BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

FORTY-FOURTH ANNUAL REPORT
AND
STATEMENT OF ACCOUNTS
2011

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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 banknotes 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*

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Deputy Governor

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Mr John Caruana
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Mr Herman Ciappara
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Mr Alexander Demarco
EU & International Relations

Mr Paul Farrugia
Human Resources & Administration

Mr Silvio Galea
Monetary Operations & Government Securities

Mr Jesmond Gatt
Strategy, Planning & Risk

Mr Jesmond Pulé
Statistics

Mr Peter Paul Tabone
Currency Services & Security

as at 30 March 2012

THE BOARD OF DIRECTORS*

(left to right) Mr Victor Busuttil (Director), Dr Bernadette Muscat (Secretary), Ms Antoinette Caruana (Director), Professor Josef Bonnici (Governor & Chairman), Mr Alfred DeMarco (Deputy Governor), Ms Philomena Meli (Director).

**as at 30 March 2012*

ORGANISATION CHART*

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  - Governors' Office
    Dr Bernard Gauci
- Deputy Governor
  Mr Alfred DeMarco
  - Director General Financial Policy and Special Projects
    Mr René G. Saliba
    - Financial Stability and Information Systems Directorate
      Mr Oliver Bonello
      - Financial Stability Department
        - Financial Stability Surveillance, Assessment and Data
        - Policy, Crisis Management and Stress Testing
      - Information Systems and Knowledge Management Department
        - Technology and Knowledge Services
        - Projects and Applications Development
    - Market Operations Directorate
      Mr Raymond Filletti
      - Reserves Management Department
        - Market Analysis
        - Investments
        - Middle Office
      - Monetary Operations and Government Securities Department
        - Monetary Operations and Collateral Management
        - Government Securities
    - Financial Services Directorate
      Mr Paul R. Muscat
      - Currency Services and Security Department
        - Currency Operations
        - Security Control
      - Payments and Banking Department
        - Payment and Banking Operations
        - Regulation and Oversight
  - Statistics and Risk Management Directorate
    Mr Anthony P. Cortis
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      - Monetary, Financial and External Statistics
      - General Economic Statistics, Securities and Data Management
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  - Corporate Services Directorate
    Mr Raymond A. Bonnici
    - Financial Control Department
      - Finance
    - Human Resources and Administration Department
      - Human Resources
      - Administration

- Internal Audit Department
- Economics and Research Department
  - Economic Analysis
  - Modelling and Research
- Communications and Legal Department
- EU and International Relations Department

**as at 30 March 2012*

Bank Ċentrali ta' Malta
Eurosistema
Il-Gvernatur

Central Bank of Malta
Eurosystem
The Governor

30 March 2012

The Hon Tonio Fenech
Minister of Finance, Economy and Investment
Maison Demandols
South 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 2011.

Yours sincerely

Professor Josef Bonnici

CONTENTS

ABBREVIATIONS

BIS	Bank for International Settlements
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EONIA	Euro OverNight Index Average
ERM II	exchange rate mechanism II
ESCB	European System of Central Banks
ETC	Employment and Training Corporation
EU	European Union
EURIBOR	Euro Interbank Offered Rate
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
LFS	Labour Force Survey
MFEI	Ministry of Finance, the Economy and Investment
MFI	Monetary Financial Institution
MFSA	Malta Financial Services Authority
MGS	Malta Government Stock
MRO	Main Refinancing Operation
MSE	Malta Stock Exchange
NACE	Statistical classification of economic activities in the European Community
NCB	national central bank
NPISH	non-profit institutions serving households
NSO	National Statistics Office
OMFI	Other Monetary Financial Institution
RPI	Retail Price Index
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
ULC	Unit Labour Costs

GOVERNOR'S STATEMENT

Global economic activity moderated during 2011, as the recovery from the international economic and financial crisis proved to be fragile. Most of the major industrial and emerging economies experienced slower growth than in 2010, while some even registered a contraction. At the same time, inflation picked up worldwide, before easing as the year drew to an end.

After having grown by 1.9% in the previous year, the euro area economy expanded by 1.4% in 2011. Following a strong start, real gross domestic product (GDP) growth moderated over the year, as the intensification of the sovereign debt crisis had an adverse impact on confidence and financial conditions tightened, while fiscal consolidation dampened demand. As a result, by the end of the year, unemployment in the euro area rose to 10.4% from 10.0% a year earlier.

Inflation in the euro area accelerated for most of 2011, reaching a peak of 3.0% late in the year, before edging down to 2.7% in December. Underlying inflation, measured by excluding unprocessed food and energy prices from the total, rose to 2.0% by the end of the year.

At the monetary policy level, the challenges related to sovereign debt and financial stability issues persisted, while changes in the inflation outlook required monetary policy adjustments during the year. In April and again in July, against a backdrop of an underlying upward momentum of economic activity, the Governing Council of the European Central Bank (ECB) raised key interest rates from historically low levels. This brought the interest rate on the main refinancing operations (MRO) up to 1.50%, and was aimed at keeping inflation rates below, but close to 2% over the medium term. At the same time, the Eurosystem continued to implement a range of non-standard measures to provide liquidity to the financial system.

However, the economic environment remained highly uncertain. Rising tensions in debt markets in various euro area countries prompted the ECB to take additional measures in the summer. Subsequently, as the outlook deteriorated further, the Governing Council reduced key ECB interest rates in November and December, bringing the MRO rate back down again to 1.00% by the end of the year.

Moreover, in December the Governing Council announced that the Eurosystem would conduct two three-year long-term refinancing operations (LTRO), accept a wider range of collateral in its monetary policy operations and reduce reserve requirements for banks. The two operations, which were conducted in December 2011 and February 2012, respectively, appear to have had a favourable impact on market sentiment and financial conditions.

Throughout the year, euro area Member States sought to contain the crisis by providing financial support to countries under pressure, notably Greece, through a variety of mechanisms. In this context, Malta granted loans to Greece worth EUR30.8 million during the year and provided guarantees to back the European Financial Stability Facility.

