issued in gold and in silver. The coin was part of a European programme with the theme "Cultural Heritage".

Anti-counterfeit measures

On 27 October 2008, following a period of public consultation, the Bank issued a directive - Directive No. 10- to regulate the redistribution, sorting and reissue of euro banknotes. The directive prohibits banks, financial institutions and professional cash handlers from reissuing any banknote they receive from the public without first subjecting it to stringent authenticity and quality tests according to Eurosystem standards. This should ensure that the integrity of euro banknotes in circulation is preserved, hence contributing to the maintenance of public confidence in the currency.

Over the year, the Bank's Currency Surveillance Unit processed over 3000 banknotes and coins suspected to be counterfeit. Bank staff gave expert evidence in court related to currency counterfeiting on various occasions.

Payment and securities settlement systems

In terms of the Central Bank of Malta Act, the Bank is responsible for the regulation and oversight of the payment and securities settlement systems in Malta. In November 2007, as part of its integration into the Eurosystem, the Bank had joined TARGET2, the payment system used by the Eurosystem for the settlement of central bank operations, large-value euro interbank transfers and other euro payments.

At the same time, as from 1 January 2008, MaRIS, which was the only payment system available in Malta for the settlement of interbank transactions in Maltese lira, ceased to operate. Whereas domestic credit institutions used to participate directly in MaRIS, they became indirect participants in TARGET2, accessing the system through correspondent banks abroad. During 2008 the only direct participants in TARGET2 in Malta were the Central Bank of Malta and the MSE.

The value and amount of transactions processed through TARGET2 in 2008 are not directly comparable with those effected through MaRIS in 2007, as the former includes only transactions processed on behalf of direct participants. Moreover, the architecture of TARGET2 is such that participants' data capture both domestic and cross-border transactions, whereas MaRIS did not have a cross-border element. The value of payments processed through TARGET2 in Malta during 2008 amounted to EUR 26.2 billion.

Apart from collaborating with the Eurosystem in providing the TARGET2 payment service, the Bank also worked on a number of related projects during 2008. These included work on the implementation of the TARGET2 Securities system and the CCBM2 system, which is a new collateral management system for counterparties.

The Bank also continued to manage the Malta Clearing House, through which most cheques issued in Malta are settled. During the year the amount of cheques cleared fell by 3.3% to 5.8 million, while their value rose by 0.9% to EUR 7.3 billion. The daily average number and value of cheques processed in 2008 amounted to 23,049 and EUR 29.2 million, respectively.

In January the Single Euro Payments Area (SEPA) went live, and European banks formally launched the first SEPA payment products for credit transfers. SEPA's main aim is 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. It also seeks to make retail cross-border payments as safe as domestic payments and with similar charges. The Bank and the domestic banking sector launched the project with the introduction of the new SEPA Credit Transfers service, which all Maltese banks are now able to offer. During the year the Bank also issued a public consultation document on the implementation of the Payment Services Directive, which will provide the legal basis for payment services provided under the SEPA initiative. The Bank, together with a number of national organisations, also organised activities with the aim of raising SEPA awareness within the community. Moreover, through interaction with the Eurosystem and the European Commission, the Bank participated in the redrafting of a number of enabling directives. The Bank also introduced SEPA compliant services for its own customers.

In 2008 the Bank initiated a process of consultation on a new strategy to develop the retail payments market in Malta. The relevant documentation was published on the Bank's website. The Bank was also involved in the revision of EU legislation in this area, notably on cross-border payments in euro, financial collateral arrangements and settlement finality in payment and securities settlement systems. Oversight also evolved over the year, with standards, assessments and methodologies being aligned with those in place in other European central banks to oversee the operating systems more effectively.

Banker to the public sector

The Bank continued to maintain accounts for the Treasury, other Government departments and a number of public corporations. It also provided various foreign exchange facilities to Government departments and public sector entities.

During 2008 the number of cheques drawn on the Bank by the Government and presented for settlement by the rest of the banking system continued to fall, decreasing by 2.5%. The value of cheques also dropped, by 2.1% over 2007, to EUR 907.3 million. In contrast, the volume of payments made by direct credit rose by 0.6% during the year, with the value of such payments increasing by 9.3% to EUR 959.1 million. The value of payments of pensions and social security benefits through direct credits continued to account for most of the increase, but that of payments of dividends on Malta Government Stocks fell.

Following the adoption of the single currency the Bank, as expected, experienced a decline in the use of its foreign exchange services, particularly as regards the sale and purchase of foreign exchange and travellers' cheques. Consequently, in the latter part of 2008, the Bank ceased trading in travellers' cheques. Most foreign exchange transactions were carried out using SWIFT transfers, the standardised service for transferring payments between banks and other financial institutions overseas. The value of foreign exchange receipts processed by the Bank on behalf of the Government and public corporations fell, to EUR 343.3 million, from EUR 657.4 million in 2007. Foreign exchange payments on behalf of the Government also fell, to EUR 312.8 million, from EUR 609.3 million in the previous year.

The Bank continued to be responsible for effecting payments in connection with the Government's external debt servicing. In 2008 capital repayments amounted to EUR 7.2 million, up from EUR 5.8 million in the previous year. At the same time, interest payments on outstanding foreign loans declined to EUR 5.3 million, from EUR 5.6 million in 2007.

Banker to the banking system

As banker to the rest of the banking system the Bank provided credit institutions with deposit facilities. Credit institutions maintain balances at the Bank to meet the reserve deposit requirements laid down by the Eurosystem. The Bank continued to manage the Investor Compensation and the Depositor Compensation Schemes, providing financial, accounting and other related services.[3] As the designated custodian of assets under the Insurance Business Act of 1998, the Bank also held in its name, on behalf of insurance companies, certain specified assets backing funds guaranteed by the latter.

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

4. INTERNAL MANAGEMENT

Administration

Board of Directors

The Board of Directors is responsible for the policy and general administration of the Bank except for certain functions which the Bank carries out directly in terms of the provisions of the EU Treaty and the Statute of the ESCB.

In 2008 the Board was composed of Michael C Bonello, Governor and Chairman, David A Pullicino, Deputy Governor and Victor Busuttil, Antoinette Caruana and Charles J Falzon as non-executive directors. Ms Caruana was appointed on 14 April 2008 for a period of five years, replacing Philomena Meli, whose term expired on 20 January. Mr Bonello and Mr Pullicino were re-appointed as Governor and Deputy Governor for a period of five years with effect from 1 October and 1 September 2008, respectively. Stephanie Sciberras served as Secretary to the Board. The Board met twelve times during the year.

Audit Committee

During 2008 the Audit Committee, which is established in terms of article 13 of the Central Bank of Malta Act, was composed of Victor Busuttil 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 Committee held nine meetings during 2008, including two with the external auditors. During these meetings it discussed various topics, including the quarterly internal audit reports of the Director responsible for internal audit, the six-monthly risk assessment reports and the appointment of the external auditors. The Committee also discussed the activities of the external auditors to ensure comprehensive audit coverage as well as the statutory audit of the Bank's financial statements within the ESCB context. It also reviewed amendments to the Internal Audit Charter, the introduction of a new Anti-Fraud Policy, the annual internal audit plan as well as risk management issues. During the year the Audit Committee commissioned an audit firm to assess the Bank's internal audit activity in accordance with the requirements of the ECB. Their report was submitted to the ESCB Internal Auditors Committee.

Management

The Executive Management Committee (EMC) is responsible for advising the Governors on administrative matters. It includes the Governor as Chairman, the Deputy Governor and the five Division Directors. During 2008 the Committee held 48 meetings.

In February, the Bank organised a series of presentations to inform employees on the Bank's new role within the Eurosystem, highlighting the changes to the Bank's Mission Statement, particularly the primacy accorded to price stability, the Bank's status as an autonomous institution and its obligations with regard to transparency and public accountability.

During the course of the year, members of the senior management participated in a number of meetings abroad on topics pertaining to the Bank's functions and operations. The Bank also participated for the first time in an exercise aimed at building an inventory of functions under the direction of a Eurosystem working group on organisational analysis. This is a biannual stock-taking exercise on the deployment of staff members within the Eurosystem, including the ECB, analysed on the basis of the functions they carry out.

Governor's official activities in Malta

In January the Governor delivered the welcome speech during the state celebrations to mark the occasion of Malta's adoption of the euro. In April he gave a presentation on the Bank's *Annual Report 2007* at a business breakfast organised by the Business Weekly newspaper. Later that month the Governor gave a similar presentation to trade unionists at a seminar organised by the Reggie Miller Foundation. In November the

Governor was invited by the Public Accounts Committee to brief it on the international financial crisis and its implications for Malta. Later in the year the Governor was once again the main speaker at the annual dinner of the Institute of Financial Services. He delivered a speech on the global financial turmoil, its consequences for Malta and policy responses to it.

In the course of the year, Mr Bonello also gave a number of interviews to the local and foreign media.

Governor's activities overseas

On joining the euro area on 1 January 2008 the Governor took his place on the Governing Council of the ECB. He participated in almost all Governing Council meetings held during the year as well as the quarterly meetings of the General Council. In June the Governor attended, as an observer, the Annual General Meeting of the BIS in Basel, while in October he participated in the IMF/EBRD Annual Meetings in Washington DC. In addition, the Governor accompanied the Minister of Finance, the Economy and Investment to two informal ECOFIN meetings, one held in Nice in April and the other in Ljubljana in September.

In January, Mr Bonello was invited by the Cypriot Monetary Authorities to participate in state celebrations marking the introduction of the euro in Cyprus. Later that month he travelled to London to give a presentation on the Maltese economy and the euro adoption process to senior officials of a number of leading banks and financial institutions.

On the tenth anniversary of the establishment of the ECB the Governor attended the official ceremony in Frankfurt in June. In July the Governor travelled to Dublin for discussions with the Irish Central Bank and Financial Services Authority. In the same month, Mr Bonello participated in the fourth Euro-Med seminar jointly organised by the ECB and the Central Bank of Egypt in Alexandria. On the tenth anniversary of the establishment of the Banque Centrale du Luxembourg Mr Bonello was a keynote speaker at the launch of the Malta Numismatic Exhibition.

Legal issues

During the year the Bank also issued Directive No. 10 on the detection and removal of counterfeit and damaged banknotes from circulation. The directive implements the Eurosystem Recycling Framework, which lays down provisions regarding euro banknote recycling by credit institutions and other professional cash handlers.

The Bank's legal staff participated in the workings of the Payment Services Directive Transposition Group of the European Commission, which works on the harmonised transposition of the Payments Services Directive, and in those of the Euro Counterfeits Experts Group of the European Commission (ECEG).

During the year, the Bank also co-operated with the MFSA, the MFEI 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.

Economic analysis and research

Bank staff continued to analyse economic and financial developments in Malta and abroad. The adoption of the euro brought about a shift in focus away from the domestic monetary policy process and towards monetary policy decision-making in the euro area. Bank staff provided key inputs into the monetary policy decision-making process by preparing reports for the Governor on economic and financial developments in the euro area ahead of his participation in Governing Council meetings. Analyses and forecasts of the Maltese economy were also undertaken regularly for the Governor, the Board of Directors and the Bank's senior management. The Bank publishes its analysis of economic developments in Malta and abroad in its *Quarterly Review* and *Annual Report*. During the year, the content of the Bank's publications was revised to give greater weight to developments in the euro area.

During the year Bank staff contributed to a Eurosystem report assessing developments in housing finance in the euro area and participated in a task force to measure potential output in the euro area. The Bank also began to participate fully in a harmonised survey of bank lending conditions that is carried out on a quarterly basis across the euro area. A study on the legal framework underpinning the euro was also published. Other work was undertaken in the area of labour market developments, wage indexation and the relationship between output composition and competitiveness.

The Bank continued to prepare its main macroeconomic projections within the context of the Eurosystem's Broad Macroeconomic Projection Exercise on a bi-annual basis, and the Narrow Inflation Projection Exercise on a quarterly basis. These serve as inputs to the production of euro area-wide projections. In addition, fiscal forecasts continued to be prepared twice a year for the General Council as part of the regular ESCB forecast exercises.

Statistics

Following the adoption of the euro, the Central Bank of Malta became subject to a legal obligation to compile statistics for the needs of the ECB and the ESCB. It began to transmit a considerable amount of data on a regular basis to the ECB. At the same time, the Bank continued to collect, compile, disseminate and publish a wide range of monetary, financial and other economic statistics for internal policy, analytical and research purposes and for release in its publications and website. The dissemination of statistics was further improved through the uploading of additional data on the Bank's website.

The adoption of the euro also had consequences for the methodologies used in preparing salient statistics relating to Malta. These were explained in a note entitled *'Presentation of statistics relating to Malta following adoption of the euro'* published in the *Quarterly Review*.

Apart from its obligations to provide statistical data to the ECB, the Bank also continued to provide various statistics to the IMF, including data for the Fund's internal analysis and statistics in line with the standards set by the Fund's General Data Dissemination System (GDDS) and the Data Quality Assessment Framework (DQAF).

As from January 2008, the Bank began transmitting to the ECB additional data on balance sheet stocks, flows and MFI interest rates (MIR). Maltese MIR[1] statistics were released for the first time during the year, and an article explaining their compilation was published in the *Quarterly Review*. Further enhancements were also carried out to the collection and compilation of data on Malta's securities issues.

As required by a new ECB Regulation on investment funds, the Bank is bound to collect and compile harmonised data on resident investment funds and to start submitting these to the ECB from early 2009. A number of meetings were held during the year with representatives of the institutions concerned, the MFSA and the NSO, to discuss the new reporting arrangements. Non-harmonised data on insurance companies were also transmitted to the ECB. Meanwhile, the Bank worked closely with the MFSA on the streamlined reporting required from insurance companies in line with the recommendations of an *ad hoc* euro area task force.

During 2008 the Bank continued to work on the compilation of financial accounts statistics, and for the first time it transmitted to the ECB the full set of quarterly financial accounts of the Maltese economy. The Bank also continued to liaise with the ECB to extend the capabilities of the ECB's Statistical Data Warehouse so that this can be deployed by the Bank as its own database.

In accordance with ECB reporting requirements for new euro area members, the Bank also prepared and transmitted to the ECB data on Malta's balance of payments, its international investment position and its international reserves.

Work also proceeded on the data quality management of Malta's securities issues statistics stored in the ECB's centralised securities database (CSDB).

[1] Monetary Financial Institutions' (MFIs) interest rate (MIR) statistics in line with Regulation (EC) No. 63/2002 of the ECB of 20 December 2001 (as amended) cover a broad range of interest rates that credit institutions apply to deposits from, and loans to, households and non-financial corporations (ECB/2001/18).

The Bank, in cooperation with the NSO, continued to transmit government finance statistics to the ECB. It also continued to provide such data to the IMF and, for the first time, also transmitted higher frequency statistics. The Bank continued to transmit to the ECB a range of macroeconomic statistics and continued work on the compilation of an index of administered consumer prices. The Bank also revised its surveying methodology to estimate negotiated wage inflation in Malta and sent the results to the ECB. Moreover, in conjunction with the NSO, the Bank participated in an ECB project on business demography indicators and began preparations to conduct a Eurosystem survey on euro area household finance and consumption, which aims to gather information on the assets and liabilities of households.

Throughout the year Bank officials regularly participated in ESCB committees, working groups and task forces and in the work of the Committee on Monetary, Financial and Balance of Payment Statistics (CMFB). The Technical Committee on Financial Statistics continued to meet during the year. The Committee, which is chaired by the Bank, includes representatives of reporting agencies in the financial sector. The committee ensured that there was a smooth transition to new reporting systems and the enhancement of existing ones. Together with the NSO and the MFEI, the Bank continued to participate in the Government Finance Statistics Committee, which was set up to improve standards in the compilation of government finance statistics and to calculate government deficit and debt levels under the Excessive Deficit Procedure notification.

Internal audit

The objective of the Bank's internal audit function is to provide an independent assurance and consultancy to senior management, the Audit Committee and the Board of Directors. Separate assurances are also provided to the ESCB through work undertaken on behalf of the ECB's Internal Auditors Committee (IAC).

The Internal Audit Plan for 2008 focused on those business areas of the Bank most affected by the euro changeover. Its aim was to provide assurance that risks brought about as a result of the changeover were being managed efficiently and that newly designed or modified control mechanisms were working as effectively as intended.

During 2008 the Bank's internal auditors concluded twenty-three risk-based audit engagements with the objective of examining, evaluating and reporting on the adequacy of systems of internal control and risk management and governance processes. Five of these audits were conducted on behalf of the ESCB. The coverage included information systems, finance, payment systems, currency issue, market operations, banking operations, statistics and the procurement process. Several procedural audits were also undertaken, together with a number of follow-up audits to ensure the implementation of recommendations made both at the local and at the ESCB level.

The Bank revised its Internal Audit Charter and its Internal Audit Manual to further align them with the Institute of Internal Auditors (IIA) Standards and best practices. As in previous years, its internal auditors examined and evaluated the Management Letter of the external auditors for 2007 in consultation with the respective Divisions of the Bank and made recommendations to the Board on its findings through the Audit Committee.

During the year an external reviewer evaluated the Bank's internal audit function. This evaluation, which was undertaken in accordance with the requirements of the ECB, had two objectives. The first was to provide assurance on the level of conformity with the IIA International Standards for Professional Practice of Internal Auditing and Code of Ethics. The second was to assess compliance with the ESCB-IAC Audit Manual for the assurance and consultancy work undertaken on behalf of the ESCB-IAC. The review covered the organisational structure of the internal audit function, the availability of resources, work practices and technology, and quality and performance management.

Risk assessment

The euro changeover brought about new business processes and various changes to existing work practices. A Bank-wide exercise was undertaken early in the year to ensure that new or changed procedures were reflected in the Bank's policies and procedures and business continuity plans.

The Bank continued to develop its business continuity management framework during the year. To this effect, it sought to strengthen its recovery capabilities by enhancing and testing its continuity plans and also by carrying out a crisis scenario exercise in terms of the Bank's Operational Crisis Management Policy, which seeks to resolve internal operational crisis situations should they occur. The Bank also participated in the three meetings of the Forum on Pandemic Preparedness in the Financial Services Sector, which was set up jointly with the MFSA, to exchange information on pandemic preparedness and to collaborate with financial institutions in this regard.

In further extending its collaboration with other NCBs on operational risk and business continuity management, the Bank continued to participate in the work of the International Operational Risk Working Group. At the ESCB level, the Bank participated actively in the work of the Task Force on Operational Risk and Business Continuity Management. It contributed to the formulation of operational risk (ORM) and business continuity (BCM) management frameworks, which will be applied to the tasks and processes of the various committees of the ESCB during 2009.

Data protection

Through its Data Protection Officer, the Bank continued to update its inventory of all personal data used within the Bank and to notify the Data Protection Commissioner accordingly. The Data Protection Officer also worked closely with the Bank's business areas on issues relating to the processing of personal data, while keeping staff members informed on matters relating to data protection.

Human resources

The Bank's staff complement as at end-December 2008 was 315 full timers and 10 part timers, compared with 314 full timers and 16 part timers a year earlier. Taking into consideration justified absences, resignations and recruitment, the staff complement in terms of full-time equivalents was 298, down from 303 in 2007.

Over the year, the Bank recruited six Economics Officers and one Security Officer, whereas six part-time employees had their work contract converted to a full-time contract. At the same time, ten employees resigned from the Bank, whereas two retired on reaching pensionable age. Seven employees were seconded to other institutions, two at the MFEI, one at the Office of the Prime Minister and another on a long-term contract with the ECB. In addition, three members of staff took up short-term employment with the ECB in the areas of legal services, human resource management and organisational issues, and information systems.

The Bank, once again, offered temporary summer employment to seven University students. It also participated in a scheme administered by the Malta College of Arts Science and Technology (MCAST) and offered work placements to three students. In addition, the Bank offered a three-week work placement to two students reading for the Diploma in Library and Information Studies at the University of Malta.

During the year, the Bank also offered three bursaries in connection with research projects on European monetary integration, the impact of the euro changeover on prices in Malta and the current global financial crisis. The Bank also approved participation in the External Work Experience Scheme of the ESCB, which is meant to promote the exchange of staff between ESCB central banks through the secondment of staff members on a temporary and reciprocal basis.

The Bank concluded a three-year collective agreement with the General Workers' Union, which represents non-clerical staff. It also renewed its agreements with the Richmond Foundation and Caritas Malta for a period of one year.

Training and development

The Bank continued to invest in the training of its human resources, both through in-house programmes and through external courses organised by local and foreign institutions.

Table 4.1
STAFF TRAINING

Type of training	Number of courses/seminars		Number of participants	
	2007	2008	2007	2008
In-house	28	31	609	511
External	126	124	265	280
Local	82	71	221	220
Overseas	44	53	44	60

Source: Central Bank of Malta

As shown in Table 4.1, a large number of employees participated in external courses on a wide range of topics related to central banking. The number of external courses attended remained broadly unchanged compared with the previous year, but the number of participants increased, particularly as regards overseas training.

Indeed, as in previous years, Bank officials continued to attend seminars and conferences organised by the ESCB. In 2008 the Bank's participation in these events focused on financial stability issues; the management of risk; economic modelling and forecasting; monetary and financial statistics; and accounting and auditing. The Bank also had recourse to the advice of experts from the ECB and other ESCB members by means of bilateral discussions. These focused on asset and liability management, the reserves management process and related reporting issues, and documentation management systems.

Meanwhile, 31 different courses were delivered in-house in the areas of management development, induction programmes, statistics, economic analysis and econometrics, accounting and auditing, IT, security, and health & safety.

In 2008 visiting lecturers and consultants from a number of institutions delivered talks on issues relating to monetary statistics, risk modelling and swaps and bond pricing. In April a Stress Management Programme was organised by the Richmond Foundation for the senior management group, while in October ten staff members from the executive grades attended an Outbound Development Programme organised by the Armed Forces of Malta. The programme was designed to enable participants to assess their personal leadership and team building skills.

In October all employees attended the annual Strategic Planning Seminar, the aim of which was twofold: to provide an overview of the progress achieved by the Bank in integration within the Eurosystem following the adoption of the euro at the beginning of the year; and to assess the current position and map out the strategic objectives for 2009 and beyond. During this seminar a senior official from the Banque de France delivered a presentation on the French central bank's sustainable development strategy.

Academic and professional courses

In 2008 the number of employees benefiting from the Bank's study scheme continued to increase. Eleven staff members completed their course of studies, while a further 32 embarked on approved courses on a

Table 4.2
ACADEMIC AND PROFESSIONAL COURSES
Number of employees

Type of programme	Programmes completed		Programmes being pursued	
	2007	2008	2007	2008
Postgraduate courses	10	4	16(1)	21(1)
Honours first degree courses	7	2	9	10
Diploma courses	4	5	6	3

(1) Includes two employees on unpaid study leave abroad to pursue doctoral programmes.
Source: Central Bank of Malta

part-time basis. Another two employees were on unpaid leave to follow doctoral programmes abroad (see Table 4.2).

Gender equality and discrimination
During 2008 the Bank's Gender Equality Working Group regularly assessed the Bank's compliance with relevant legislation on gender equality. It also continued to monitor adherence with best practices and made recommendations to senior management in this regard. It also kept regular contact with official entities working in this field.

Health and safety
The Bank's internal Health & Safety Committee was responsible for drawing up new Health & Safety Policies & Procedures during 2008.

Premises, procurement and security
During the year, refurbishment works were carried out in the Bank's canteen areas. In the premises at St James' Counterguard, the floor space was designed in such a way as to cater for a first aid room, a storage room for IT equipment, and another room for storage purposes.

Furthermore, during the year, Bank officials began to attend meetings of the Eurosystem Procurement Coordination Office (EPCO). EPCO aims at allowing member central banks to benefit from efficiencies in the purchase of supplies and services through pooling and at facilitating the adoption of best procurement practices within the Eurosystem.

The Bank also drew up a green strategy paper, containing proposals for a number of environmentally-friendly measures.

During the year, and consequent to the adoption of the euro, the Bank stepped up its participation in the ECB's Security Working Group, which deals with the security aspects related to the production, processing, storage and transport of banknotes. It also participated in the Heads of Security Forum, which is composed of security experts from euro area central banks and other G-10 countries.

Information technology
On 1 January 2008, the Bank's core systems in euro went live as planned. Throughout the year further software enhancements and new hardware were installed to cater for the Bank's new status as a member of the Eurosystem. The Bank also implemented SWIFT security updates to provide a simpler yet effective security arrangement between the Bank and its SWIFT counterparties. Furthermore, the Bank's IT staff worked on the rollout of the initial SEPA payment setup.

In 2008 the Bank participated in the Information and Document Management System (DARWIN) of the ECB. This system, which is available to all NCBs, acts as a central repository for ESCB-related information and provides users with a tool for further collaboration. Indeed, in April Bank officials visited the National Bank of Belgium to evaluate their Information Management System regarding ECB Governing/General Council document management. In the course of the year, Bank officials participated in task forces related to the CoreNet Refresh and ESCBNet Optimisation ESCB projects. In fact, in September the Bank hosted two meetings of these task forces.

Information and public relations
The Bank continued to communicate information about its operations and other activities through regular press releases, its publications and its website. In particular, during the first quarter of 2008 the Bank was responsible for communicating all information related to the euro cash changeover process. This it did by distributing published material either directly or through the local media. In the early part of the year the Bank also launched an awareness campaign to remind the public that the Lm2 and Lm5 banknotes (fourth series) would no longer be exchangeable at the Bank as from 16 June 2008.

During the year, staff members began participating fully in the Eurosystem structures and sub-structures relating to communications. A new Task Force on Eurosystem Crisis Communication Framework was set up and the Bank participated in an *ad hoc* ECB Cultural Days Co-ordinators Group and in meetings of the Directors of Communication organised by the European Commission.

In 2008 the Bank introduced a new format for its publications and continued to upgrade its website with the introduction of more educational material and further alignment with other Eurosystem websites.

The Bank also handled various requests for information and interviews from both the local and the international media. In the latter case, there was a considerable increase in interest following Malta's entry into the euro area.

Library

The Central Bank of Malta Library continued to enhance its print and electronic collections in specialised areas such as banking, finance, and economics. Library facilities were provided primarily to the Bank's staff, though selected services were also made available to external users, particularly students involved in research work.

In line with its collection development policy, the Library continued to be upgraded with new acquisitions of books, periodicals, and other specialised publications related to central banking. It also maintained its comprehensive newspaper clippings service. The Bank's Library continued to serve as a depository for publications issued by international organisations, such as the IMF, the World Bank Group and the EBRD.

Cultural and educational activities

The Bank was actively involved in the state celebrations that were hosted by the Maltese Government for the introduction of the euro. These were held on 12 January at the Mediterranean Conference Centre. Besides the Prime Ministers of a number of euro area Member States, the event was also attended by the President of the ECB and several members of the ECB Governing and General Councils.

To mark the 40th anniversary of its establishment, the Bank organised a number of activities. It launched a new logo and also published a commemorative booklet entitled *"The Central Bank of Malta – The Building and its History".* Then, in late September, it organised an orchestral concert by the Malta Philharmonic Orchestra under the patronage of the President of the Republic. In December the Bank donated a number of publications to all secondary schools and public libraries in Malta.

The Bank also participated in various events held to commemorate the tenth anniversary of the ECB/Eurosystem. These included the organisation of a concert, jointly with other NCBs, the loan of paintings from the Bank's collection for the ECB's Cultural Days programme, and participation in cultural and sports events. The Bank also set up a panel exhibition in its foyer and held an open day in June. In addition, in December the Bank loaned a selection of Maltese coins from its Currency Museum to be displayed at the Banque Centrale du Luxembourg as part of the latter's tenth anniversary celebrations.

Educational visits to the Bank were again organised in 2008. During the first half of the year the emphasis was on the various aspects of the euro changeover process and the changes implemented by the Bank to comply with its new role within the Eurosystem. Later in the year, the visits concentrated on audiovisual material related to the Eurosystem's role and functions.

In September the Archbishop of Malta, Mgr. Paul Cremona, made a pastoral visit to the Bank, and in November the Bank and the Chinese Cultural Centre co-hosted a talk by Professor Li Yi'ning of Beijing University entitled *"Thirty Years of China's Reform and Opening Up"* at the Malta Chamber of Commerce.

As in past years the Bank continued to support the Community Chest Fund and other philanthropic organisations through donations and sponsorships.

5. INTERNATIONAL RELATIONS

With the introduction of the euro in Malta on 1 January 2008, the Central Bank of Malta became a member of the Eurosystem, which includes the ECB and the NCBs of the euro area countries. This implied that the monetary policy stance adopted by the ECB for the euro area would apply to Malta as well. Consequently, the Governor of the Bank took his seat on the Governing Council of the ECB and began to be directly involved in the monetary policy decisions taken by the ECB.

In assuming its new status as a Eurosystem central bank, the Central Bank of Malta was obliged to contribute to the implementation of the tasks of the Eurosystem in accordance with the Treaty and the Statute of the European System of Central Banks and of the European Central Bank (the Statute). The main tasks are detailed below.[1]

In the course of the year, the Bank continued to fine tune its procedures and operating systems to ensure their conformity with those of the Eurosystem. In the process, it intensified its relationship with the ECB and the other NCBs of the euro area. The Bank also continued to strengthen its relationship with the other NCBs of the ESCB and with international financial institutions, such as the IMF, the World Bank Group and the EBRD.

European System of Central Banks

According to the principle of decentralisation, which is one of the key tenets of the Eurosystem, those tasks that can be carried out more efficiently through the NCBs of the euro area, rather than centrally by the ECB, should be executed accordingly. To this end, as documented in the previous edition of the Bank's *Annual Report*, most of the preparations necessary for the Bank to achieve the standards required of Eurosystem members were completed by the end of 2007. As a result, the Bank's integration with the Eurosystem at the start of 2008 proceeded smoothly.

With effect from 1 January 2008, a number of guidelines and other legal instruments of the ECB that until then did not apply to the Bank and its counterparties due to its status as a non-euro area central bank became binding. Those tasks falling within the scope of these guidelines were executed within the parameters established therein. The Bank also became subject to the regular monitoring and oversight processes carried out by the Governing Council, and to the related infringement procedures.

On joining the Eurosystem, in accordance with the relevant provisions of the Statute, the Central Bank of Malta paid up the remainder of its subscription to the capital of the ECB, amounting to just over EUR 3.3 million. At the same time, it also transferred its contribution to the foreign reserve assets of the ECB, which was equivalent to almost EUR 36.6 million. These transactions took place in early January 2008. During that month, the Bank also became a party to the Central Bank Gold Agreement, which sets limits on annual sales of gold by signatory central banks.

In the course of the year, the Governor participated actively in all the ECB Governing Council meetings during which monetary policy decisions were taken. Governing Council meetings are normally held twice a month, with the first meeting focusing on the monetary policy stance and the second being dedicated to matters relating to the other statutory tasks of the Eurosystem. The Governor also continued to participate in ECB General Council meetings. The General Council mainly performs an advisory role and meets four times a year.

Consequent to the Bank's integration into the Eurosystem, experts from different areas of the Bank started to participate in ESCB committees and working groups when these meetings were held in Eurosystem composition. The list of existing Eurosystem/ESCB committees is given in Table 5.1. During 2008 Bank officials also participated in the working groups and task forces that provide technical support to these committees.

[1] See also the Box entitled "The Role of the Central Bank of Malta in the Eurosystem", which appears on page 69 of this Report.

In its first year as a member of the Eurosystem the Bank hosted the meetings of two of these working groups, which report to the Statistics and Banknote Committees of the ESCB. On a separate occasion, the Chairman of the Statistics Committee visited the Bank to discuss the progress achieved by the Bank in meeting its statistical reporting commitments and pending tasks to enhance the ECB's statistical information.

Table 5.1
EUROSYSTEM/ESCB COMMITTEES

Accounting and Monetary Income Committee (AMICO)
Banking Supervision Committee (BSC)
Banknote Committee (BANCO)
Budget Committee (BUCOM)
Committee on Cost Methodology (COMCO)
Eurosystem/ESCB Communications Committee (ECCO)
Eurosystem IT Steering Committee (EISC)
Human Resources Conference (HRC)
Information Technology Committee (ITC)
Internal Auditors Committee (IAC)
International Relations Committee (IRC)
Legal Committee (LEGCO)
Market Operations Committee (MOC)
Monetary Policy Committee (MPC)
Payment and Settlement Systems Committee (PSSC)
Statistics Committee (STC)

During the year the Governor participated in the discussions on Slovakia's preparedness for euro adoption that took place in the Governing Council and the General Council, including the assessment of the 2008 Convergence Report. In the course of the year, a senior official from the National Bank of Slovakia visited the Bank to exchange views on practical matters related to the governance structure of the two central banks and on the Bank's internal preparations for Governing Council meetings. Slovakia became the 16th member of the euro area with effect from 1 January 2009.

The Bank also had recourse to the advice of experts from the ECB and other ESCB members. These focused on asset and liability management, the reserves management process and related reporting issues, and documentation management systems.

EU institutions

During the year, the Governor accompanied the Minister of Finance, the Economy and Investment to two informal meetings of the ECOFIN Council. As in previous years, the Deputy Governor and other senior officials of the Bank took part in meetings of the Economic and Financial Committee (EFC) and its sub-committees when issues relevant to central banks were discussed.

The Bank participated in EFC discussions on the May 2008 edition of the Convergence Report, which was used as a basis for the assessment of Slovakia's preparedness for euro adoption, and the Maltese Stability Programme covering the period from 2007 to 2010, which was prepared by the MFEI. It also co-operated with the Ministry and the NSO in the preparation of reports on the Excessive Deficit Procedure and participated, together with the Ministry, in discussions with the European Commission on the latter's economic forecasts for Malta.

Senior Bank officials continued to attend meetings of the European Anti-Fraud Office of the European Commission (OLAF) on anti-counterfeiting measures, and those of the Committee of European Bank Supervisors, which discusses issues related to the regulation and supervision of the financial sector and its stability. In March, the Bank participated in a meeting of the Public Administration Network Committee II (PAN II), which helps governments and central banks prepare for euro adoption. During this meeting, the Maltese delegation shared its experience on the euro changeover with the other participants.

International Monetary Fund

The Bank remained primarily responsible for Malta's relations with the IMF. In his capacity as Governor for Malta at the IMF, the Governor, in consultation with the MFEI, voted on resolutions proposed by the Fund's Executive Board in the course of the year, including those related to IMF quota and voice.