At the same time, several other policy initiatives sought to address the roots of the debt crisis through fiscal consolidation and structural reforms in a number of countries. The framework governing economic policy-making in Europe, and especially in the euro area, was reinforced, notably through tighter surveillance of economic imbalances and stricter budgetary rules. Indeed, earlier this year, 25 European Union (EU) Member States agreed to a fiscal pact intended to limit structural budget deficits to 0.5% of GDP and to strengthen the procedures dealing with excessive deficits.

In Malta, economic developments were generally positive. The economy continued to expand during 2011, growing at a faster rate than the euro area average, though there was considerable dispersion around this average across euro area countries. Real GDP growth of 2.1%, which was mainly driven by net exports, was slightly below the 2.3% reported in 2010, but still 0.7 percentage point higher than in the euro area.

Growth in employment maintained a steady pace of 2.4%, while the average unemployment rate of 6.5% was well below the comparable figure of 10.1% in the euro area.

Meanwhile, inflation, as measured by the Harmonised Index of Consumer Prices, moderated over the course of the year, with the annual rate dropping to 1.3% by December.

In the context of a difficult external environment, Malta's positive economic performance attests to a degree of resilience which the economy has built up over the years through a gradual process of structural reform that goes back to the period preceding entry into the EU in 2004. These reforms have been ongoing and have contributed to a process of diversification towards new areas of economic activity largely backed by foreign direct investment. They have also enhanced the economy's capacity to withstand the effects of a decline in external demand for manufactured goods during the international economic downturn.

Indeed, the combined exports of new areas of economic activity, such as remote gaming, information and communication technology, financial services and other business related services, have increased from slightly less than 10% of nominal GDP in 2004 to above 30% in 2010.[1] Together with the long-established tourism industry, the share of service exports has risen to more than 50% in 2010. New manufacturing activities, such as pharmaceuticals and aircraft maintenance, are also contributing positively to growth, although the ratio of manufacturing to GDP has continued to decline.

In recent years there have been clear indications of a narrowing current account imbalance and an increase in export market shares. The growth of the new export-oriented sectors has definitely contributed to this improved external performance, which is further evidenced by a decline in the current account deficit during the first three quarters of 2011.

The Maltese financial system emerged from the international financial crisis relatively unscathed. Capital and liquidity ratios remained well above the regulatory minima, which helped to retain investor confidence. The health of the domestic banking system is also reflected in its uninterrupted ability to respond to the demand for credit. At 4.2% in 2011, the rate of growth in lending by Maltese credit institutions to private sector residents of Malta exceeds the corresponding figure of 1.0% for loans provided by credit institutions across the euro area to euro area private sector borrowers.

On the fiscal front, Malta is expected to have ended 2011 with a general government deficit at 2.7% of GDP. The moderate nature of the recession and the strength of the rebound since then have helped to narrow the deficit. This notwithstanding, the government debt ratio at 70% of GDP remains high and concerted efforts need to be made to reduce it to below 60% in the medium term.

Going forward, the outlook for the current year is rather subdued, given the expected weakness of external demand, particularly in key foreign markets. According to the latest ECB staff projections, the economy of the euro area as a whole will shrink slightly in 2012, with negative repercussions on the Maltese economy. The Bank's latest macroeconomic projections point to a moderation in activity, with real GDP growth expected to ease to 1.6% in 2012, before picking up to 2.0% in 2013.

A strong case remains, therefore, for further structural reforms that will enable the economy to exploit more fully the opportunities that will arise as the recovery unfolds and external economic and financial conditions improve.

[1] A detailed breakdown for 2011 was unavailable at the time of writing.

Measures to further promote labour force participation, an area in which Malta lags behind its European peers, should have a significant positive impact.

There also has to be continued recognition that wage increases are sustainable only if supported by gains in productivity. Towards this end, consideration should be given to measures that would permit a greater degree of flexibility in the application of the cost-of-living adjustment (COLA) mechanism, and ultimately detach automatic wage growth from previous increases in consumer prices. One proposal would be to apply the COLA only in cases where workers are not covered by a collective agreement. The parties engaged in collective bargaining would still be informed on the inflation rate, but it will be up to them to decide on wage awards that will take into consideration the need to ensure that compensation for inflation does not prejudice competitiveness and hence the viability of employment.

The sustainability of wage increases must also be fully recognised in the debate surrounding the recent proposal to increase the minimum wage. This proposal was made primarily on the basis of an analysis of expenditure patterns of a household group comprising two adults and two children. This raises the question of whether a minimum wage is intended as compensation for work carried out or as a social benefit to sustain a family of four. Furthermore, it has to be ensured that any such increases would not lead to greater unemployment among low income earners, further marginalising and unintentionally hurting precisely those social groups that the proponents seek to protect. At a time when various neighbouring countries have been cutting minimum wages to improve competitiveness, great caution is required before adopting policies that move in the opposite direction, especially at this juncture of the economic cycle and the current level of public debt.

The key to higher living standards for low-wage earners is the provision of further skill-enhancing programmes that would improve workers' marketability and productivity. More broadly, investment in education and training needs to be sustained and fine-tuned at all levels in order to promote human development and also reduce skill mismatches in the domestic workforce.

Other possible reforms include measures to improve competition in the domestically-oriented sectors of the economy and, where this is not feasible, such as in the public utilities, to pursue efficiency gains. In the short term such measures would help bring down costs, thus increasing both purchasing power and external competitiveness. From a longer-term perspective, they should boost the country's supply capacity, thereby supporting rising living standards. As regards export-oriented sectors, continued efforts to attract high value added industries to Malta would also serve the same purpose.

With regard to public finances, the recently announced measures to curtail growth in current expenditure, as well as the strengthening of domestic fiscal rules through amendments to the Constitution, are welcome. However, the long-term sustainability of public finances also requires solutions to the more permanent challenges of prioritising expenditure programmes and ensuring that all items of recurrent expenditure are sustainably funded.