The Bank continued to monitor ongoing discussions on the reform of the IMF. It also followed closely discussions within the International Monetary and Financial Committee on the international policy response to the financial crisis and the global economic slowdown.[2]

In April the Board of Governors of the IMF approved changes to the method used to calculate members' quotas in the Fund, as well as amendments to its Articles of Agreement aimed at enhancing the voice and participation of low-income countries. These amendments must be formally accepted by the governments of at least three-fifths of Fund members representing 85% of total voting power to become effective. As formal procedures had not been concluded by the end of the year, Malta's quota in the Fund at end-December was unchanged from its level at the end of 2007. The national currency component of Malta's quota and Malta's reserve position in the Fund remained unchanged from the previous year's levels, at SDR 61.7 million and SDR 40.3 million, respectively.

By contrast, Malta's holdings of SDRs declined by SDR 26.2 million to SDR 11.7 million in 2008, mainly reflecting outright sales of excess holdings at the request of the Central Bank of Malta. These were undertaken in accordance with the Bank's investment policy.

In May an IMF Mission visited Malta in the context of the regular bilateral discussions in terms of Article IV of the Fund's Articles of Agreement on economic developments and policies. During the visit discussions were held with the Minister of Finance, the Economy and Investment and with the Governor. The Mission also met representatives of the public sector, financial institutions and the social partners. The resultant Staff Report for Malta, and a Public Information Notice summarising the views of the Executive Board, were published in August.

As in previous years, and as discussed elsewhere in this *Report*, the Bank also co-operated with the IMF on statistical issues.

World Bank Group

The Bank continued to assist the MFEI in monitoring relevant developments in the World Bank Group. As in past years, it also offered advice to both the MFEI and the Ministry of Foreign Affairs on proposals originating from the Group that were of interest to them.

Further to the 2006 decision of the World Bank Small States Forum to locate the headquarters of the Small States Network for Economic Development (SSNED) in Malta, the Central Bank of Malta finalised arrangements permitting the lease of part of its premises to serve as the Network's headquarters. In February the Bank hosted the second meeting of the Board of Trustees of the Network. The Bank continued to provide administrative support to the SSNED. The Bank is also authorised to receive funds from the World Bank and other donors as fiduciary agent for the account of the Board of Trustees.

European Bank for Reconstruction and Development

The Bank continued to monitor developments at the EBRD and to collaborate with the MFEI on issues related to Malta's membership of this institution.

With the Ministry, it examined a number of project proposals and resolutions that required a decision by the Governors of this institution, including the decision to allow Turkey to become a country of operations of the EBRD.

In April, a constituency meeting was organized by the Austrian EBRD Director, who leads the constituency of Austria, Bosnia and Herzegovina, Cyprus, Israel, Kazakhstan and Malta. The Deputy Governor and a senior official from the MFEI participated in this meeting, which was held in Kazakhstan. In May, the EBRD held its 17th annual meeting in Kiev, Ukraine. The Deputy Governor and the Director General of the MFEI represented Malta at this meeting.

[2] This Committee advises the Fund's Board of Governors on a number of issues, including international monetary and financial affairs, global liquidity conditions and disturbances that might threaten the international financial system.

Other

The Bank continued to monitor developments related to initiatives endorsed by the BIS in the field of financial stability and took part in seminars organised by the Financial Stability Institute, which is a joint institution of the BIS and the Basel Committee on Banking Supervision.

During the year, a senior Bank official continued to participate in the meetings of the Council of Europe Select Committee of Experts on the evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) as part of the Maltese delegation. He also provided training to evaluators and represented the Committee in chairing a session of the OSCE Conference on Partnership of State Authorities, Civil Society and the Business Community in Combating Terrorism held in Vienna in September.

In December, the Committee approved a progress report on Malta's arrangements to combat money laundering and the funding of terrorism. The Bank's representative on the Committee was also appointed as a scientific expert to the Committee on preventive and financial matters. Another senior Bank official now forms part of the Maltese delegation to the Committee.

ECONOMIC AND FINANCIAL POLICY CALENDAR 2008

This calendar lists important developments in the monetary, fiscal and exchange rate fields during the year

1 January: Malta joins the euro area and adopts the euro
Malta adopts the euro as its currency and the Central Bank of Malta becomes a member of the Eurosystem.

2 January: The Central Bank of Malta pays the remainder of its subscription to the capital of the ECB and its contribution to the ECB's reserve assets
The Central Bank of Malta pays up the remainder of its subscription to the capital of the ECB in accordance with Article 49 of the Statute of the ESCB and of the ECB. A payment equivalent to 7% of the subscription had been paid when Malta joined the EU in May 2004. Settlement of the remaining 93% balance involved a payment of EUR 3,332,306.98.

3 January: The Central Bank of Malta transfers its contribution to the foreign reserve assets of the ECB
In line with Eurosystem regulations the Central Bank of Malta transfers a portion of its foreign reserve assets to the ECB. The amount is equivalent to EUR 36,553,305.17, composed of EUR 31,070,309.39 in US dollars (85%) and EUR 5,482,995.78 in gold (15%). These reserve assets are managed by the Central Bank of Malta on behalf of the ECB in conformity with the investment parameters set by the ECB.

14 January: Government sells shares in Maltapost
The Government offers a pre-placement of 45% of its shares in Maltapost for sale to stockbrokers. The following day the remaining shares are offered for sale to the general public. Both offers are heavily oversubscribed. In all, a total of 11,200,000 ordinary shares with a nominal value per share of EUR 0.25 (11c) are offered at a price of EUR 0.50 (21c) per share. All Maltapost shares are listed on the MSE.

25 January: The Central Bank of Malta joins the ECB's Central Bank Gold Agreement
The Central Bank of Malta and the ECB issue a joint press release in which the Central Bank of Malta commits itself to abide by the ECB's Central Bank Gold Agreement dated 8 March 2004. The maximum annual sales of gold, as well as the total sales, both specified in the original agreement by the signatories thereto, are to remain unchanged over the period of the agreement.

28 January: Launch of the Single Euro Payments Area
The Single Euro Payments Area (SEPA), whose objective is to make payments throughout the euro area as quick, safe and easy as national payments, is launched. As a first step, the Central Bank of Malta and the Maltese banking sector introduce the SEPA Credit Transfer Service.

30 January: The Central Bank of Malta issues a consultative document on retail payment services policy
The Central Bank of Malta issues a consultative document on the Bank's future initiatives in relation to payment services and to inform the public about Malta's transposition of Directive (EC) 2007/64, known as the Payment Services Directive, which has to be completed by November 2009.

29 February: Board of Trustees of Small States Network for Economic Development meets in Malta to discuss initiation of its operations
The Board of Trustees of the Small States Network for Economic Development (SSNED) meets in Malta to discuss the initiation of its operations. The Network's mission is to facilitate the exchange of best practices among small states, to promote the increased integration of the concerns and interests of small states into the policies and programmes of the international community, and to undertake or support such related actions as will further these goals and the sustainable development of SSNED members.

At the invitation of the Government, the SSNED locates its headquarters in Malta, which is the progenitor of the Network proposal. Barbados, Mauritius, St Kitts & Nevis, Samoa and Vanuatu are the other founding members of the Network.

29 February: Malta - Singapore double taxation agreement comes into force

Legal Notice 194 of 2008 brings into force an agreement between Malta and Singapore for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income. The agreement had been signed by the governments of the two countries on 26 March 2006.

27 March: Treaty for the Avoidance of Double Taxation between Malta and the United States of America initialled

The text of a treaty for the avoidance of double taxation between Malta and the United States of America was initialled by the Minister of Finance and a senior official from the US Treasury. This concludes the formal negotiations on the treaty, which had begun in 2005 and had involved a ratification process through the United States Senate Committee for Foreign Relations. As agreed by the two governments, the treaty text will be published on ratification by the Maltese parliament and the US Congress.

1 February – 28 March: Legislation related to banking and finance

1 February: Legal Notice 42 carries ratification of Lisbon Treaty into Maltese law

This legal notice, issued under the European Union Act (Cap. 460), publishes the Treaty of Lisbon Order, 2008, which carries into Maltese law Malta's ratification of the Lisbon Treaty. The Treaty of Lisbon (also known as the Reform Treaty) is the treaty signed on 13 December 2007 in Lisbon, Portugal. It changes the way the EU works through a series of amendments to the Treaty on European Union (TEU, Maastricht) and the Treaty establishing the European Community (TEC, Rome),

8 February: Legal Notice 57 amends regulations governing European passport rights for credit institutions

This legal notice, issued under the Banking Act (Cap. 371), amends the European Passport Rights for Credit Institutions Regulations, 2004 which were published by Legal Notice 88 of 2004. The objective of these amendments is to implement Article 42 of Council Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast).

19 February: Legal Notice 76 publishes regulations governing capital adequacy of investment firms and credit institutions

This legal notice, issued under the Banking Act (Cap. 371), publishes the Banking Act (Capital Adequacy) Regulations, 2008, the objective of which is to implement articles 36 and 38 of Council Directive 2006/49/EC of 14 June 2006 (the Capital Adequacy Directive) on the capital adequacy of investment firms and credit institutions.

19 February: Legal Notice 77 amends regulations governing penalties for offences and infringements

This legal notice, issued under the Central Bank of Malta Act (Cap. 204), publishes the Central Bank of Malta (Penalties for Offences and Infringements) (Amendment) Regulations, 2008. These amend the regulations on the same subject published by Legal Notice 75 of 2003.

22 February: Legal Notice 83 publishes index of inflation for 2007

This legal notice, issued under the Housing (Decontrol) Ordinance (Cap. 158), publishes the Index of Inflation for the Year 2007. It establishes this index at 712.68, in continuation of the schedule to the Ordinance. This represents a change of 1.25% from 2006.

29 February: Legal Notice 87 publishes regulations governing the capital adequacy of investment firms and credit institutions

This legal notice, issued under the Investment Services Act (Cap. 370), publishes the Investment Services Act (Capital Adequacy) Regulations, 2008, the objective of which is to implement articles 36 and 38 of Council Directive 2006/49/EC of 14 June 2006 (the Capital Adequacy Directive) on the capital adequacy of investment firms and credit institutions.

7 March: Legal Notice 99 amends the previous Order in respect of the euro equivalent of Lm1000

This legal notice, issued under the Euro Adoption Act (Cap. 485), publishes the Adaptation of Laws (Chapters 51-100) (Amendment) Order, 2008. This amends the previous Order in respect of the euro equivalent of Lm1000.

28 March: Legal Notice 105 amends various legal instruments in order to smooth monetary amounts following adoption of the euro

This legal notice, issued under the Euro Adoption Act (Cap. 485), publishes the Adaptation of Laws (Smoothing of Monetary Amounts and other amendments) Order, 2008. The Order amends various legal instruments in order to smooth monetary amounts following the adoption of the euro as the national currency of Malta.

June 24: Prime Minister announces Government plans to privatise shipyards company

The Prime Minister announces in Parliament that the Government would be privatising the shipyards company, Malta Shipyards Ltd., later in the year. The part of the shipyards known as Boiler Wharf will be retained by the Government and converted into a berthing spot for cruise liners.

30 August: Double taxation agreement between Malta and Greece comes into force

A double taxation agreement between Malta and Greece that had been signed by representatives of the two governments on 13 October 2006 and had been ratified by Malta on 3 November 2006 is brought into force by Legal Notice 268 of 2008.

27 June – 26 September: Legislation related to banking and finance

27 June: Legal Notice 163 repeals the Interest Rate on Offshore Loans Order, 1980

This legal notice, issued under the Banking Act (Cap. 371), repeals the Interest Rate on Offshore Loans Order, 1980.

31 July: Legal Notice 180 implements Directive 2005/60/EC of the European Parliament

This legal notice, issued under the Prevention of Money Laundering Act (Cap. 373), implements the provisions of Directive 2005/60/EC of the European Parliament on the prevention of the use of the financial system for the purposes of money laundering and terrorist financing. It also revokes Legal Notice 199 of 2003.

29 August: Legal Notice 201 publishes immovable property price index

This legal notice, issued under the Immovable Property (Acquisition by Non-Residents) Act (Cap. 246), publishes the latest immovable property price index. This is established at 149.52 with effect from 1 April 2008.

26 September: Legal Notice 238 amends regulations governing the prevention of the abuse of financial markets

This legal notice, issued under the Prevention of Financial Markets Abuse Act (Cap. 476), amends similar regulations published in 2005.

15 October: Part II of the Central Bank of Malta Act enters into force

Legal Notice 263 of 2008, issued on 24 October under Act No. 1 of 2007, establishes 15 October 2008 as the date when Part II of the said Act came into force. This part of the Act amends the definition of "resident" in the External Transactions Act (Cap. 233 of the Laws of Malta).

27 October: The Central Bank of Malta issues Directive No. 10 on the detection and removal of counterfeit and damaged banknotes from circulation

The Central Bank of Malta issues Directive No. 10 to regulate the redistribution, sorting and reissue of euro banknotes. The Directive forbids banks, financial institutions and professional cash handlers from reissuing currency notes they receive from the public without first subjecting them to stringent authenticity and quality tests according to Eurosystem-wide standards. Through this Directive the Bank brings into force measures to implement the Eurosystem banknote recycling framework, which is the common Eurosystem regime for the detection and withdrawal from circulation of counterfeit and soiled or damaged euro banknotes.

The Directive enters into force on 1 January 2009, but it allows for a 12-month transitional period so that the institutions concerned can make the necessary changes to their policies and procedures and to their equipment.

31 October: The Central Bank of Malta publishes consultation report on payment services
The Central Bank of Malta publishes a report on the reactions it received to its consultation document entitled 'Consultative Document on Retail Payment Services Policy and the Payment Services Directive', issued earlier in the year.

The Directive will regulate electronic payment services, including direct debits, credit transfers and debit and credit card payments, and is to be incorporated into national laws across the EU by November 2009.

3 November: Measures introduced in the Budget for 2009
The Minister of Finance, the Economy and Investment presents the Budget for 2009 to Parliament.

The main fiscal measures include:

Wage increase
- A weekly wage increase of EUR 4.08 to public sector employees to compensate for the increase in the cost of living.

Tax relief
- A widening of all income tax brackets.
- A one-year tax break for mothers returning to work.
- Penalties for late payment of income tax and VAT reduced from 12% to 9%.
- Removal of VAT on registration tax on new motor vehicles.
- Non-taxable income for families hosting foreign students to rise to EUR 3,500.

Subsidies
- Part-refund of payments for solar heaters, photovoltaic panels, roof insulation and double glazing to help promote the use of environment-friendly equipment.
- Financial incentives to help first-time buyers become owners of their own home.

4 November: Malta signs double taxation agreement with Montenegro
An agreement between Malta and Montenegro for the avoidance of double taxation with respect to taxes on income is signed in Marseilles during a meeting of EU Foreign Ministers.

14 November: Malta and Ireland sign double taxation convention
A convention between Malta and the Republic of Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income is signed in Rome. The two countries agree to implement measures to ratify the convention so that it can enter into force at the beginning of 2009.

27 November: Enemalta's gas activities privatised
Enemalta Corporation signs a concession agreement with Gasco Energy Ltd. and Liquigas Malta Ltd., a Maltese-Italian consortium, according to which Enemalta transfers the management and operation of its liquefied petroleum gas (LPG) activities to the consortium. According to this agreement, Gasco Energy Ltd. will operate a new LPG bottling and storage facility while Liquigas Malta, the other company in the Gasco Consortium, will, as from 1 February 2009, be responsible for the distribution of LPG cylinders.

10 December: Government launches business schemes for Small and Medium Enterprises

The Government launches five business schemes aimed at encouraging investment and innovation in industry. The schemes, which are to be administered by Malta Enterprise, are worth EUR 20 million, and are intended to promote further growth and job creation in Malta.

18 December: Malta and Switzerland sign double taxation agreement

An agreement between Malta and Switzerland for the avoidance of double taxation with respect to taxes on income is signed in Malta. The agreement will enter into force following ratification by the parliaments of the two countries.

28 December: Malta and Libya sign double taxation convention

Malta and Libya sign a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income. The convention will enter into force following ratification by the two countries. It will then supersede a previous convention signed in 1972.

7 October – 30 December: Legislation related to banking and finance

7 October: Legal Notice 250 partly implements Directive 2003/7/EC

This legal notice, issued under the Investment Services Act (Cap. 370), and entitled Investment Services Act (Investment Advertisements and Prospectus Exemption Regulations, 2008), partly implements Directive 2003/71/EC on the prospectus to be published when securities are offered for sale to the public.

7 October: Legal Notice 251 amends regulations governing European passport rights for investment firms

This legal notice, entitled European Passport Rights for Investment Firms (Amendment) Regulations 2008, is issued under the Investment Services Act (Cap. 370). It amends similar regulations published in 2007.

7 October: Legal Notice 252 amends regulations on the fair presentation of investment recommendations and the disclosure of conflicts on interest

This legal notice, entitled Prevention of Financial Markets Abuse (Fair Presentation of Investment Recommendations and Disclosure of Conflicts of Interest) (Amendment) Regulations, 2008, is issued under the Prevention of Financial Markets Abuse Act (Cap. 476). It amends similar regulations published in 2005.