On the financial side, banks should continue to strengthen their capital buffers. The new regulatory regime coming into force internationally will have a significant impact on credit institutions, requiring them to hold larger and better-quality capital and liquidity buffers. Furthermore, enhanced levels of capital are necessary to mitigate downside risks associated mainly with non-performing loans in certain economic sectors and address the concentration in bank lending and collateral towards property.

The adoption of more prudent dividend policies is also recommended, while banks should also pay more attention to loan loss provisioning and collateral valuation practices. Domestic banks are also encouraged to address longer-term structural issues through greater diversification of their asset holdings and by lengthening the maturity structure of their customer deposits.

The Maltese economy remains extremely open and, therefore, highly exposed to shifts in market conditions and downturns in external demand. At the same time, the sovereign debt crisis has prompted structural reforms in a number of Malta's competitors in international markets leading to an increasingly intense competitiveness challenge as the recovery unfolds. Unless matched by similar efforts locally, the competitiveness of the Maltese economy may gradually be eroded. There is, therefore, no room for complacency or undue delays in the implementation of a number of strategic reforms.

Bank policies and operations

As a member of the Eurosystem, the Bank contributes to the formulation of monetary policy in the euro area through participation in the Governing Council of the ECB. The Bank is also responsible for the implementation, in Malta, of the single monetary policy as determined by the Governing Council, including both standard monetary operations and non-standard measures. During the year it conducted open market operations with eligible banks worth an aggregate of EUR20.5 billion, only slightly less than the amount registered in the previous year. This ensured that the banking system in Malta had access to liquidity as required.

In line with its mandate, the Bank continued to monitor the financial system in Malta, assessing potential risks to which the system may be exposed. During the year the Bank maintained close contacts with the Malta Financial Services Authority (MFSA) and with the Ministry of Finance, the Economy and Investment. The Bank also participated actively in the work of the European Systemic Risk Board.

In liaison with the MFSA, the Bank played a key role in a stress test carried out on a Maltese credit institution as part of an EU-wide exercise. The bank concerned met the necessary requirements of the test and comfortably exceeded the capital threshold.

Efficient payment and settlement systems form part of the basic infrastructure underpinning a modern financial system. The Bank issues euro banknotes and coins, regulates and oversees payment and securities settlement systems in Malta, and provides various banking services to the Government and to the banks.

From an operational perspective, the Bank participates in TARGET2, which is an automated, real-time settlement system for large-value payments in euro. The value of payments processed through TARGET2 in Malta rose substantially to EUR105.0 billion, as a result of an increase in the number of banks participating directly in the system.

The year under review was also characterised by major internal organisational changes. A new organisational structure fully came into effect in January 2011 and was further refined in October.

The Bank's operating profit for the year amounted to EUR52.5 million, as against EUR57.6 million in 2010. Although net interest income increased compared with the previous year, this was offset by a drop in "other income", largely due to one-off revenue taken in 2010 from the demonetisation of the Maltese lira, and higher write-downs on the Bank's assets.

On behalf of the Board of Directors, I would like to thank Mr Michael C. Bonello, who ended his term as Governor at the end of June 2011, after almost 12 years at the helm of the Bank. Mr Bonello guided the Bank to the position it enjoys today, as a member of the Eurosystem, laying down sound foundations for the future. I also wish to thank the Bank's staff for their dedication and hard work, which contributed to the outcomes that are explained in more detail in this *Report*.

Professor Josef Bonnici

PART I

FINANCIAL AND

ECONOMIC DEVELOPMENTS

1. INTERNATIONAL ECONOMIC DEVELOPMENTS AND THE EURO AREA ECONOMY

Global economic activity moderated during 2011 as most major industrial and emerging economies experienced slower output growth than in the previous year. However, Japan and a number of euro area countries registered a contraction, with the former substantially affected by natural disasters and the latter being impacted by the ongoing sovereign debt crisis. Meanwhile, inflationary pressures worldwide generally increased through the third quarter of the year, but moderated in the last quarter.

In 2011 the euro area economy expanded at a slower pace than in the previous year, with growth easing as the year progressed. Consequently, the labour market conditions remained weak, with the unemployment rate exceeding 10%. Meanwhile, euro area inflation as measured by the Harmonised Index of Consumer Prices (HICP) continued to pick up, with energy and food prices increasing strongly.

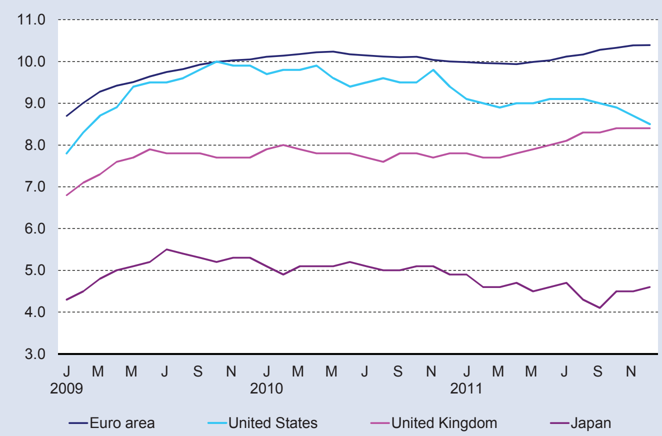
The Governing Council of the European Central Bank (ECB) increased key interest rates in April and July but decreased them in the final two months of the year as signs of a further slowdown in the euro area began to emerge. In addition, the Council launched a number of non-standard measures aimed at easing monetary conditions.

The international economy

United States

The US economy continued to expand during 2011, but at a slower pace as real gross domestic product (GDP) increased by 1.7% from 3.0% in the previous year (see Table 1.1). Domestic demand was the main driver of growth, supported by private consumption and investment. On the other hand, government consumption and inventory changes dampened growth. Net exports contributed to the expansion in GDP, albeit marginally, as exports grew faster than imports.

Chart 1.1
UNEMPLOYMENT RATE
(monthly data; seasonally adjusted)



Source: Eurostat.