7 October: Legal Notice 253 amends regulations governing insurance companies' accounts

This legal notice, entitled Insurance Business (Companies Accounts) Regulations, 2008, is issued under the Insurance Business Act (Cap. 403). It amends similar regulations published in 2000.

10 October: Legal Notice 257 amends regulations governing tax on the investment income of collective investment schemes

This legal notice, entitled the Collective Investment Schemes (Investment Income) Regulations 2008, is issued under the Income Tax Act (Cap. 123). It amends similar regulations published in 2001.

30 December: Legal Notice 351, and Legal Notices 353 to 361, reduce registration and other fees applicable to the banking and financial sector

These legal notices, issued under various Acts related to the banking and financial sector, deal with the reduction of registration and annual fees applicable to the sector.

PART III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2008

Directors' report

The Directors present their report and the audited financial statements of the Central Bank of Malta for the year ended 31 December 2008.

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 2008, and of its profit for the year then ended. The financial statements have been prepared in accordance with the provisions established by the Governing Council of the European Central Bank under article 26.4 of the Statute of the European System of Central Banks and of the European Central Bank and in accordance with the requirements of the Central Bank of Malta Act (Cap. 204). The provisions established by the Governing Council are outlined in the Accounting Guideline (ECB/2006/16 as amended by ECB/2007/20 and ECB/2008/21) on the legal framework for accounting and financial reporting in the European System of Central Banks adopted by the Governing Council on 10 November 2006.

Financial results

The Bank's financial statements for the year ended 31 December 2008 are set out on pages A-6 to A-46 and disclose an operating profit of €48.6 million. The amount payable to the Government of Malta is €41.6 million.

Board of Directors

The members of the Board of Directors during the year ended 31 December 2008 and up to the date of authorisation for issue of the financial statements were:

Mr Michael C. Bonello - Governor
Mr David A. Pullicino - Deputy Governor
Mr Charles J. Falzon (whose term of office expired on 6 February 2009)
Mr Victor Busuttil (appointed on 1 January 2008)
Ms Antoinette Caruana (appointed on 14 April 2008)

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

Auditors

Ernst & Young and PricewaterhouseCoopers were the Bank's auditors for the current financial year. The Bank has appointed KPMG as its external auditors with effect from the financial year ending 31 December 2009.

By order of the Board

M. C. Bonello
Governor

D. A. Pullicino
Deputy Governor

Pjazza Kastilja
Valletta
Malta
23 March 2009

Statement of Directors' responsibilities in respect of the financial statements

The Board of Directors is responsible for ensuring that the financial statements are drawn up in accordance with the requirements of the Central Bank of Malta Act (Cap. 204). The Bank is required to prepare financial statements in accordance with the requirements of the Accounting Guideline (ECB/2006/16 as amended by ECB/2007/20 and ECB/2008/21) on the legal framework for accounting and financial reporting in the European System of Central Banks adopted by the Governing Council of the European Central Bank on 10 November 2006.

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 2008 and of the profit for the year then ended.

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

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

The financial statements of the Central Bank of Malta for the year ended 31 December 2008 are included in the Annual Report 2008, which is published in hard-copy printed form and on the Bank's website. The Directors are responsible for the maintenance and integrity of the Annual Report on the website in view of their responsibility for the controls over, and the security of, the website. Access to information published on the Bank's website is available in other countries and jurisdictions, where legislation governing the preparation and dissemination of financial statements may differ from requirements or practice in Malta.

Independent auditors' report

To the Board of Directors of the Central Bank of Malta

Report on the financial statements

We have audited the financial statements of the Central Bank of Malta on pages A-6 to A-46 which comprise the Balance sheet as at 31 December 2008, the Profit and loss account 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 the provisions established by the Governing Council of the European Central Bank outlined in the Accounting Guideline (ECB/2006/16 as amended by ECB/2007/20 and ECB/2008/21) on the legal framework for accounting and financial reporting in the European System of Central Banks adopted by the Governing Council on 10 November 2006 and in accordance with the requirements of the Central Bank of Malta Act (Cap. 204). As described in the statement of directors' responsibilities on page A-3, 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' judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the 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.

Opinion

In our opinion the financial statements give a true and fair view of the financial position of the Central Bank of Malta as at 31 December 2008 and of its financial performance for the year then ended in accordance with the requirements of the Accounting Guideline (ECB/2006/16 as amended by ECB/2007/20 and ECB/2008/21) on the legal framework for accounting and financial reporting in the European System of Central Banks adopted by the Governing Council of the European Central Bank on 10 November 2006 and in accordance with the requirements of the Central Bank of Malta Act (Cap. 204).

Emphasis of matter

Without qualifying our opinion, we draw attention to Note 4 *“Transition to the requirements of the Accounting Guideline”* in the General notes to the financial statements, which states that the Bank’s Profit and loss account for year ended 31 December 2008 does not include comparative figures for the prior year since the ECB Accounting Guideline does not require presentation of such comparative amounts in the Profit and loss account in the year of transition.

ERNST & YOUNG

Malta

Anthony P. Doublet
Partner

23 March 2009

PRICEWATERHOUSECOOPERS

Malta

Fabio Axisa
Partner

23 March 2009

Balance sheet as at 31 December 2008

		31 Dec 2008	1 Jan 2008
	Assets		
		€'000	€'000
A 1	**Gold and gold receivables**	**4,141**	**9,429**
A 2	**Claims on non-euro area residents denominated in foreign currency**	**251,436**	**359,869**
A 2.1	Receivables from the IMF	57,385	83,884
A 2.2	Balances with banks and security investments, external loans and other external assets	194,051	275,985
A 3	**Claims on euro area residents denominated in foreign currency**	**435,407**	**291,851**
A 4	**Claims on non-euro area residents denominated in euro**	**259,973**	**817,693**
A 4.1	Balances with banks, security investments and loans	259,973	817,693
A 4.2	Claims arising from the credit facility under ERM II	-	-
A 5	**Lending to euro area credit institutions related to monetary policy operations denominated in euro**	**454,000**	**-**
A 5.1	Main refinancing operations	164,000	-
A 5.2	Longer-term refinancing operations	290,000	-
A 5.3	Fine-tuning reverse operations	-	-
A 5.4	Structural reverse operations	-	-
A 5.5	Marginal lending facility	-	-
A 5.6	Credits related to margin calls	-	-
A 6	**Other claims on euro area credit institutions denominated in euro**	**164,004**	**1,050,421**
A 7	**Securities of euro area residents denominated in euro**	**474,769**	**536,704**
A 8	**General government debt denominated in euro**	**-**	**-**
A 9	**Intra-Eurosystem claims**	**47,322**	**75,334**
A 9.1	Participating interest in ECB	11,491	3,583
A 9.2	Claims equivalent to the transfer of foreign reserves	35,831	-
A 9.3	Claims related to promissory notes backing the issuance of ECB debt certificates[1]	-	-
A 9.4	Net claims related to the allocation of euro banknotes within the Eurosystem	-	-
A 9.5	Other claims within the Eurosystem (net)	-	71,751
A 10	**Items in course of settlement**	**5,008**	**9,249**
A 11	**Other assets**	**626,456**	**357,071**
A 11.1	Coins of euro area	23	-
A 11.2	Tangible and intangible fixed assets	21,669	23,008
A 11.3	Other financial assets	446,953	201,501
A 11.4	Off-balance sheet instruments revaluation differences	308	-
A 11.5	Accruals and prepaid expenses	38,576	30,247
A 11.6	Sundry	118,927	102,315
Total Assets		**2,722,516**	**3,507,621**

[1] Only an ECB balance sheet item

		31 Dec 2008	1 Jan 2008
	Liabilities		
		€'000	€'000
L 1	**Banknotes in circulation**	**693,098**	**1,193,699**
L 2	**Liabilities to euro area credit institutions related to monetary policy operations denominated in euro**	**483,475**	**1,386,759**
L 2.1	Current accounts (covering the minimum reserve system)	474,475	973,528
L 2.2	Deposit facility	9,000	81,761
L 2.3	Fixed-term deposits	-	331,470
L 2.4	Fine-tuning reverse operations	-	-
L 2.5	Deposits related to margin calls	-	-
L 3	**Other liabilities to euro area credit institutions denominated in euro**	**-**	**54,732**
L 4	**Debt certificates issued**[1]	**-**	**-**
L 5	**Liabilities to other euro area residents denominated in euro**	**366,314**	**398,111**
L 5.1	General government	361,949	369,098
L 5.2	Other liabilities	4,365	29,013
L 6	**Liabilities to non-euro area residents denominated in euro**	**80,371**	**97,687**
L 7	**Liabilities to euro area residents denominated in foreign currency**	**33,793**	**24,262**
L 8	**Liabilities to non-euro area residents denominated in foreign currency**	**65**	**-**
L 8.1	Deposits, balances and other liabilities	65	-
L 8.2	Liabilities arising from the credit facility under ERM II	-	-
L 9	**Counterpart of special drawing rights allocated by the IMF**	**12,471**	**12,123**
L 10	**Intra-Eurosystem liabilities**	**721,127**	**32,992**
L 10.1	Liabilities equivalent to the transfer of foreign reserves[1]	-	-
L 10.2	Liabilities related to promissory notes backing the issuance of ECB debt certificates	-	-
L 10.3	Net liabilities related to the allocation of euro banknotes within the Eurosystem	54,547	32,992
L 10.4	Other liabilities within the Eurosystem (net)	666,580	-
L 11	**Items in course of settlement**	**-**	**-**
L 12	**Other liabilities**	**42,873**	**54,044**
L 12.1	Off-balance sheet instruments revaluation differences	2,738	-
L 12.2	Accruals and income collected in advance	22,781	4,768
L 12.3	Sundry	17,354	49,276
L 13	**Provisions**	**5,119**	**-**
L 14	**Revaluation accounts**	**8,135**	**-**
L 15	**Capital and reserves**	**234,060**	**224,521**
L 15.1	Capital	20,000	20,000
L 15.2	Reserves	214,060	204,521
L 16	**Profit for the year**	**41,615**	**28,691**
Total Liabilities		**2,722,516**	**3,507,621**

Profit and loss account for the year ended 31 December 2008

		2008
		€'000
1.1	Interest income	126,486
1.2	Interest expense	(57,888)
1	**Net interest income**	**68,598**
2.1	Realised gains / losses arising from financial operations	808
2.2	Write-downs on financial assets and positions	(8,564)
2.3	Transfer (to) / from provisions for foreign exchange rate, price risks and monetary policy operations	(5,119)
2	**Net result of financial operations, write-downs and risk provisions**	**(12,875)**
3.1	Fees and commissions income	56
3.2	Fees and commissions expense	(511)
3	**Net income / (expense) from fees and commissions**	**(455)**
4	**Income from equity shares and participating interests**	**1,076**
5	**Net result of pooling of monetary income**	**(2,783)**
6	**Other income**	**11,814**
	Total net income	**65,375**
7	**Staff costs**	**(9,304)**
8	**Administrative expenses**	**(3,545)**
9	**Depreciation of tangible and intangible fixed assets**	**(1,468)**
10	**Banknote production services**	**(2,338)**
11	**Other expenses**	**(105)**
	Profit for the year	**48,615**
	Transfer to reserves for risks and contingencies	**(7,000)**
	Payable to the Government of Malta in terms of article 22(2) of the Central Bank of Malta Act (Cap. 204)	**41,615**

The financial statements on pages A-6 to A-46 were approved for issue by the Board of Directors on 23 March 2009 and were signed on its behalf by:

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

Notes to the financial statements for the year ended 31 December 2008

General notes to the financial statements

1 Introduction of the euro

Malta introduced the euro as the new legal tender on 1 January 2008. The Bank became part of the Eurosystem and took over joint responsibility for monetary policy and for exercising the common strategic goals of the European System of Central Banks (ESCB)[2].

2 Basis of preparation

As a result of Malta's adoption of the euro, the Central Bank of Malta (the "Bank") is required under article 21(5) of the Central Bank of Malta Act (Cap. 204) to prepare its financial statements in accordance with the provisions established by the Governing Council of the European Central Bank (the "ECB") under article 26.4 of the Statute of the European System of Central Banks and of the European Central Bank (the "Statute"). These provisions are outlined in the Accounting Guideline (ECB/2006/16 as amended by ECB/2007/20 and ECB/2008/21) on the legal framework for accounting and financial reporting in the European System of Central Banks adopted by the Governing Council of the ECB on 10 November 2006. The Bank adopted the Accounting Guideline on 1 January 2008 and its financial statements for the year ended 31 December 2008 have been prepared in accordance with the requirements of this Guideline. The Bank's financial statements for the financial years up to 31 December 2007 had been prepared in accordance with the requirements of International Financial Reporting Standards. In the absence of requirements and guidance provided by the Accounting Guideline that specifically apply to transactions, other events or conditions, the requirements of International Financial Reporting Standards are applied.

The transition process to the requirements of the Accounting Guideline is outlined in Note 4 *"Transition to the requirements of the Accounting Guideline"*.

These financial statements have been drawn up so as to give a true and fair view of the state of affairs of the Bank as at 31 December 2008 and of its profit for the year then ended. The accounts have been prepared on a historical cost basis, modified to include market valuation of marketable securities classified as other than held-to-maturity, gold and all instruments, on-balance sheet and off-balance sheet, denominated in foreign currency.

[2] The "European System of Central Banks (ESCB)" comprises the ECB and the national central banks (NCBs) of all EU Member States (Article 107.1 of the Treaty) whether they have adopted the euro or not. The "Eurosystem" comprises the ECB and the NCBs of those countries that have adopted the euro. The Eurosystem and the ESCB will co-exist as long as there are EU Member States outside the euro area.

3 Accounting policies

(a) Basic accounting principles

The following accounting principles have been applied in the preparation of these financial statements:

- economic reality and transparency
- prudence
- review of post-balance sheet events
- materiality
- going-concern basis
- accruals principle
- consistency and comparability

(b) Recognition of assets and liabilities

An asset or liability is only recognised in the Balance sheet when it is probable that any associated future economic benefit will flow to or from the Bank, substantially all of the associated risks and rewards have been transferred to the Bank, and the cost or value of the asset or the amount of the obligation can be measured reliably.

(c) Recording of transactions

Foreign exchange transactions, comprising spot and forward transactions in gold and foreign currencies, are recorded off-balance sheet on trade date at the prevailing spot exchange rate for ascertaining the average acquisition costs and the realised gains and losses. Accordingly, purchases and sales of foreign currency affect the net foreign currency position on the trade date and realised gains and losses arising from the net reduction in foreign currency positions are calculated on trade date. On-balance sheet recording of these transactions is carried out on settlement date at the original spot exchange rates. In the case of foreign exchange swaps, spot and forward amounts are translated to euro at the same exchange rate, and accordingly these contracts do not affect foreign currency positions.

All securities transactions are recorded on-balance sheet on settlement date at the applicable exchange rate. Accrued interest, premiums and discounts related to financial assets and liabilities are calculated and booked daily from the settlement date at daily exchange rates, as applicable, and the foreign currency position is affected daily by these accruals denominated in foreign currency.

All other transactions are recorded in the Balance sheet at market exchange rates prevailing on the day of the transaction.

(d) Balance sheet valuation rules

Financial assets and liabilities denominated in foreign currency, including off-balance sheet positions, are revalued at the prevailing mid-market exchange rates at the balance sheet date. Securities and Treasury bills other than those classified as held-to-maturity are revalued at the prevailing mid-market prices at the balance sheet date.

Gold balances are valued at market prices prevailing at the year end. No distinction is made between price and currency revaluation differences for gold, but a single gold revaluation difference is accounted for on the basis of the euro price per defined unit of weight of gold derived from the euro-US dollar exchange rate at the balance sheet date.

Foreign currency positions (including off-balance sheet transactions) are revalued on a currency-by-currency basis. In the case of securities, revaluation is carried out on a code-by-code basis (same ISIN number / type) and is treated separately from exchange rate revaluation.

All other assets and liabilities are presented at purchase price or, where applicable, at their nominal value. The Bank's participating interest in the ECB is measured at cost.

(e) Cost of transactions

The average cost method is used on a daily basis for calculating the acquisition cost in the case of assets and liabilities that are subject to price and / or exchange rate movements. The average cost price of securities and / or the average rate of the foreign currency position is adjusted by unrealised losses taken to the Profit and loss account at the end of the year.

All securities are initially recorded at acquisition cost. For the purpose of calculating the average purchase cost of a security, all purchases made during the day are added to the cost of the previous day's holding to produce a new weighted average price before applying the sales for the same day.

In the case of long foreign currency or gold positions, net inflows made during the day are added, at the average cost of the inflows for each respective currency or gold, to the previous day's holding to produce a new weighted average cost. Where a short position exists, the reverse treatment applies whereby the average cost is affected by net outflows.

The market prices and exchange rates applied to the opening balance sheet upon adoption of the Accounting Guideline on 1 January 2008 are considered as the opening average cost of the Bank's assets and liabilities. In respect of foreign currency positions and gold, the opening average costs are the exchange rates prevailing on 1 January 2008. For securities, the market prices or carrying amounts as at 1 January 2008 represent the opening average prices for the purposes of determining premium or discount amortisation and computing realised gains or losses.

(f) Income recognition

Income and expenses are recognised in the period in which they are earned or incurred.

(i) Interest income and expense

Interest income and expense are recognised in the Profit and loss account for all interest-bearing assets and liabilities. Premiums or discounts arising from the difference between the average acquisition cost and the redemption price on securities are presented as part of interest income and are amortised over the remaining term of the security using either the straight-line method or the internal rate of return method. The internal rate of return method is used in the case of discounted securities. Interest accruals on foreign currency assets and liabilities are converted at the mid-market rate on each business day and are included in the respective foreign currency position to determine the average book value, as applicable.

Accordingly, interest income includes coupons earned on securities and amortised premiums or discounts on Treasury bills and other instruments. In respect of forward exchange contracts the difference between the deemed spot exchange rate of the forward contract and the deal rate is considered as interest income or expense and is amortised on a straight-line basis from the trade date to settlement date.

(ii) Gains and losses arising from foreign exchange, gold and securities

Realised gains and realised losses can only arise in the case of transactions leading to a reduction in foreign currency positions or on the sale of securities.

In the case of foreign currency or gold positions, any inflows and outflows are compared against each other to determine any realised gains or losses. The resulting net inflow or outflow, apart from changing the position in that currency, will give rise to a change in the average cost of that currency or to the realisation of a further profit or loss depending on whether the Bank has a long or short position in that currency respectively. Every day, a weighted average price is calculated, firstly on inflows and secondly on outflows. The realised gain / loss is calculated by applying the difference between these average prices to the lower of the day's inflows or outflows.

For long positions, where outflows exceed inflows, a second realised gain / loss is calculated, equating to the difference between the net outflows of the day valued at the average outflow price and at the average cost of the day's opening position. Where inflows exceed outflows, the net inflow is added to the position held at the beginning of the day, thus changing the average cost of the position. For short positions, the reverse accounting treatment is applied.

In the case of securities, realised gains or losses are derived by comparing the transaction value with the average book value using the average cost method.

Realised gains and losses are taken to the Profit and loss account.

Unrealised revaluation gains and unrealised revaluation losses arise as a result of the revaluation of assets and liabilities by comparing the market value with the average book value. Unrealised gains are not recognised as income but are transferred directly to a revaluation account within the Bank's liabilities. Unrealised losses are taken to the Profit and loss account when they exceed previous unrealised gains registered in the corresponding revaluation account. Unrealised losses recorded in the Profit and loss account in previous years are not reversed against new unrealised gains in subsequent years. Unrealised losses in any one security or in any foreign currency (including gold holdings) are not netted against unrealised gains in other securities or foreign currency.

(g) Off-balance sheet instruments

Spot and forward foreign exchange contracts are included in the net foreign currency position for the purpose of calculating the average cost of currencies and determining realised foreign exchange gains and losses.

Gains and losses arising from spot and forward foreign exchange contracts are recognised and treated in a similar manner to on-balance sheet instruments. Realised and unrealised gains and losses are measured and accounted for in the manner outlined in Accounting policy (f) *"Income recognition"* above. Unrealised valuation gains / losses on spot and forward foreign exchange contracts are recorded from the trade date to the settlement date under asset sub-item A11.4 *"Off-balance sheet instruments revaluation differences"* and under liability sub-item L12.1 *"Off-balance sheet instruments revaluation differences"* as applicable.

(h) Securities

Marketable securities classified as held-to-maturity are measured at amortised cost less provisions for impairment. Held-to-maturity securities are securities with fixed or determinable payments and a fixed maturity, which the Bank intends to hold until maturity.

Marketable securities other than those held-to-maturity are carried at mid-market prices prevailing at the balance sheet date. Unrealised gains and losses in respect of such securities are measured and recognised as outlined in Accounting policy (f) *“Income recognition”* above.

Securities which are designated as part of an earmarked portfolio comprising earmarked investments held on the assets side of the Balance sheet as a counterpart to the Bank’s capital and statutory reserves are classified as held-to-maturity investments.

Securities forming part of an earmarked portfolio comprising Malta Government securities purchased on the secondary market by the Bank in its role as a market maker are measured at mid-market prices prevailing at the balance sheet date. Unrealised gains are reflected on-balance sheet in the liability sub-item L12.3 *“Sundry liabilities”* whilst unrealised losses are recognised in asset sub-item A11.6 *“Sundry assets”*.

(i) Sale and repurchase agreements and lending of securities

Securities sold subject to repurchase agreements (“repos”) are retained in the financial statements in the appropriate classification on the assets side of the Balance sheet; the counterparty liability is included as a collateralised inward deposit on the liabilities side of the Balance sheet, as appropriate. Securities purchased under agreements to resell (“reverse repos”) are recorded as a collateralised outward loan on the assets side of the Balance sheet, as appropriate. The difference between the sale and repurchase price is treated as interest and is accrued in the Profit and loss account over the term of the agreement on a straight-line basis.

Securities lent to counterparties are also retained in the financial statements.

(j) Claims on the International Monetary Fund (“IMF”)

The IMF Reserve Tranche Position and Special Drawing Rights are translated into euro at the year end ECB euro / SDR exchange rate. The IMF euro holdings are revalued against the SDR at the prevailing representative rate for the euro as quoted by the Fund at the close of business on 31 December 2008. Adjustments on revaluation of the IMF holdings are reflected in the corresponding asset *“Currency Subscription”* disclosed in asset sub-item A11.6 *“Sundry assets”*.

(k) Accounting for euro coins

Subsequent to the agency agreement between the Bank and the Government of Malta, the face value of the euro coins issued by the Bank gives rise to a reserve in the form of a capital contribution by the Government. Deposits of euro coins with the Bank constitute a reversal of the capital contribution as disclosed in Note L15.2 *“Reserves”* in the Notes to the Balance sheet.

(l) Demonetised Maltese lira currency notes and coins

(i) Demonetised Maltese lira currency notes

Demonetised Maltese lira currency notes shall, until ten years following the expiration of the period mentioned in the notice of demonetisation, be redeemable by the Bank on demand for euro currency at the conversion rate of the Maltese lira for the euro established in terms of the Treaty and without charge.

In accordance with article 62 of the Central Bank of Malta Act (Cap. 204), after the expiration of one year following the end of the period established in the notice, any unpresented demonetised Maltese lira currency notes cease to be included in the Bank's currency liabilities. The value of such notes, after deducting therefrom the value of any notes which are subsequently redeemed, are recognised in the Profit and loss account of the Bank up to the expiration of ten years from the end of the period above mentioned. After the expiry of ten years from the notice of demonetisation, demonetised currency notes not yet presented are not redeemed by the Bank.

(ii) Demonetised Maltese lira currency coins

Demonetised Maltese lira currency coins shall, until two years following the expiration of the period mentioned in the notice of demonetisation, be redeemable by the Bank on demand for euro currency at the conversion rate of the Maltese lira for the euro established in terms of the Treaty and without charge.

In accordance with article 63 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, any unpresented demonetised Maltese lira currency coins cease to be included in the Bank's currency liabilities. The value of such coins, after deducting therefrom the value of any coins which are subsequently redeemed, are recognised in the Profit and loss account of the Bank until the expiration of two years from the end of the period above mentioned. After the expiry of two years from the notice of demonetisation, demonetised coins not yet presented are not redeemed by the Bank.

(m) Tangible and intangible fixed assets

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

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

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

Tangible and intangible fixed assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. 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.

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.

(n) Provisions

Provisions are recognised when the Bank has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated.

(o) Presentation of cash flow statement

The financial reporting requirements of the Accounting Guideline do not require the presentation of the cash flow statement taking cognisance of the information presented by the items and amounts that would be disclosed in this statement. Accordingly the Directors resolved not to present the cash flow statement on the premise that non-presentation of this statement does not impact on the truth and fairness of the financial statements in accordance with the requirements of the Accounting Guideline.

4 Transition to the requirements of the Accounting Guideline

The requirements of the Accounting Guideline have been applied by the Bank with effect from 1 January 2008. On this date, the Bank has drawn up its opening Balance sheet on the basis of the Bank's reported balance sheet figures as at 31 December 2007. The Bank's assets, liabilities and equity components as at 31 December 2007 have been included in the opening Balance sheet at their carrying amounts as measured under the requirements of International Financial Reporting Standards and accordingly no adjustments were necessary to the opening carrying amounts. The amounts presented in Maltese lira have been translated into euro at the irrevocably fixed conversion rate. The balance sheet items as at 1 January 2008 have been classified and presented according to the requirements of the Accounting Guideline. The opening Balance sheet has been presented as comparative financial information with respect to the Bank's financial position in these financial statements. Whilst no adjustments were necessary to carrying amounts as at 1 January 2008, certain reclassifications were necessary to comply with the Accounting Guideline and to reflect the Bank's status and legal framework as at 1 January 2008. The euro banknotes frontloaded up to 31 December 2007 have been reflected as banknotes in circulation on the Balance sheet as at 1 January 2008 in accordance with the Bank's banknote allocation key thereby requiring recognition of an intra-Eurosystem liability in the opening Balance sheet representing the excess of frontloaded notes over the allocated amount. The euro coins frontloaded up to 31 December 2007 have been reflected as a capital contribution from the Government as at 1 January 2008.

The comparative amounts presented are comparable to the current year figures taking cognisance of the requirements of International Financial Reporting Standards and the requirements of the Accounting Guideline. Held-to-maturity marketable securities as at 31 December 2008 and 1 January 2008 are carried at amortised cost. Marketable securities classified as other than held-to-maturity were carried at fair value, based on bid prices quoted in active markets, as at 1 January 2008 and are carried at mid-market prices at 31 December 2008. The opening fair value reserve as at 1 January 2008, reflecting unrealised fair value changes on available-for-sale securities up to 31 December 2007, is recorded separately from any unrealised valuation gains and losses arising on or after 1 January 2008 which are accounted for in accordance with the accounting principles disclosed above. The fair value reserve balance as at 31 December 2007 has been grossed up under asset sub-item A11.6 *"Sundry assets"* representing the negative fair value adjustments and liability sub-item L12.*3 "Sundry liabilities"* representing the positive fair value adjustments. The fair value reserve is being amortised to the Profit and loss account on a straight-line basis over the term of the respective security. Derivative financial instruments were measured at fair value as at 1 January 2008; the accounting rules applicable to such instruments subsequent to euro adoption are reflected in the accounting policies above. The aggregate fair value of the outstanding contracts as at 1 January 2008 has been classified under asset sub-item A11.6 *"Sundry assets"* and these unrealised net fair value gains have been amortised to Profit and loss account over the term of the contract. All other assets and liabilities are measured on the same basis both as at 31 December 2008 and 1 January 2008.

The requirements of the Accounting Guideline in respect of recognition, measurement and presentation of profit and loss account items and the requirements of IFRSs are substantially different, in particular in relation to realised and unrealised gains and losses. Presentation of comparative figures for the Profit and loss account on the basis of the prior year's financial statements was considered to hinder the understanding of the current year's Profit and loss account. Also it was not deemed practicable to restate the figures presented under the requirements of IFRSs in view of the differences in accounting treatment highlighted above. The ECB Accounting Guideline does not require presentation of comparative figures in the Profit and loss account in the year of transition.

5 Capital key

The capital key determines the allocation of the ECB's share capital to the NCBs. It is determined on the basis of population and gross domestic product data. It is adjusted every five years and every time that a new member state joins the European Union in accordance with the requirements of the Statute. The capital key of the Bank during the financial year ended 31 December 2008 was 0.0622%. The Eurosystem capital key is the respective NCB's share of the total share capital held by Eurosystem members in the ECB and is utilised as the basis for allocation of monetary income, banknotes in circulation and the ECB's results.

6 Change to ECB capital key on 1 January 2009

On 1 January 2009 the ESCB experienced a quinquennial capital key change in accordance with article 29.3 of the Statute. As a result, the Central Bank of Malta's share in the fully paid up capital of the ECB increased from 0.0622% to 0.0632%. As at the same date the Eurosystem also expanded due to the accession of the Národná banka Slovenska which paid its capital share in full.

7 Euro banknotes in circulation

Euro banknotes are issued by the ECB and the fifteen participating national central banks ("NCBs"), which together comprise the Eurosystem. The total value of euro banknotes in circulation is allocated on the last working day of each month in accordance with the banknote allocation key[3].

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation, whereas the remaining 92% has been allocated to the NCBs according to their capital key. In the year under review, the Bank had a 0.0892% share in the fully paid-up capital of the ECB, (referred also as Eurosystem Capital Key) and a 0.0825% share of the euro banknotes in circulation in accordance with the banknote allocation key. The share of banknotes allocated to each NCB is disclosed in the Balance sheet under liability item L1 *"Banknotes in circulation"*.

[3] Banknote allocation key means the percentages that result from taking into account the ECB's share in the total euro banknote issue and applying the Eurosystem capital key to the NCBs' share in such total.

The difference between the value of the euro banknotes allocated to each NCB in accordance with the banknote allocation key and the value of the euro banknotes that it actually puts into circulation, as reduced by banknotes withdrawn from circulation, gives rise to intra-Eurosystem balances remunerated at the main refinancing operations rate. If the value of the euro banknotes actually issued is greater than the value according to the banknote allocation key, the excess is recorded in the Balance sheet under liability sub-item L10.3 *"Net liabilities related to the allocation of euro banknotes within the Eurosystem"*. If the value of the euro banknotes actually issued is less than the value according to the banknote allocation key, the shortfall is recorded in the Balance sheet under asset sub-item A9.4 *"Net claims related to the allocation of euro banknotes within the Eurosystem"*.

In the cash changeover year[4] and in the following five years following the cash changeover year the intra-Eurosystem balances arising from the allocation of euro banknotes are adjusted in order to avoid significant changes in the NCB's relative income positions as compared to previous years. The adjustments are effected by taking into account the differences between the average value of the banknotes which the NCB had in circulation in the reference period[5] and the average value of banknotes which would have been allocated to it during that period in accordance with its capital key. The adjustments are reduced in annual stages until the first day of the sixth year after the cash changeover year, when income on banknotes will be allocated fully in proportion to the NCB's paid-up share capital in the ECB. The Bank's adjustment period started on 1 January 2008 and will end on 31 December 2013.

The interest income and expense on these balances is cleared through the accounts of the ECB and is disclosed in the Profit and loss account of the Bank under item 1 *"Net interest income"*.

Furthermore, the Governing Council of the ECB has decided that the seigniorage income of the ECB, which arises from the 8% share of euro banknotes allocated to the ECB, shall be due to the NCBs in the same financial year it accrues and distributed on the second working day of the following year in the form of an interim distribution of profit. It shall be so distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation and subject to any decision by the Governing Council to reduce this income in respect of costs incurred by the ECB in connection with the issue and handling of euro banknotes. The Governing Council may also decide to transfer part or all of the ECB's seigniorage income to a provision for foreign exchange rate, interest rate and gold price risks. With respect to 2008, the Governing Council decided that an amount of €1,024,801,908 should be retained by the ECB. The amount distributed to the Bank is disclosed in the Profit and loss account under item 4 *"Income from equity shares and participating interests"*.

8 Intra-Eurosystem balances

Intra-Eurosystem transactions are cross-border transactions that occur between Eurosystem NCBs. These transactions are processed primarily via TARGET and give rise to the daily net bilateral position vis-à-vis the ECB. This position in the financial statements of the Bank represents the net claim or liability of the Bank against the rest of the ESCB members connected to TARGET. The resulting balance is included as an asset or liability, as appropriate, under the sub-items A9.5 / L10.4 *"Other claims / liabilities within the Eurosystem (net)"*.

---

[4] Cash changeover year refers to the year in which the euro banknotes are introduced as legal tender in the respective Member State; for the Bank this is 2008.

[5] The reference period refers to the 24 months which start 30 months before the day on which euro banknotes become legal tender in the respective Member State; for the Bank this is the period from July 2005 to June 2007.

Notes to the Balance sheet

Assets

A 1 Gold and gold receivables

The Bank's gold balances consist of correspondent accounts with foreign banks and holdings of numismatic coins. During 2008, gold balances declined mainly due to the transfer of gold to the ECB in accordance with article 30 of the Statute. On 31 December 2008 gold has been revalued at €621.542 per fine ounce. The resultant unrealised valuation gains of €350,770 are disclosed under liability item L14 *"Revaluation accounts"*.

	€'000	Fine troy ounces
Balance as at 1 January 2008	9,429	16,594
Transfer of gold to the ECB	(5,483)	(9,649)
Net transactions during the year	(156)	(283)
Revaluation on 31 December 2008	351	-
Balance as at 31 December 2008	**4,141**	**6,662**

A 2 Claims on non-euro area residents denominated in foreign currency

These claims consist of receivables from the IMF and claims on counterparties resident outside the euro area denominated in foreign currency.

A 2.1 Receivables from the IMF

	31 Dec 2008 €'000	1 Jan 2008 €'000	Change €'000
Reserve Tranche Position	**44,478**	43,238	1,240
Special Drawing Rights	**12,907**	40,646	(27,739)
Total	**57,385**	83,884	(26,499)

Malta's membership subscription to the IMF amounts to SDR102,000,000 (1 January 2008: SDR102,000,000). The Bank's position with the IMF at 31 December 2008 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 IMF and represents the difference between the quota of SDR102,000,000 and the balances in euro at the disposal of the Fund.