The unemployment rate declined further during the year, with the jobless

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

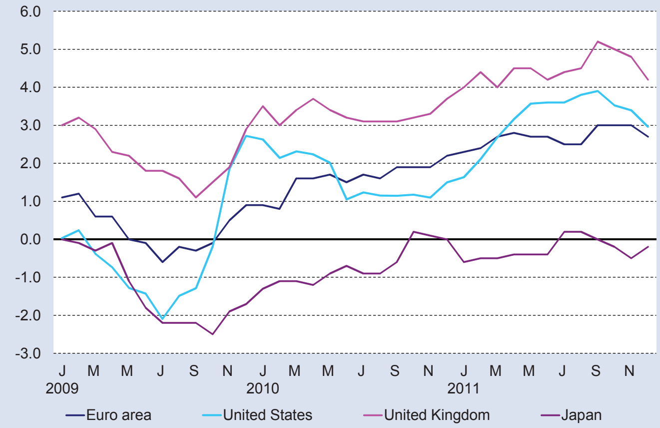
	2009	2010	2011	2011 Q1	2011 Q2	2011 Q3	2011 Q4
United States	-3.5	3.0	1.7	2.2	1.6	1.5	1.6
Euro area	-4.3	1.9	1.4	2.4	1.6	1.3	0.7
United Kingdom	-4.4	2.1	0.9	1.7	0.6	0.5	0.8
Japan	-5.5	4.4	-0.9	-0.1	-1.7	-0.6	-1.0
China	9.1	10.3	9.2	9.7	9.5	9.1	8.9
India	6.8	9.9	-	7.5	8.5	7.1	-
Brazil	-0.3	7.5	-	4.2	3.3	2.2	-

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

rate falling by 0.9 percentage point to reach 8.5% in December, the lowest rate recorded since February 2009 (see Chart 1.1).

During 2011 consumer price inflation averaged 3.2% compared with 1.6% in 2010 (see Chart 1.2). The annual inflation rate increased persistently throughout the first three quarters, reaching 3.9% in September, partly reflecting higher energy and food prices. Annual inflation moderated during the fourth quarter, mainly on account of easing commodity prices. However, at 3.0% in December, it was still 1.5 percentage points higher on the previous year.

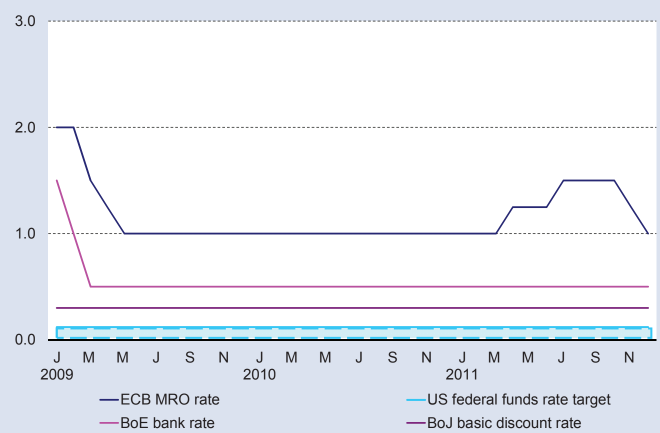
Chart 1.2
CONSUMER PRICE INFLATION IN ADVANCED ECONOMIES
(annual percentage changes)



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

The Federal Reserve maintained the federal funds rate target range unchanged at between zero and 0.25% during 2011 (see Chart 1.3). During the year, the US central bank continued to purchase long-term Treasury securities as part of the USD600 billion asset purchase programme that was launched in December 2010. As this target was reached in June 2011, new purchases of long-term Treasury securities amounting to USD400 billion were announced in September, together with the disposal of the equivalent amount of shorter-term paper, in a bid to put downward pressure on longer-term interest rates. During the year, it also continued to roll over maturing Treasury securities and to invest in agency mortgage-backed securities.

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



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

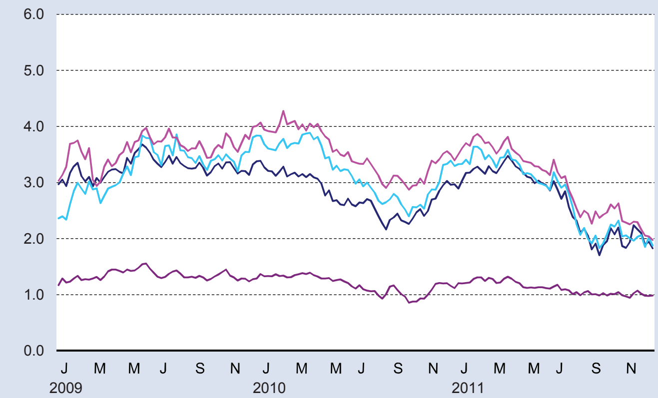
In the early months of 2011, the US long-term government bond yields rose, largely reflecting positive macroeconomic data. However, they subsequently declined, as investors responded to the natural disasters that hit Japan towards the end of March and to political tensions in North Africa and the Middle East, triggering safe-haven flows. This downward path was maintained throughout most of the year, as US bond yields also reacted to renewed tensions in the euro area, the weakening global economic outlook and monetary policy easing in the United States. Yields temporarily recovered slightly in October, driven by an improvement in market sentiment towards the euro area. Nevertheless, the increase was reversed towards the end of the year, with bond yields closing at 1.88% in December, 141 basis points less than their end-2010 level (see Chart 1.4).

At the end of 2011, equity prices, measured by Standard & Poor's 500, were unchanged compared with a year earlier (see Chart 1.5). The index rose during the first quarter of 2011, largely reflecting indications of economic recovery. This path was subsequently reversed during the following two quarters, following unfavourable macroeconomic data, increased tensions in the euro area and uncertainty about the strength of the global recovery. Stock prices recovered during the last quarter of 2011, amid improved market sentiment triggered by positive news.

United Kingdom

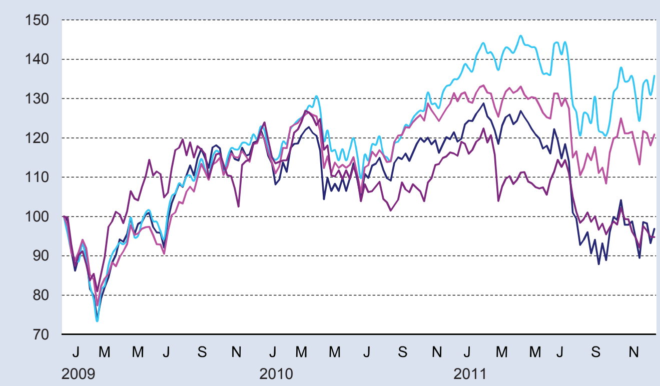
In the United Kingdom, economic growth decelerated sharply to 0.9% in 2011 from 2.1% a year earlier. Net exports were the sole contributor to the expansion, as domestic demand contracted, mainly reflecting lower private consumption and investment. Government expenditure, on the other hand, contributed positively to growth. The unemployment rate remained relatively stable during the first few months of the year, but subsequently rose to 8.4% in the last quarter of the year.

Chart 1.4
TEN-YEAR GOVERNMENT BOND YIELDS
(percentages per annum; end of week)



Source: Reuters.

Chart 1.5
STOCK PRICE INDICES
(end of week index; 1 Jan. 2009=100)



Source: Reuters.

Average annual consumer price inflation accelerated from 3.3% in 2010 to 4.5% in 2011. This increase mainly reflected a rise in the standard VAT rate to 20% as from January 2011, as well as higher energy costs and import prices of non-energy commodities. The acceleration was particularly pronounced during the first three quarters of the year, with the rate peaking at 5.2% in September, the highest in three years. Subsequently, the rise in prices moderated slightly with consumer price inflation ending the year at 4.2%. This mainly reflected developments in food and petrol prices.

The Bank of England maintained its official bank rate at 0.50% during 2011, unchanged since March 2009. It continued with its asset purchase programme throughout the year, increasing it in October by GBP75 billion, to a cumulative figure of GBP275 billion by the end of 2011.

Ten-year UK government bond yields mirrored those in the United States during 2011. Yields initially rose, reaching 3.89% on 10 February. However, they subsequently lost ground and continued to fall over the remainder of the year. Bond yields ended December at 1.98%, 142 basis points lower on an annual basis (refer to Chart 1.4).

Meanwhile, UK equity prices, as measured by the FTSE 100, generally declined during 2011 (refer to Chart 1.5). The index rose slightly over the first half of the year, mirroring developments in other major equity markets. Going into the third quarter, however, share prices fell before recovering some of these losses in the following quarter. The index ended the year 5.6% lower than at the end of 2010.

Japan

The Japanese economy contracted by 0.9% during 2011, primarily under the impact of the natural disasters that hit the east coast of the country in the first quarter. Net exports declined, as imports continued to expand, while exports remained constant. Private consumption registered no growth, while private investment and inventory changes declined. Government expenditure was the only domestic demand component contributing positively to growth, although it grew at a slightly slower pace than in the previous year.

In the labour market, both employment and unemployment fell, implying a contraction in the size of the labour force in the context of an ageing population. As a result, the unemployment rate declined during most of the year, falling to 4.1% in September. Although it rose somewhat in the last quarter, to reach 4.6% in December, it was still 0.3 percentage point lower on a year earlier.

Following a brief period of positive rates in the last quarter of 2010, consumer price inflation in Japan turned negative again in January 2011, and remained so through the first half of the year. Prices then rose moderately in the third quarter. However, as can be seen in Chart 1.2, inflation went back to negative territory in the December quarter, ending the year at -0.2%.

The Bank of Japan maintained an accommodative monetary policy stance throughout 2011. It kept the basic discount rate at 0.3% and the target uncollateralized overnight call rate in a range between zero and 0.1%. In response to the natural disasters in March, the central bank increased the size of the asset purchase programme and introduced a liquidity programme to support financial institutions in the affected areas. It also conducted USD fund-supplying operations and established a temporary bilateral liquidity swap arrangement with other major central banks.

Ten-year Japanese government bond yields were generally on a downward path during 2011 (refer to Chart 1.4). They rose briefly during the first quarter, but subsequently fell, ending the year at 0.99%, 13 basis points lower than in the same period of the previous year.

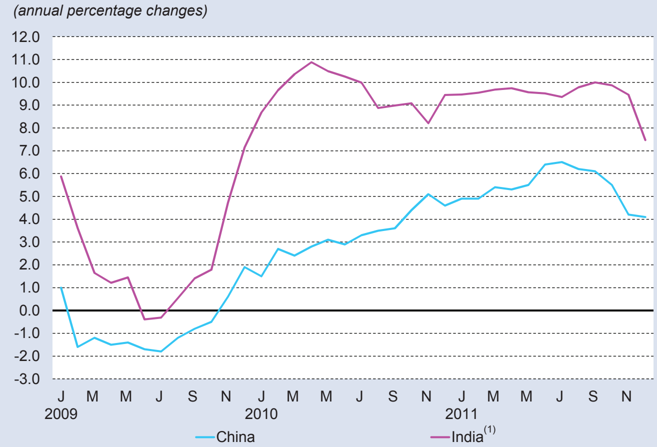
During 2011, equity prices fell sharply in the wake of the natural disasters in March. Subsequently, they generally followed a downward trend. Thus, by the end of the year the Nikkei 225 was 17.3% lower than in December 2010 (see Chart 1.5).

Emerging Asia

Economic activity in the main emerging Asian economies grew at a slower pace in 2011 compared with the previous year. In China, real GDP growth eased to 9.2% from 10.3% in 2010. Available information suggests that output growth in India is expected to have decelerated to around 7.4% from 9.9% in the previous year (refer to Table 1.1).