(b) Special Drawing Rights included in the table above are equivalent to SDR11,682,189. 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 liability item L9 *“Counterpart of special drawing rights allocated by the IMF”* together with other Special Drawing Rights acquired in accordance with IMF 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 within asset sub-item A11.6 *“Sundry assets”* is stated at €68,332,103 and represents the balance of the quota paid in euro. A corresponding liability included in liability item L6 *“Liabilities to non-euro area residents denominated in euro”* exists in the form of IMF current accounts of €68,332,103 or SDR61,740,993.

The Reserve Tranche Position, Special Drawing Rights and SDR allocation (liability item L9 *“Counterpart of special drawing rights allocated by the IMF”*) are subject to floating interest rates determined by reference to the official rate quoted by the Fund on a weekly basis. The Currency Subscription and IMF current accounts are not subject to interest.

A 2.2 Balances with banks and security investments, external loans and other external assets

These assets principally include security investments issued by non-euro area residents and balances with banks outside the euro area.

	31 Dec 2008	1 Jan 2008	Change
	€’000	€’000	€’000
Marketable debt securities other than those held-to-maturity	**87,239**	152,824	(65,585)
Balances with banks			
Fixed-term deposits	**59,639**	74,723	(15,084)
Current accounts and overnight deposits	**46,816**	47,969	(1,153)
Other external assets	**357**	469	(112)
Total	**194,051**	275,985	(81,934)

A 3 Claims on euro area residents denominated in foreign currency

These foreign currency assets mainly comprise investments in marketable securities issued by euro area residents and balances with banks within the euro area.

This item includes claims arising from reverse operations with Eurosystem counterparties amounting to €258,279,011 in connection with the short-term US dollar liquidity-providing programme Term Auction Facility. Under this programme, US dollars were provided by the Federal Reserve to the ECB by means of a temporary reciprocal currency arrangement (swap line) with the aim of offering short-term US dollar funding to Eurosystem counterparties. The ECB simultaneously entered into back-to-back swap transactions with NCBs that have adopted the euro, which used the resulting funds to conduct liquidity-providing operations with the Eurosystem counterparties in the form of reverse and swap transactions. The back-to-back swap transactions between the ECB and NCBs resulted in intra-Eurosystem balances reported under liability sub-item L10.4 *"Other liabilities within the Eurosystem (net)"* and are not remunerated.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**69,789**	128,688	(58,899)
Balances with banks			
Fixed-term deposits	**107,335**	163,032	(55,697)
Current accounts and overnight deposits	**4**	131	(127)
US dollar Term Auction Facility	**258,279**	-	258,279
Total	**435,407**	291,851	143,556

A 4 Claims on non-euro area residents denominated in euro

These claims include marketable debt securities issued by non-euro area residents and balances with banks outside the euro area.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**94,290**	116,784	(22,494)
Held-to-maturity debt securities	**115,481**	15,524	99,957
Balances with banks			
Fixed-term deposits	**50,000**	682,000	(632,000)
Current accounts and overnight deposits	**202**	3,385	(3,183)
Total	**259,973**	817,693	(557,720)

As at 31 December 2008 the market value of held-to-maturity debt securities, based on mid-market prices, amounted to €118,231,390 (1 January 2008: €15,456,060).

A 5 Lending to euro area credit institutions related to monetary policy operations denominated in euro

This item reflects operations carried out by the Bank within the framework of the single monetary policy of the Eurosystem.

A 5.1 Main refinancing operations

Main refinancing operations are regular liquidity-providing reverse transactions carried out by the Eurosystem NCBs with a weekly frequency and generally a maturity of one week. These operations are carried out in the form of standard tender operations with a variable or fixed rate tender procedure[6]. All counterparties that fulfil the general eligibility criteria may submit bids within a specified timeframe. Participation in main refinancing operations requires the availability of eligible collateral. The aggregate main refinancing operations with the Bank carried out during the year amounted to €2,412,891,343. The outstanding operations at the end of the year amounted to €164 million.

The following table discloses the changes in the main refinancing operations rate during 2008 as decided by the Governing Council of the ECB:

With effect from	Change in bps	Effective rate (%)
1 January		4.00
9 July	+25 bps	4.25
15 October	-50 bps	3.75
12 November	-50 bps	3.25
10 December	-75 bps	2.50

A 5.2 Longer-term refinancing operations

Longer-term refinancing operations are regular liquidity-providing reverse transactions carried out in the form of variable or fixed rate tender procedure[7], with a monthly frequency and a maturity of three months[8]. These operations aim to provide counterparties with additional longer-term refinancing. Participation in longer-term refinancing operations requires the availability of eligible collateral. The aggregate longer-term refinancing operations with the Bank carried out during the year amounted to €525 million. The outstanding operations at the end of the year amounted to €290 million.

A 5.3 Fine-tuning reverse operations

Fine-tuning reverse operations are executed on an *ad hoc* basis with a view of managing the liquidity situation in the market and steering interest rates. The choice of fine-tuning instruments and procedures depends on the type of transaction and its underlying objective. Fine-tuning operations are normally executed by the NCBs through quick tenders or through bilateral procedures. The Governing Council of the ECB may, under exceptional circumstances, empower the ECB to conduct bilateral fine-tuning operations itself. During 2008, the ECB conducted eight liquidity-providing fine-tuning reverse operations, however there was no participation by domestic eligible counterparties in such operations. Participation in liquidity-providing reverse operations would only be allowed against eligible collateral.

---

[6] Prior to 15 October 2008, main refinancing operations were conducted through variable rate tender procedure. However, with effect from the operation settled on 15 October 2008, main refinancing operations started being carried out through fixed rate tender procedure with full allotment.

[7] On 15 October 2008, the ECB announced that the longer-term refinancing operations will be conducted at a fixed rate with full allotment.

[8] During 2008, the ECB introduced supplementary 3-month longer-term refinancing operations. Additionally, the ECB also introduced the 6-month longer-term refinancing operations and special term refinancing operations with a tenor matching the length of a reserve maintenance period.

A 5.4 Structural reverse operations

Structural operations can be executed in the form of reverse open market transactions aimed at adjusting the structural position of the Eurosystem vis-à-vis the financial sector. Structural reverse operations are liquidity-providing operations with a non-standardised maturity period. All eligible counterparties may submit bids for such operations and must be backed by underlying eligible assets. No structural operations were conducted by the ECB during 2008.

A 5.5 Marginal lending facility

The marginal lending facility is available to eligible counterparties to obtain overnight liquidity from NCBs at a predetermined interest rate against eligible assets and is intended to satisfy counterparties' temporary liquidity needs. Under normal circumstances, the interest rate on the facility provides a ceiling for the overnight market interest rate. During 2008, the aggregate volume of such transactions with the Bank amounted to €71,149,226. There were no outstanding balances as at 31 December 2008 in this respect.

The following table discloses the changes in the interest rate on the marginal lending facility during 2008 as decided by the Governing Council of the ECB:

With effect from	Change in bps	Effective rate (%)
1 January		5.00
9 July	+25 bps	5.25
8 October	- 50 bps	4.75
9 October	-50 bps	4.25
12 November	-50 bps	3.75
10 December	-75 bps	3.00

A 5.6 Credits related to margin calls

This sub-item refers to cash paid to counterparties in those instances where the market value of the collateral exceeds an established trigger point implying an excess of collateral with respect to outstanding monetary policy operations. Since the Bank operates a general pooling system, no payments to counterparties are effected.

A 6 Other claims on euro area credit institutions denominated in euro

This item relates to claims on credit institutions within the euro area which do not relate to monetary policy operations, consisting mainly of balances and placements with banks. As at 1 January 2008 these assets included claims arising from the frontloading of euro banknotes and coins to credit institutions amounting to €592,490,000 and €20,313,250 respectively.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Fixed-term deposits	**163,550**	435,000	(271,450)
Current accounts and overnight deposits	**-**	1,698	(1,698)
Claims related to frontloaded notes and coins	**-**	612,803	(612,803)
Other claims	**454**	920	(466)
Total	**164,004**	1,050,421	(886,417)

Other claims as at 1 January 2008 comprise claims amounting to €466,000 stemming from monetary policy operations initiated by the Bank prior to joining the Eurosystem.

A 7 Securities of euro area residents denominated in euro

This item comprises all the Bank's holdings of debt securities issued by euro area residents that are not used in monetary policy operations and are not part of investment portfolios earmarked for specific purposes.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Malta Government Treasury bills	**14,575**	2,111	12,464
Marketable debt securities other than those held-to-maturity	**304,416**	306,402	(1,986)
Held-to-maturity debt securities	**155,778**	228,191	(72,413)
Total	**474,769**	536,704	(61,935)

As at 31 December 2008 the market value of held-to-maturity debt securities, based on mid-market prices, amounted to €161,871,980 (1 January 2008: €226,496,538). Malta Government Treasury bills, which are classified as other than held-to-maturity and are accordingly carried at mid-market prices, are acquired on the secondary market at discounted amounts.

A 9 Intra-Eurosystem claims

This item consists of claims arising from the Bank's share in the ECB's capital, reserves and provisions and claims equivalent to the transfer of foreign reserves to the ECB. It may also include net claims related to the allocation of euro banknotes within the Eurosystem and other net claims within the Eurosystem.

A 9.1 Participating interest in ECB

On 1 May 2004 Malta joined the European Union and consequently the Bank became a member of the ESCB and in accordance with article 28 of the Statute it became a subscriber to the capital of the ECB. Subscriptions are determined on the basis of population and gross domestic product data provided by the European Commission in line with article 29.1 of the Statute and which are adjusted every five years and every time that a new member state joins the European Union in accordance with article 49.3 of the Statute. The share of the Bank in the ECB's capital on 1 May 2004 was 0.0647%. With effect from 1 January 2007 the Bank's share in the ECB's capital was determined at 0.0622% pursuant to the decision of the ECB of 15 December 2006. As Malta did not participate in the euro area until 1 January 2008, the transitional provisions of article 48 of the Statute applied. Consequently, the Bank was required to pay-up a contribution of 7% of its allocated share capital in the ECB upon entry into the ESCB on 1 May 2004 amounting to €252,024, which was adjusted to €250,819 on 1 January 2007. The Bank paid up the remaining 93% of its capital subscription amounting to €3,332,307 as at 1 January 2008. Accordingly the total share of the paid-up share capital in the ECB is €3,583,126. There have been no changes in the Bank's share capital in the ECB during the current financial year.

The following table discloses information on the 27 NCBs in the capital of the ECB as at 31 December 2008:

	Capital key	Subscribed capital	Paid-up capital	Eurosystem capital key
	%	€'000	€'000	%
Nationale Bank van België / Banque Nationale de Belgique	2.4708	142,334	142,334	3.5451
Deutsche Bundesbank	20.5211	1,182,149	1,182,149	29.4437
Central Bank and Financial Services Authority of Ireland	0.8885	51,183	51,183	1.2748
Bank of Greece	1.8168	104,660	104,660	2.6067
Banco de España	7.5498	434,918	434,918	10.8324
Banque de France	14.3875	828,814	828,814	20.6431
Banca d'Italia	12.5297	721,792	721,792	17.9776
Central Bank of Cyprus	0.1249	7,195	7,195	0.1792
Banque centrale du Luxembourg	0.1575	9,073	9,073	0.2260
Central Bank of Malta / Bank Ċentrali ta' Malta	0.0622	3,583	3,583	0.0892
De Nederlandsche Bank	3.8937	224,303	224,303	5.5867
Oesterreichische Nationalbank	2.0159	116,129	116,129	2.8924
Banco de Portugal	1.7137	98,720	98,720	2.4588
Banka Slovenije	0.3194	18,400	18,400	0.4583
Suomen Pankki-Finlands Bank	1.2448	71,709	71,709	1.7860
Total euro area NCBs	**69.6963**	**4,014,962**	**4,014,962**	**100.0000**
Česká národní banka	1.3880	79,958	5,597	
Danmarks Nationalbank	1.5138	87,205	6,104	
Eesti Pank	0.1703	9,810	687	
Latvijas Banka	0.2813	16,205	1,134	
Lietuvos bankas	0.4178	24,068	1,685	
Magyar Nemzeti Bank	1.3141	75,701	5,299	
Narodowy Bank Polski	4.8748	280,820	19,657	
Národná banka Slovenska	0.6765	38,971	2,728	
Sveriges Riksbank	2.3313	134,298	9,401	
Bank of England	13.9337	802,672	56,187	
Bulgarian National Bank	0.8833	50,884	3,562	
Banca Națională a României	2.5188	145,099	10,157	
Total non-euro area NCBs	**30.3037**	**1,745,691**	**122,198**	
Total euro area and non-euro area NCBs	**100.0000**	**5,760,653**	**4,137,160**	**100.0000**

In accordance with article 49.2 of the Statute, the Bank also effected contributions of €7,908,437 to the ECB's reserves and provisions in two tranches. As a result of a difference between the euro equivalent of foreign reserves transferred to the ECB at prevailing exchange rates and the amount determined in accordance with the capital key (disclosed under asset sub-item A9.2 *"Claims equivalent to the transfer of foreign reserves"*), the amount of €722,047 was considered as an advance contribution to the ECB reserves and provisions in January 2008. The balance of the contribution was settled after the approval of the ECB's Annual Accounts for the year ended 31 December 2007 by the Governing Council of the ECB.

	31 Dec 2008
	€'000
Contribution to reserves effected in:	
January 08	722
March 08	4,798
Contribution to provisions effected in:	
March 08	2,388
Total	**7,908**

A 9.2 Claims equivalent to the transfer of foreign reserves

This asset includes the Bank's euro-denominated claims arising from the transfer of foreign reserves to the ECB. In accordance with article 30.1 of the Statute, on 2 and 3 January 2008 the Bank transferred foreign reserve assets to the ECB with a total equivalent amount of €36,553,305, being 15% in gold and 85% in US dollars. The Bank's claim according to the capital key amounted to €35,831,258. The difference was utilised as an advance contribution to the ECB reserves (see Note A9.1 *"Participating interest in ECB"* above). As gold does not earn interest, the claim is remunerated at 85% of the applicable rate for the main refinancing operations.

A 9.4 Net claims related to the allocation of euro banknotes within the Eurosystem

This sub-item reflects claims which would arise from application of the banknote allocation key (see Note *7 "Euro banknotes in circulation*" in the General notes to the financial statements). As at 31 December 2008 the Bank had no claims in this respect but had a liability which is presented in liability sub-item L10.3 *"Net liabilities related to the allocation of euro banknotes within the Eurosystem"*.

A 9.5 Other claims within the Eurosystem (net)

As at 31 December 2008 the Bank had no such claims but had liabilities which are presented under liability sub-item L10.4 *"Other liabilities within the Eurosystem (net)"*. At 1 January 2008 the Bank's claims consisted principally of correspondent accounts with euro area NCBs net of the Bank's liability in relation to 93% of its capital subscription in the ECB (see Note A9.1 *"Participating interest in ECB"* above).

A 10 Items in course of settlement

These assets comprise payments which had not yet been settled by the end of the financial year.

A 11 Other assets

A 11.1 Coins of euro area

This item represents the Bank's holdings of euro coins issued by euro area countries.

A 11.2 Tangible and intangible fixed assets

Tangible and intangible fixed assets principally comprise the Bank's premises, equipment, computer hardware and software.

	Land and buildings €'000	Computer equipment and other assets €'000	Total €'000
Cost			
As at 1 January 2008	22,740	3,338	26,078
Additions	21	107	128
As at 31 December 2008	**22,761**	**3,445**	**26,206**
Accumulated depreciation			
As at 1 January 2008	1,518	1,552	3,070
Charge for the year	848	619	1,467
As at 31 December 2008	**2,366**	**2,171**	**4,537**
Net book value			
As at 1 January 2008	21,222	1,786	23,008
As at 31 December 2008	**20,395**	**1,274**	**21,669**

A 11.3 Other financial assets

Other financial assets comprise all debt securities held by the Bank as part of an earmarked portfolio. At 31 December 2008 the Bank had an earmarked portfolio comprising held-to-maturity debt securities as a counterpart to the Bank's capital and statutory reserves. The Bank also held another earmarked portfolio comprising of Malta Government securities purchased on the secondary market by the Bank in its role as market maker.

	31 Dec 2008 €'000	1 Jan 2008 €'000	Change €'000
Malta Government Stocks	**256,625**	201,501	55,124
Held-to-maturity debt securities	**190,328**	-	190,328
Total	**446,953**	201,501	245,452

As at 31 December 2008, the market value of held-to-maturity debt securities, based on mid market prices, amounted to €198,398,234. Malta Government Stocks, which are classified as other than held-to-maturity and are accordingly carried at mid-market prices, are subject to fixed interest rates.

A 11.4 Off-balance sheet instruments revaluation differences

This item reflects unrealised revaluation gains arising on off-balance sheet positions, principally forward foreign exchange contracts outstanding at 31 December 2008. At year end, these unrealised gains amounted to €308,345.

A 11.5 Accruals and prepaid expenses

This sub-item consists of accrued interest income on income earning assets and any prepaid expenditure.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Accrued interest income	**38,469**	30,236	8,233
Prepaid expenditure	**107**	11	96
Total	**38,576**	30,247	8,329

Accrued interest income at 31 December 2008 includes an amount of €6,576,564 attributable to interest on intra-Eurosystem claims.

A 11.6 Sundry

Sundry assets consist of IMF currency subscription and other assets.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
IMF Currency Subscription (see Note A2.1)	**68,332**	66,310	2,022
Other	**50,595**	36,005	14,590
Total	**118,927**	102,315	16,612

Other assets include unrealised revaluation losses arising from Malta Government Stocks held as part of an earmarked portfolio (31 December 2008 - €114,737); and the balance of unrealised fair value changes attributable to foreign exchange derivatives and available-for-sale securities arising prior to joining the Eurosystem (31 December 2008 - €9,997,447; 1 January 2008 - €26,397,113). The latter balance is being amortised on a straight-line basis from 1 January 2008 onwards over the term of the instrument. These assets also include realised gains attributable to off-balance sheet positions, principally forward foreign exchange contracts outstanding at year end, which are offset by realised losses arising from on-balance sheet positions and the net result is disclosed within Note 2.1 "*Realised gains / losses arising from financial operations"* to the Profit and loss account.

Liabilities

L 1 Banknotes in circulation

The total value of euro banknotes issued by Eurosystem NCBs is distributed among these banks on the last day of each month in accordance with the key for allocating euro banknotes (see Note 7 *"Euro banknotes in circulation"* in the General notes to the financial statements). In accordance with the banknote allocation key applicable on 31 December 2008, the Bank has a 0.0825% share of the value of all euro banknotes in circulation. During the year ended 31 December 2008 the total value of banknotes in circulation within the Eurosystem increased from €678,179 million to €762,775 million. In accordance with the banknote allocation key, the Bank discloses holdings of euro banknotes amounting to €629,289,375 at the end of the year. The value of the euro banknotes actually issued by the Bank as at that date was €683,836,185. As this amount exceeded the allocated amount, the difference of €54,546,810 is presented in liability sub-item L10.3 "*Net liabilities related to the allocation of euro banknotes within the Eurosystem"*.

Maltese lira banknotes ceased to be legal tender on 31 January 2008 following the adoption of the euro on 1 January 2008. During 2008, being the changeover year, Maltese lira banknotes were still included within the banknotes in circulation figure. With effect from 1 January 2009, these banknotes have been transferred to liability sub-item L12.3 *"Sundry liabilities"*.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Euro banknotes	**629,289**	559,498	69,791
Maltese lira banknotes	**63,809**	634,201	(570,392)
Total	**693,098**	1,193,699	(500,601)

L 2 Liabilities to euro area credit institutions related to monetary policy operations denominated in euro

These interest-bearing liabilities arise from the monetary policy operations conducted by the Bank on behalf of the ESCB.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Current accounts (covering the minimum reserve system)	**474,475**	973,528	(499,053)
Deposit facility	**9,000**	81,761	(72,761)
Fixed-term deposits	**-**	331,470	(331,470)
Total	**483,475**	1,386,759	(903,284)

L 2.1 Current accounts (covering the minimum reserve system)

These liabilities include deposits by the credit institutions which are utilised to meet the minimum reserve requirement and settlement of payments. The main criterion for including these deposits within this sub-item is that the respective credit institutions must appear in the list of institutions which are subject to the minimum reserve regulations of the Eurosystem. Minimum reserve requirements have to be met on average over the reserve maintenance period in accordance with the schedule published by the ECB. Banks' minimum reserve balances are remunerated at the average of the ECB's rate for the main refinancing operations calculated over the maintenance period and weighted according to the number of calendar days. The balance at 1 January 2008 represents primarily reserve deposits by banks held in terms of the requirements applicable prior to joining the Eurosystem.

L 2.2 Deposit facility

The overnight deposit facility is available to eligible counterparties to make overnight deposits with NCBs at pre-specified rates. Under normal circumstances, the interest rate on the facility provides a floor for the overnight market interest rate. During 2008, the aggregate volume of such transactions with the Bank amounted to €8,187,300,000. The outstanding balance as at year end amounted to €9 million. The balance at 1 January 2008 relates to deposits effected by local credit institutions under the overnight deposit facility available prior to joining the Eurosystem.

L 2.3 Fixed-term deposits

These liabilities relate to liquidity-absorbing fine-tuning operations for a fixed-term subject to a fixed rate of interest. During 2008 the aggregate volume of such transactions with the Bank amounted to €879,697,237. There were no outstanding fixed-term deposits at the balance sheet date. The respective balance as at 1 January 2008 represents liabilities arising from monetary policy instruments attributable to term deposit auctions conducted by the Bank as part of its open market operations prior to joining the Eurosystem.

L 2.4 Fine-tuning reverse operations

Fine-tuning liquidity-absorbing reverse operations are executed on an *ad hoc* basis with the purpose of managing the liquidity situation in the market and setting interest rates. Liquidity-absorbing fine-tuning reverse operations are executed, as a rule, through bilateral procedures. Moreover, their frequency and maturity are not standardised. No fine-tuning absorption reverse operations were conducted during 2008.

L 2.5 Deposits related to margin calls

This sub-item refers to cash received from counterparties in those instances where the market value of the collateral has fallen below an established trigger point implying a shortfall of collateral to cover the outstanding monetary policy operations. Since the Bank operates a general pooling system, which was always over-collateralised during 2008, no deposits from counterparties were required.

L 3 Other liabilities to euro area credit institutions denominated in euro

This balance sheet item includes credit institutions' accounts which are unrelated to monetary policy operations. The balance at 1 January 2008 represents funds deposited by credit institutions under the Special Registration Scheme 2007 which was launched by the Ministry of Finance with effect from 23 April 2007. The purpose of this Scheme was to provide individuals residing in Malta with a one-time opportunity to regularise their position in respect of their holdings of eligible assets in those cases where the associated income had not been declared for the purposes of the Income Tax Act. To benefit from this scheme such eligible assets had to be registered with registration agents appointed by the Bank. Deposits effected by credit institutions under this Scheme had a one-year term and accordingly no such balances were outstanding at 31 December 2008.

L 5 Liabilities to other euro residents denominated in euro

L 5.1 General government

This liability includes current and sinking fund accounts denominated in euro held by the Government of Malta. These balances are repayable on demand and are subject to variable interest rates linked to the ECB's main refinancing operations rate.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Current accounts	**214,922**	235,213	(20,291)
Sinking fund accounts	**147,027**	133,885	13,142
Total	**361,949**	369,098	(7,149)

L 5.2 Other liabilities

Current accounts and fixed-term deposits denominated in euro by Maltese public sector corporations are presented within this item. Current accounts are repayable on demand and subject to variable interest rates linked to the ECB's main refinancing operations rate. Fixed-term deposits are subject to fixed interest rates.

L 6 Liabilities to non-euro area residents denominated in euro

This sub-item includes balances denominated in euro held by international and supranational organisations and by non-Eurosystem central banks, including the IMF current accounts. These liabilities are principally non interest-bearing.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
IMF current accounts (see Note A2.1)	**68,332**	66,310	2,022
Others	**12,039**	31,377	(19,338)
Total	**80,371**	97,687	(17,316)

L 7 Liabilities to euro area residents denominated in foreign currency

Balances held by the Government of Malta which are repayable on demand and other deposits by Maltese public sector corporations are included in this item. These balances are principally subject to floating interest rates based on weekly average rates applied to call funds.

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Government of Malta			
Current accounts	**23,648**	14,281	9,367
Sinking fund accounts	**3,946**	3,862	84
Maltese public sector corporations			
Current accounts and fixed-term deposits	**6,199**	6,119	80
Total	**33,793**	24,262	9,531

L 9 Counterpart of special drawing rights allocated by the IMF

This item represents the counterpart of special drawing rights allocated by the IMF to Malta (see Note A2.1 *"Receivables from the IMF"* above).

L 10 Intra-Eurosystem liabilities

This liability represents the Bank's liabilities to the ECB and to the other Eurosystem NCBs.

L 10.3 Net liabilities related to the allocation of euro banknotes within the Eurosystem

This item consists of the liability of the Bank vis-à-vis the Eurosystem relating to the excess of euro banknotes issued by the Bank over and above the amount allocated to the Bank by the ECB in accordance with the banknote allocation key (see Note L1 *"Banknotes in circulation"* above). This liability is subject to interest at the ECB main refinancing operations rate, taking cognisance of the adjustments referred to in Note 7 "*Euro banknotes in circulation"* in the General notes to the financial statements in the cash changeover year and in the subsequent five years.

	31 Dec 2008	1 Jan 2008
	€'000	€'000
Issued banknotes	**683,836**	592,490
Banknotes allocated as per banknote allocation key	**(629,289)**	(559,498)
Excess of issued banknotes over allocation	**54,547**	32,992

L 10.4 Other liabilities within the Eurosystem (net)

These liabilities mainly include the TARGET2 balance arising from cross-border euro transfers with other NCBs in the ESCB and the ECB, and correspondent accounts of other Eurosystem NCBs. The TARGET2 balance is subject to interest at the prevailing rate for the ECB main refinancing operations. Moreover, these liabilities include the net liability at year end arising from the difference between monetary income to be pooled and that distributed (see Note 5 *"Net result of pooling of monetary income"* to the Profit and loss account) and the claim arising from the distribution of the ECB's seigniorage income.

	31 Dec 2008 €'000
TARGET2 balance and correspondent accounts	664,873
Net result from pooling of monetary income	2,783
Seigniorage income receivable	(1,076)
Total	**666,580**

L 12 Other liabilities

L 12.1 Off-balance sheet instruments revaluation differences

This item reflects unrealised revaluation losses arising on off-balance sheet positions, primarily forward foreign exchange contracts outstanding at 31 December 2008. At year end, these unrealised losses amounted to €2,737,703.

L 12.2 Accruals and income collected in advance

These liabilities include accrued interest expense on interest-bearing liabilities and other accrued expenses. Moreover, these also include the balance of demonetised Maltese lira notes and coins which have not yet been presented. This amount is recognised as deferred income until the final date when such notes and coins cease to be exchangeable at the Bank.

	31 Dec 2008 **€'000**	1 Jan 2008 €'000	Change €'000
Accrued interest payable	**2,790**	1,095	1,695
Deferred income in respect of demonetised Maltese lira currency notes and coins	**19,237**	3,673	15,564
Other	**754**	-	754
Total	**22,781**	4,768	18,013

Accrued interest expense at 31 December 2008 includes an amount of €429,348 attributable to interest on intra-Eurosystem liabilities.

L 12.3 Sundry

Sundry liabilities mainly comprise of unrealised revaluation gains attributable to Malta Government stocks held as part of an earmarked portfolio (31 December 2008 - €10,838,076) and the balance of unrealised fair value changes attributable to available-for-sale securities arising prior to joining the Eurosystem (31 December 2008 - €201,916; 1 January 2008 - €816,484). The latter balance is being amortised on a straight-line basis from 1 January 2008 onwards over the term of the instrument. At 1 January 2008 these liabilities also included the balance of Maltese lira coins still in circulation on that date (€43,602,468).

L 13 Provisions

In accordance with the general accounting principle of prudence, the Governing Council has deemed it appropriate to establish a buffer totalling €5,736 million against counterparty risks in monetary policy operations. In accordance with article 32.4 of the Statute, this buffer will be funded amongst all the NCBs of participating Member States in proportion to their Eurosystem capital key prevailing during 2008. Accordingly, a provision for €5,118,806, equivalent to 0.0892% of the total provision, was recognised in these financial statements.

L 14 Revaluation accounts

The revaluation accounts include the unrealised revaluation gains arising from the valuation of foreign currency on and off-balance sheet positions, gold and marketable securities at year end.

	31 Dec 2008 €000
Gold	351
Securities	7,040
Foreign currency positions	744
Total	**8,135**

Net unrealised gains and losses attributable to the valuation of gold and foreign currency positions, including off-balance sheet instruments, that arose prior to euro adoption, were recognised in the Profit and loss account. In view of the Accounting Guideline requirements with effect from 1 January 2008, there were no balances on the revaluation accounts as at this date.

The opening fair value reserve as at 1 January 2008, reflecting unrealised fair value changes on available-for-sale securities up to 31 December 2007 has been split under asset sub-item A11.6 *"Sundry assets"* representing the negative fair value adjustment and liability sub-item L12.*3 "Sundry liabilities"* representing the positive fair value adjustment. The fair value reserve is being amortised to the Profit and loss account on a straight-line basis over the useful term of the respective security.

L 15 Capital and reserves

The following table analyses the movement in capital and reserves of the Bank.

	Capital €'000	General reserve fund €'000	Special reserve fund €'000	Reserves for risks and contingencies €'000	Capital contribution €'000
Balance as at 1 January 2008					
Prior to reclassifications	11,647	53,576	30,282	100,384	28,632
Reclassifications	8,353	21,929	(30,282)	-	-
Net issuance of euro coins	-	-	-	-	2,539
Transfer from profits for the year	-	-	-	7,000	-
Balance as at 31 December 2008	**20,000**	**75,505**	**-**	**107,384**	**31,171**

The reclassifications disclosed in the table above are attributable to the revised requirements of the Central Bank of Malta Act (Cap. 204), which increased the Bank's capital and amalgamated the Special reserve fund into the General reserve fund as at 1 January 2008.

L 15.1 Capital

In terms of article 19(1) of the Central Bank of Malta Act (Cap. 204), the Bank shall have an authorised capital of €20 million. This is fully paid up and is held exclusively by the Government of Malta.

L 15.2 Reserves

(a) General reserve fund

In terms of article 19(2) of the Central Bank of Malta Act (Cap. 204), the Bank shall also maintain a General reserve fund which shall be of not less than €20 million and which shall be available for any purpose as may be determined by the Board of Directors. Whenever amounts are drawn from the General reserve fund, these shall be replaced as may be decided by the Board.

(b) Reserves for risks and contingencies

Reserves for risks and contingencies are maintained in terms of article 22 of the Central Bank of Malta Act (Cap. 204) to cover the broad range of risks to which the Bank is exposed. The major risks in this regard arise from potential movements in market values of the Bank's holdings of domestic and foreign securities and other investments, losses which could arise from support of the financial system in the Bank's role as a lender of last resort, and other non-insured losses.

(c) Capital contribution

This reserve represents the capital contribution made by the Government of Malta to the Bank in respect of the agency agreement between the Bank and the Government relating to the issuance of euro coins. The Bank shall act as agent of the Government and shall retain full responsibility for procurement, storage and issuance of euro coins. This reserve represents seigniorage revenue arising from the issue of euro coins. In terms of the agency agreement the Government has agreed not to withdraw such revenue and retain these amounts in a reserve account held at the Bank. Allocation of revenue to the reserve account shall be deemed as a capital contribution to the Bank by the Government.

Notes to the Profit and loss account

1 Net interest income

This item represents the net result of interest income and interest expense.

1.1 Interest income

Interest income includes income on foreign reserve assets and euro-denominated portfolios, as well as interest income on intra-Eurosystem claims and on monetary policy instruments.

	2008
	€'000
Marketable debt securities	
- In euro	39,135
- In foreign currency	9,400
Fixed-term deposits	
- In euro	31,788
- In foreign currency	9,239
Current accounts and overnight deposits	
- In euro	166
- In foreign currency	197
IMF	1,676
Monetary policy operations	
- Main refinancing operations	1,667
- Longer-term refinancing operations	4,459
- Marginal lending facility	10
Intra-Eurosystem claims	
- Claims arising from the transfer of foreign reserves	1,246
- Net claims related to the allocation of banknotes within the Eurosystem	24,893
Forward foreign exchange contracts	2,502
Other interest income	108
Total	**126,486**

Income from *"Net claims related to the allocation of banknotes within the Eurosystem"* principally comprises of interest income arising on a notional amount representing the differences between the average value of the banknotes which the Bank had in circulation in the reference period and the average value of banknotes which would have been allocated to the Bank during that period in accordance with its capital key. Interest is calculated at the prevailing ECB rate for the main refinancing operations. This is in line with the provisions established by the Governing Council as outlined in the ECB Decision on the allocation of monetary income (ECB/2001/16 as amended by ECB/2006/7). The adjustments are reduced in annual stages until the first day of the sixth year after the cash changeover year, when income on banknotes will be allocated fully in proportion to the NCBs' paid-up share capital in the ECB. The Bank's adjustment period started on 1 January 2008 and will end on 31 December 2013. This item also includes net interest income on the difference between the euro banknotes allocated to the Bank in accordance with the banknote allocation key and the value of the euro banknotes that the Bank actually puts into circulation, as reduced by banknotes withdrawn from circulation.

1.2 Interest expense

Interest expense arises from interest payable on Government of Malta and other customer accounts, TARGET2 balances as well as liabilities to euro area credit institutions related to monetary policy operations.

	2008
	€'000
Government accounts	
- In euro	9,338
- In foreign currency	830
Other customer accounts	
- In euro	667
- In foreign currency	113
Monetary policy operations	
- Minimum reserves	16,998
- Overnight deposits	802
- Fixed-term deposits	238
Intra-Eurosystem liabilities	
- TARGET2 balances	28,713
Other interest expense	189
Total	**57,888**

2 Net result of financial operations, write-downs and risk provisions

2.1 Realised gains / losses arising from financial operations

This item includes gains and losses arising from transactions leading to reductions in foreign currency positions and disposals of financial instruments, mainly securities.

	2008
	€'000
Net gains / (losses) on disposal of financial instruments	991
Net gains / (losses) on foreign currency positions	(183)
Total	**808**

2.2 Write-downs on financial assets and positions

This item comprises unrealised revaluation losses arising from the price revaluation of securities and the exchange rate revaluation of foreign currency assets and liabilities, including off-balance sheet positions, by comparing the market value at balance sheet date with the average book value.