Consumer price inflation in China accelerated in the first three quarters of the year, reaching 6.5% in July. The rise in prices then moderated in the last quarter, ending December at 4.1%, compared with 4.6% a year earlier. In India, wholesale price inflation advanced to 10.0% in September, before slowing down to 7.5% in December, falling by 1.9 percentage points over the year as a whole (see Chart 1.6).

Chart 1.6
CONSUMER PRICE INFLATION IN EMERGING ASIA
(annual percentage changes)



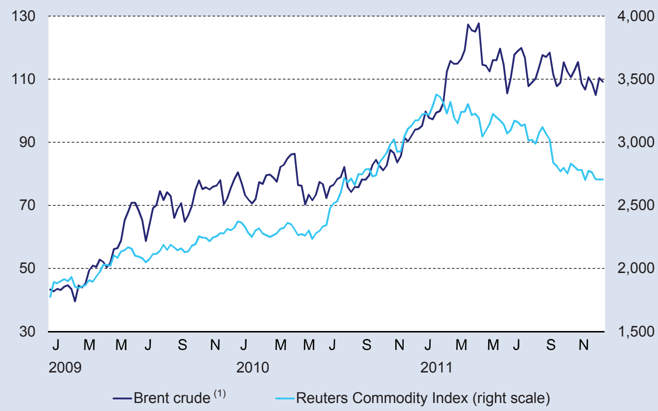
(1) Wholesale price inflation.
Sources: Reserve Bank of India; OECD.

Commodities

Oil

During 2011, the price of Brent Crude oil extended the upward trend observed since 2009 (see Chart 1.7). Initially, the price increased robustly, supported by strong demand from emerging economies, and by expectations of higher demand owing to the nuclear power shutdown in Japan. The supply disruptions following the unrest in the Middle East and North African countries also contributed to the rise in oil prices through the first four months of the year. Oil reached USD127.69 per barrel on 28 April, the highest level seen since July 2008, before reversing its path in the subsequent months. The price of Brent crude partly recovered during the December quarter, ending the year at USD109.19 per barrel, 15.9% higher than at end-December 2010.

Chart 1.7
COMMODITY PRICES
(end of week)



(1) US dollars per barrel.
Source: Reuters.

Other commodities

After rising by around 36.7% during 2010, the prices of non-energy commodities, as measured by the Reuters Commodity Index, reversed their path in 2011, declining by 14.8% over the year as a whole (see Chart 1.7).

During the first quarter, commodity prices increased, dipping only in March in response to the disasters in Japan, which had a dampening effect on demand. The subsequent increase in the index was due mainly to higher food prices, as strong demand was accompanied by adverse weather conditions. Metal prices also contributed to higher commodity prices, driven mainly by the price of copper, which rose amid supply concerns.

Non-energy commodity prices generally declined over the subsequent three quarters, reflecting developments in both food and metal prices, which were negatively affected by concerns about the global economy.

Gold

The price of gold remained broadly on an upward trend in the first nine months of 2011 (see Chart 1.8). A pick-up in investor confidence in January prompted a shift out of gold, which led to a sharp decline in its price. However, the gold price resumed its upward path, amidst inflation concerns and unrest in the Middle East and North Africa. The price of the metal continued to increase in the subsequent two quarters, supported by concerns about the euro area sovereign debt market and the fiscal outlook in the United States, reaching a record high of USD1,898.99 per ounce on 5 September.

Chart 1.8
GOLD
(US dollars per ounce; end of week)

Source: Reuters.

Between September and December, the price of gold broadly declined, as investors became less risk averse and shifted to other assets. It ended the year at USD1,563.80 per ounce, around 10% higher than at the end of the previous year.

The euro area

Gross domestic product[1]

Having expanded by 1.9% in 2010, real GDP in the euro area grew at the slower pace of 1.4% during the year under review (see Table 1.2). In 2011, growth was mainly driven by net exports. The quarterly profile shows slower growth in real GDP as the year progressed, reflecting the intensification of the sovereign debt crisis, tighter financial conditions, and fiscal consolidation.

Domestic demand expanded in 2011, contributing 0.5 percentage point to growth. Thus, investment grew by 1.4% while private and government consumption increased by 0.2% and 0.1%, respectively. On the external front, both exports and imports rose less rapidly in 2011 than in 2010. As exports grew by 6.1% and imports put on 3.9%, the contribution of net exports to growth was also positive.

Inflation

The annual rate of the euro area HICP inflation generally rose during 2011, reaching 2.7% in December from 2.2% a year earlier (see Chart 1.9). On average over the year, area-wide inflation went up to 2.7% from 1.6% in 2010.

During 2011, the energy price component, which increased by 9.7% year-on-year, registered the fastest growth among the major index components, mirroring international oil price developments. At the same time, the annual rate of processed food price inflation rose to 4.1% by December 2011. In contrast, unprocessed food price inflation dropped to 1.6%.

Table 1.2
REAL GDP GROWTH IN THE EURO AREA

	2010	2011	2011			
			Q1	Q2	Q3	Q4
			Annual percentage changes			
Private consumption	0.9	0.2	0.9	0.3	0.3	-0.6
Government consumption	0.5	0.1	0.4	0.3	0.0	-0.3
Gross fixed capital formation	-0.5	1.4	3.5	1.5	1.0	0.6
Domestic demand	**1.1**	**0.5**	**1.6**	**0.7**	**0.3**	**-0.5**
Exports	11.3	6.1	9.9	6.3	5.5	3.6
Imports	9.6	3.9	8.1	4.2	3.3	0.6
GDP	**1.9**	**1.4**	**2.4**	**1.6**	**1.3**	**0.7**
			Percentage point contributions			
Private consumption	0.5	0.1	0.5	0.2	0.1	-0.3
Government consumption	0.1	0.0	0.1	0.1	0.0	-0.1
Gross fixed capital formation	-0.1	0.3	0.7	0.3	0.2	0.1
Changes in inventories	0.6	0.1	0.3	0.1	0.0	-0.3
Domestic demand	**1.1**	**0.5**	**1.6**	**0.7**	**0.3**	**-0.5**
Net exports	**0.8**	**1.0**	**0.8**	**0.9**	**1.0**	**1.3**
GDP	**1.9**	**1.4**	**2.4**	**1.6**	**1.3**	**0.7**

Source: Eurostat.

[1] The cut-off date for euro area GDP statistics is 6 March 2012.

Meanwhile, the annual growth rates of prices of services and of non-energy industrial goods accelerated to 1.9% and 1.2%, respectively.

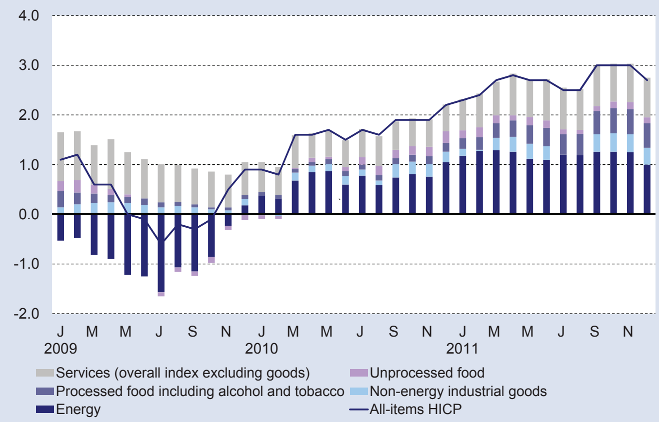
As a result of these developments, core inflation, measured by excluding energy and unprocessed food from the HICP, almost doubled to 2.0% in December 2011 from 1.1% a year earlier. However, it still ended the year significantly below overall HICP inflation.

Labour market

After some improvement during 2010 and the first part of 2011, conditions in the euro area labour markets deteriorated during the second half of the year. Data available until the third quarter show that year-on-year employment growth rates picked up during the first half of 2011, but eased thereafter.

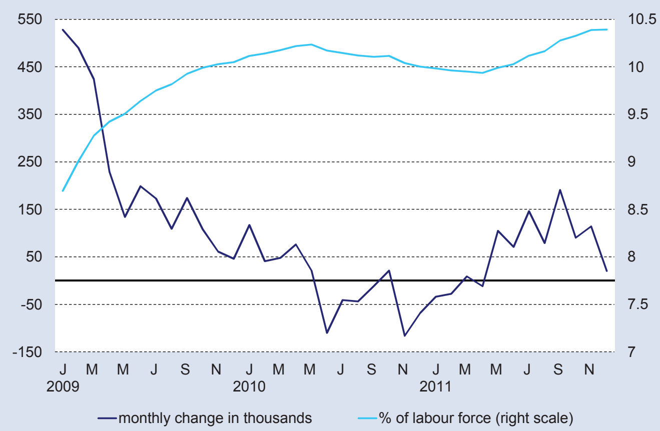
Meanwhile, the area-wide unemployment rate remained virtually unchanged at 10.0% throughout the first half of 2011, barring a marginal drop in April (see Chart 1.10). With the number of unemployed rising in the second half of the year, the jobless rate then rose consistently after June and ended the year at 10.4%, or 0.4 percentage point higher than the rate at the end of 2010.

Chart 1.9
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION IN THE EURO AREA
(percentage points; annual percentage change)



Source: Eurostat.

Chart 1.10
UNEMPLOYMENT IN THE EURO AREA
(monthly data; seasonally adjusted)



Source: Eurostat.

Monetary policy

The Governing Council of the ECB decided to change key interest rates four times during 2011, after keeping them unchanged at historically low levels for almost two years. The first two changes took place in April and July, when the Governing Council raised official rates by 25 basis points in both instances, bringing the Main Refinancing Operation (MRO) rate up to 1.50%. In both cases, the Council said that the increase was warranted in the light of upside risks to price stability and was aimed at keeping inflation expectations firmly anchored.

Subsequently, the ECB lowered key interest rates by 25 basis points in November and again in December. This took the MRO rate back down to 1.00%. The rate cuts were based on the observation that while inflation in the euro area remained elevated, the intensified tensions in financial markets were expected to continue dampening economic activity in the euro area so that cost, wage and price pressures were expected to remain modest.

To address the impairment in the transmission of monetary policy, the Eurosystem also continued to implement non-standard monetary policy measures throughout the year under review.[2]

As with policy interest rates, several financial indicators changed course during the year.

[2] More detailed information on these non-standard monetary policy measures can be found in Chapter 1 of Part 2 of this *Annual Report*, titled "The Conduct of Monetary Policy".

Table 1.3
EURO AREA MONETARY AGGREGATES
Annual percentage changes

	2010	2011	2011			
			Mar.	June	Sep.	Dec.
M1	**4.3**	**1.6**	**2.9**	**1.3**	**2.0**	**1.6**
Currency in circulation	5.0	6.1	3.9	4.4	5.7	6.1
Overnight deposits	4.2	0.6	2.8	0.7	1.4	0.6
M2-M1 (Other short-term deposits)	-0.4	2.1	2.3	3.7	3.1	2.1
Deposits with an agreed maturity of up to two years	-6.6	2.1	-0.2	3.2	3.2	2.1
Deposits redeemable at notice of up to three months	6.3	2.0	4.8	4.2	3.0	2.0
M2	**2.2**	**1.8**	**2.6**	**2.3**	**2.5**	**1.8**
M3	**1.7**	**1.6**	**2.2**	**2.0**	**2.9**	**1.6**

Source: ECB.

Money and credit

For most of 2011, broad money (M3) in the euro area continued to accelerate. However, in the final quarter of the year it contracted so that its overall growth rate fell slightly from 1.7% in December 2010 to 1.6% a year later (see Table 1.3).

The slight easing in M3 growth during the year reflected a slowdown in the narrow money component (M1). Indeed, the annual growth rate of M1 dropped to 1.6% in December 2011 from 4.3% a year earlier, with overnight deposits slowing down considerably.