	2008
	€'000
Write-downs on securities	(8,497)
Write-downs on foreign currency positions	(67)
Total	**(8,564)**

2.3 Transfer (to) / from provisions for foreign exchange rate, price risks and monetary policy operations

Following the decision by the Governing Council of the ECB to establish a buffer against counterparty risks from monetary policy operations carried out in 2008, the Bank has recognised a provision of €5,118,806, being the Bank's share in accordance with its Eurosystem capital key (see Note L13 *"Provisions"* in the Notes to the Balance sheet).

3 Net income / (expense) from fees and commissions

Fees and commissions receivable mainly arise from the provision of banking services. Fees and commissions payable include correspondent account charges, handling fees on cheques drawn on the Bank and TARGET2 connection and participation fees.

4 Income from equity shares and participating interests

Included under this caption is the distribution of the ECB's income on euro banknotes amounting to €1,075,997 in proportion to the Bank's Eurosystem capital key (see Note 7 *"Euro banknotes in circulation"* in the General notes to the financial statements). In 2008 the ECB's income on euro banknotes in circulation amounted to €2,230,477,327 of which €1,024,801,908 was retained by the ECB in accordance with the decision of the Governing Council with respect to the establishment of a provision for foreign exchange rate, interest rate and gold price risks.

5 Net result of pooling of monetary income

The amount of each Eurosystem NCB's monetary income is determined by measuring, on a daily basis, the actual income that is derived from the earmarkable assets held against the liability base.

The liability base consists of the following items: banknotes in circulation; liabilities to credit institutions related to monetary policy operations denominated in euro; net intra-Eurosystem liabilities resulting from TARGET2 transactions; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is to be deducted from the monetary income to be pooled.

The earmarkable assets consist of the following items: lending to euro area credit institutions related to monetary policy operations denominated in euro; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET2 transactions; net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem; and a limited amount of each NCB's gold holdings in proportion to each NCB's capital key. Gold is considered to generate no income.

Where the value of an NCB's earmarkable assets exceeds or falls short of the value of the liability base, the difference shall be offset by applying to the value of the difference the applicable rate for the ECB main refinancing operations.

The monetary income pooled by the Eurosystem is allocated among NCBs in relation to the Eurosystem capital key. The net result arising from the calculation of monetary income is a payment by the Bank of €2,783,274, being the difference between the monetary income pooled amounting to €27,346,802 and the amount redistributed of €24,563,528.

6 Other income

Other income includes an amount of €10 million relating to the balance of unredeemed Maltese coins, which as at 31 December 2008 amounted to €26,780,161. These coins will cease to be exchangeable at the Bank subsequent to 1 February 2010. The value of unredeemed coins, after deducting therefrom the amount of coins which are expected to be redeemed until that date, is recognised as income in the Profit and loss account in a systematic manner over the period to 1 February 2010. In this respect the Board approved the recognition of income amounting to €10 million from the balance of such coins in profits for the year. This accounting treatment is in accordance with the provisions of article 63(3) of the Central Bank of Malta Act (Cap. 204) (see Note 3(l) *"Demonetised Maltese lira currency notes and coins"* in the General notes to the financial statements). Other operating income also includes income from numismatic issues of notes and coins.

7 Staff costs

Staff costs include salaries and other ancillary costs.

	2008 €'000
Staff salaries	7,677
Other staff costs	885
Training, welfare and other related expenditure	742
Total	**9,304**

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

	2008
	Number
Governors	2
Divisional Directors	5
Heads and executives	83
Supervisory and clerical staff	204
Non-clerical staff	34
Total	**328**

8 Administrative expenses

This item consists of operating expenditure incurred by the Bank.

	2008
	€'000
Market information and communication expenses	568
Other administrative expenditure	2,977
Total	**3,545**

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 €100,000.

Compensation to the members of the Board of Directors for the financial year under review amounted to €204,271. 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.

9 Depreciation of tangible and intangible fixed assets

Depreciation of buildings, equipment, computer hardware and software was charged to the Bank's Profit and loss account according to the depreciation rates disclosed in Note 3(m) *"Tangible and intangible fixed assets"* in the General notes to the financial statements.

10 Banknote production services

This item includes expenditure relating to the procurement and transportation of euro banknotes and other ancillary costs. Accrued expenditure also reflects the expected costs attributable to the consumption of banknotes issued.

Other notes

(a) Off-balance sheet instruments

At the balance sheet date, the principal outstanding off-balance sheet instruments consisted of forward foreign exchange contracts with a notional amount of €352,350,000 involving the forward purchase of euro against the forward sale of other currencies.

In addition to the above figures, the Bank also had outstanding €258,279,011 net forward liabilities to the ECB which arose in connection with the short-term US dollar liquidity-providing programme Term Auction Facility in agreement with the Federal Reserve (see Note A3 – *"Claims on euro area residents denominated in foreign currency"* in the Notes to the Balance sheet).

(b) Contingent liabilities and commitments

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Contingent liabilities			
Guarantees and letters of credit	**120,755**	74,090	46,665
Financial commitments			
Repayment of foreign loans on behalf of the Government	**7,738**	11,409	(3,671)
Total	**128,493**	85,499	42,994

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

The Bank'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 currency exposure with respect to these contingent liabilities and commitments is principally in US dollar and euro.

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.

(c) Related parties

In the course of its operations, the Bank conducts banking transactions with, and provides several banking services to, the Government of Malta, government departments, public sector corporations and other entities owned by the Government. The Bank holds the principal accounts of the Government and maintains accounts for the other entities. Balances held with the Bank by the Government and the other entities as at the balance sheet dates, together with the terms of such instruments, are disclosed in Notes L5 *"Liabilities to other euro residents denominated in euro"* and L7 *"Liabilities to euro area residents denominated in foreign currency"* to the Balance sheet. The principal impact of banking transactions entered into with the Government and the entities referred to above on the Bank's Profit and loss account is interest payable on deposits as disclosed in Note 1.2 *"Interest expense"* to the Profit and loss account. The Bank provides these entities with foreign exchange and related services, which do not have a significant impact on the Bank's Profit and loss account. The principal outstanding transactions as at the balance sheet dates are reflected in Note (b) *"Contingent liabilities and commitments"* above. The Bank acts as market maker in Malta Government securities and Treasury bills and ensures their liquidity in the secondary market by being ready to trade in such securities on the initiative of the market (see Notes A7 *"Securities of euro area residents denominated in euro"* and A11.3 *"Other financial assets"* to the Balance sheet). Income earned by the Bank from these assets is principally included in Note 1.1 *"Interest income"* to the Profit and loss account.

(d) Demonetised Maltese lira currency notes and coins

(i) Demonetised Maltese lira currency notes

Maltese lira banknotes were replaced by euro banknotes when Malta became part of the Eurosystem on 1 January 2008. Consequently, Maltese lira banknotes remained legal tender until 31 January 2008 but can be redeemed at the conversion rate of the Maltese lira for the euro of 0.4293 and without charge until 31 January 2018.

During 2008, demonetised Maltese lira currency notes presented for redemption amounted to €149,974,335. At 31 December 2008, the value of unpresented demonetised currency notes amounted to €66,264,893 analysed as follows:

	31 Dec 2008	1 Jan 2008	Change
	€'000	€'000	€'000
Ten year period expires in:			
- 2008	-	2,108	(2,108)
- 2010	**2,456**	2,974	(518)
- 2018	**63,809**	-	63,809
Total	**66,265**	5,082	61,183

The value of demonetised notes which ceased to be redeemable by the Bank during 2008 amounted to €2,061,971.

(ii) Demonetised Maltese lira currency coins

Maltese lira coins were replaced by euro coins when Malta became part of the Eurosystem on 1 January 2008. Consequently, Maltese lira coins remained legal tender until 31 January 2008 but can be redeemed at the conversion rate of the Maltese lira for the euro of 0.4293 without charge until 1 February 2010.

During 2008, demonetised Maltese lira currency coins presented for redemption amounted to €5,399,385. At 31 December 2008 the value of unpresented demonetised currency coins amounted to €26,780,161.

(e) Investment securities pledged as collateral

As at 31 December 2008, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of USD45 million or €32 million approximately (1 January 2008: USD45 million or €30 million approximately). No amounts were borrowed under these facilities at the balance sheet dates.

(f) Assets held in custody

At 31 December 2008, assets held in custody by the Bank in terms of the Maltese Insurance Business Act amounted to €36,260,160 (1 January 2008: €39,231,307).

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

In 2003, the Bank had been appointed as investment manager in respect of funds belonging to the Investor and Depositor Compensation Schemes. The Bank manages these funds on a discretionary basis in accordance with the investment parameters set by the Management Committees of the respective Schemes. As at 31 December 2008, the Investor and Depositor Compensation Schemes had interest and non interest-bearing deposits of €25,057 and €25,495 respectively, with the Bank.

(h) Financial risk management

The nature of the Bank's operations implies that financial instruments, including derivatives, are extensively used in the course of its activities. The Bank is exposed to a range of financial risks and its operations involve the analysis, evaluation, acceptance and management of some degree of risk. Accordingly, the Bank operates a risk management strategy with the objective of controlling its exposures in this respect. The Bank's operational functions identify, evaluate and hedge financial risks. The Board approves written principles for overall risk management, as well as written policies covering specific areas, such as foreign exchange risk, interest rate risk, credit risk, use of derivative financial instruments and non-derivative financial instruments.

(i) Credit risk

The Bank is exposed to credit risk, which is the risk that a counterparty will cause a financial loss for the Bank by failing to discharge an obligation. The Bank's exposures to credit risk arise principally in investment activities that bring placements with banks and marketable debt securities into the Bank's asset portfolio. The Bank's portfolio of securities is composed of listed debt instruments issued mainly by governments and international financial institutions.

The Bank manages, limits and controls concentrations of credit risk where they are identified; in particular, to individual financial institutions or counterparties and groups of financial institutions classified by country of origin. The Bank places limits on the level of credit risk undertaken in relation to any single financial institution or counterparty. The exposure to a counterparty is restricted by specific sub-limits, by amount and term, for exposures arising from the different classes of investments and transactions. The limits are assigned in accordance with external ratings based on Fitch's ratings or their equivalents. The limits on the level of credit risk are reviewed on a regular basis and are approved by the Board of Directors at regular intervals. Actual exposures are monitored against limits on a daily basis.

The Bank places funds with permitted financial institutions having credit ratings within approved thresholds and it invests only in securities or paper with credit quality that falls within specific approved parameters. As outlined above, external ratings such as Fitch's ratings or their equivalents are used by the Bank for managing the credit risk exposures with a view to attaining an adequate credit quality mapping.

The Bank's principal credit risk exposures relating to on-balance sheet assets, reflecting the maximum exposure to credit risk before collateral held or other credit enhancements, are based on carrying amounts as reported in the balance sheet. As at 31 December 2008 and 1 January 2008, the Bank did not hold any past due or impaired financial assets.

The Bank's principal exposures, excluding Malta Government securities, as at the balance sheet date, are analysed in the tables below which present an analysis of the principal categories of financial assets by rating agency designation based on Fitch's ratings or their equivalent.

Financial asset category							Carrying amount
	AAA	AA+	AA	AA-	A+	A	€'000
	%	%	%	%	%	%	
Investment securities:							
- Other than held-to-maturity	70	10	10	3	2	5	555,735
- Held-to-maturity	92	8	-	-	-	-	461,587
			AA	AA-	A+	A-	
			%	%	%	%	
Placements with banks			32	52	3	13	380,974

Note (i) "*Statement of the Bank's Investments*" below presents an analysis of the Bank's placements with banks by exposure country and of the Bank's debt securities by issuer category. Whilst no significant concentration is present with respect to the former, the issuers of the Bank's securities are mainly Governments and monetary financial institutions.

(ii) Market risk

The Bank is exposed 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. Market risks arise from open positions in interest rate and currency products, which are exposed to general and specific market movements and changes in the level of volatility of market rates or prices such as interest rates, credit spreads and foreign exchange rates.

Currency risk

The Bank is exposed to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. The Board sets limits on the level of net exposure or deviation in net holdings by currency, including contracted amounts under foreign exchange derivatives, which are monitored on an ongoing basis. The Bank is exposed to the risk of currency movements in respect of its holdings denominated in currencies other than euro. For macro-hedging purposes, the Bank uses derivative transactions for the forward purchase of euro and simultaneous forward sale of US dollar or sterling with a view of eliminating foreign currency exposures from holdings in US dollar and sterling, such that the Bank's net balance sheet exposure is substantially denominated in euro.

Interest rate risk

Cash flow interest rate risk is the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates.

The Bank mainly invests in, and places funds under, instruments subject to fixed interest rates. Whilst all placements with banks are subject to fixed interest rates, approximately 90% of the Bank's aggregate portfolio of securities are fixed interest instruments with the remaining portion representing floating rate bonds. Accordingly, it is not exposed to cash flow interest rate risk in respect of placements with banks, investment securities and local government securities. However the Bank is exposed to fair value interest rate risk particularly in respect of its investment securities other than those held-to-maturity. The Bank has in place techniques, principally based on the concept of modified duration, to measure the sensitivity of the fair value of its fixed-income instruments to changes in market yields.

The Bank's measure of its exposure to fair value interest rate risk as at the balance sheet date in respect of fixed interest other than held-to-maturity investment securities is analysed by currency below:

	Modified duration	Shift in fair value with shift of 25 bps in yields €'000
EUR	2.61	2,354
GBP	1.55	163
USD	0.88	259

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 investment securities. Moreover, the Bank's interest-bearing liabilities, other than minimum reserve deposits, are mainly repayable on demand or within short time periods from the balance sheet date. All liabilities are repriceable within short time frames, with floating interest rates linked to the ECB's main refinancing operations rate or reference market interest rates. The Bank is exposed to cash flow interest rate risk in respect of such instruments. However this exposure is offset intrinsically by the Bank's exposure on income earning assets which in substance reprice within short periods of time. The Bank actively manages its net interest income on this basis.

(iii) Liquidity risk

Liquidity risk is the risk that the Bank is unable to meet its payment obligations associated with its financial liabilities when they fall due. The Bank's main liabilities consist of banknotes in circulation and deposits, comprising minimum reserve deposits. Whereas reserve deposits and banknotes in circulation have no specified contractual maturity, other deposits are mainly repayable on demand or mature principally within very short periods of time from the balance sheet date.

The Bank's assets which are available to meet liabilities principally include placements with banks, investment securities and local government securities. The Bank places funds with banks for relatively short periods of time with varying terms and maturities. The Bank's investment securities consist of highly marketable investments which are readily realisable to meet commitments and funding requirements. The Bank's liquidity risk is hence relatively insignificant in view of the short-term maturities or realisable nature of the principal categories of its financial assets and due to the nature of the Bank's main liabilities.

Liquidity risk monitoring focuses on information on the contractual maturity of the financial assets and the interaction of this information with an analysis of the expected or projected maturity of the Bank's financial liabilities. The Bank manages the concentration, terms and profile of its assets in accordance with this monitor, subject to internal benchmarks, to ensure that requirements can be met. The contractual maturity of the Bank's principal income earning assets as at 31 December 2008 is presented in the table below:

	Within one month €000	Within three months but over one month €000	Within one year but over three months €000	Within five years but over one year €000	Over Five Years €000	Total €000
Fixed-term deposits	210,437	170,537	-	-	-	380,974
Marketable securities other than those held-to-maturity	19,358	26,087	117,929	289,343	103,018	555,735
Malta government securities	-	6,716	4,628	121,405	123,876	256,625
Held-to-maturity securities	5,000	-	130,608	151,192	174,788	461,588
Total	**234,795**	**203,340**	**253,165**	**561,940**	**401,682**	**1,654,922**

(i) Statement of the Bank's investments

The statement of the Bank's investments below is disclosed in accordance with the requirements of article 21(2)(b) of the Central Bank of Malta Act (Cap. 204).

The exposure country is the country of location of the institution or entity with which the Bank's placements and other financial assets are held. The exposure country in respect of assets held with branches of international banks and financial institutions is usually deemed to be the country of location of the parent. In case of subsidiaries of banks and financial institutions, the exposure country is generally determined on the basis of the location of the subsidiary undertaking.

	EUR €'000	GBP €'000	USD €'000	Total €'000
Cash and balances with banks				**47,402**
Gold balances				**4,141**
Placements with banks by exposure country:				
Australia	-	-	41,676	**41,676**
Belgium	64,549	-	-	**64,549**
France	-	16,798	76,166	**92,964**
Malta	50,000	-	-	**50,000**
The Netherlands	15,000	-	14,371	**29,371**
United Kingdom	50,000	-	17,963	**67,963**
Other countries	34,000	-	-	**34,000**
	213,549	**16,798**	**150,176**	**380,523**
Securities by issuer category:				
Government	659,048	-	6,835	**665,883**
Monetary financial institutions	299,247	16,559	81,745	**397,551**
Supranational	129,003	-	7,273	**136,276**
Other financial institutions	39,133	14,630	5,054	**58,817**
Insurance	3,064	10,215	-	**13,279**
Non-financial institutions	1,998	-	14,718	**16,716**
	1,131,493	**41,404**	**115,625**	**1,288,522**
Claims on the IMF				**57,385**
Participating interest in the European Central Bank				**11,492**
Other foreign currency assets				**70**
Total investments				**1,789,535**