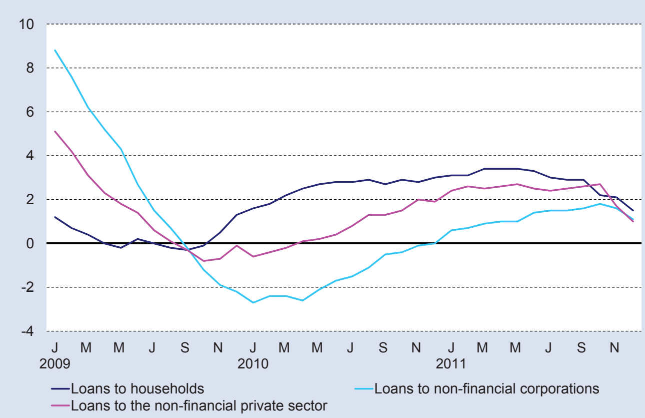
Short-term deposits other than overnight deposits (M2-M1) resumed their expansion again in 2011, after having contracted since the middle of 2009. Annual growth of these deposits ended the year at 2.1%, as opposed to -0.4% in December 2010.

On the counterparts' side, credit to euro area residents (including general government) decelerated in 2011, with the annual growth rate dropping to 1.0% in December from 3.5% a year earlier. More specifically, credit to residents outside general government expanded at a faster pace during the first five months of 2011, only to slow down for the remainder of the year. Thus, its annual growth rate declined to 0.4% by the end of the year from 1.6% a year earlier.

Developments in credit mirrored changes in loans granted by Monetary Financial Institutions (MFIs) to the private sector, which increased up to May 2011, before falling in the subsequent months. Thus, the annual growth rate of lending to the private sector almost halved during 2011, going from 1.9% in December 2010 to 1.0% a year later (see Chart 1.11).

The slowdown in bank lending to the private sector was itself driven

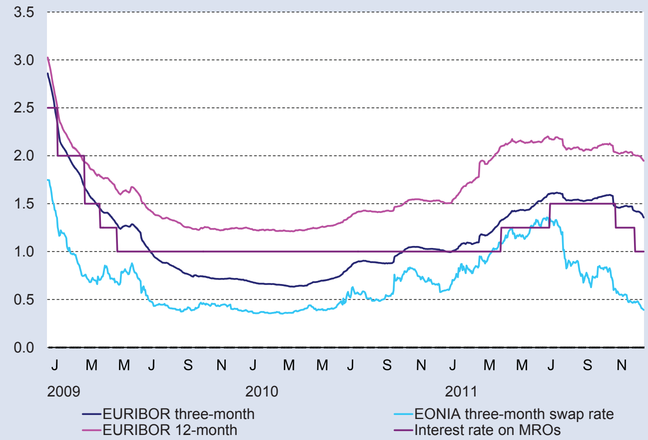
Chart 1.11
MFI LOANS TO THE NON-FINANCIAL PRIVATE SECTOR IN THE EURO AREA
(annual percentage changes)



Source: ECB.

by developments in loans to households. As economic prospects dimmed, and amid concerns about housing market developments in several euro area countries, the annual growth rate of MFI loans to households slowed down to 1.5% by December 2011 from 3.0% a year earlier. In contrast, MFI loans to non-financial corporations expanded more rapidly than before, with their annual growth rate rising from zero to 1.1%, over the same period.

Chart 1.12
KEY INTEREST RATES
(percentages per annum; daily data)



Sources: ECB; Euribor FBE.

The money market

Unsecured money market interest rates in the euro area, as measured by EURIBOR, generally increased during 2011, as they had done in the previous year (see Chart 1.12).[3] Nevertheless, they decreased slightly towards the end of the year following reductions in official interest rates. Over the year as a whole, at the three-month and 12-month maturities, EURIBOR rates rose by 35 basis points and 44 basis points, to end 2011 at 1.36% and 1.95%, respectively.

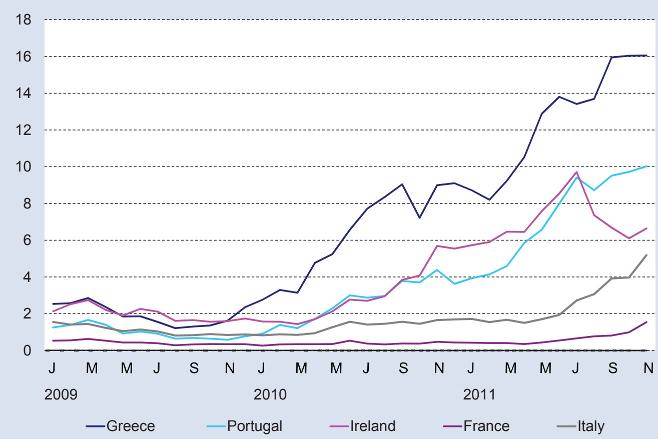
Secured rates, such as those implicit in the three-month EONIA swap index, declined during the year under review, shedding 20 basis points to 0.39%, the lowest level seen since mid-2010.[4] As a result, the spread between unsecured EURIBOR rates and secured EONIA swap rates at the three-month maturity generally widened over the course of the year. By the end of 2011, the spread had increased to 96 basis points from 41 points a year earlier, indicating a market perception that risk in the banking sector had risen.

Bond yields

Ten-year German government bond yields, which are often taken as a low-risk benchmark for the euro area, decreased significantly during the year under review (refer to Chart 1.4). During 2011, they dropped by 114 basis points, to end the year at 1.83%. This was a much larger fall than the 41 basis point drop recorded in 2010.

This decline mainly reflected the intensification of tensions related to the euro area sovereign debt crisis, which weighed on sentiment and triggered flight-to-safety investment flows. As a result, with yields on other euro area sovereign bonds rising, spreads vis-à-vis German

Chart 1.13
EURO AREA TEN-YEAR GOVERNMENT BOND YIELD SPREADS
(vis-a-vis German ten-year government bond yields)



Source: ECB.

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[3] The Euro Interbank Offered Rate (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.

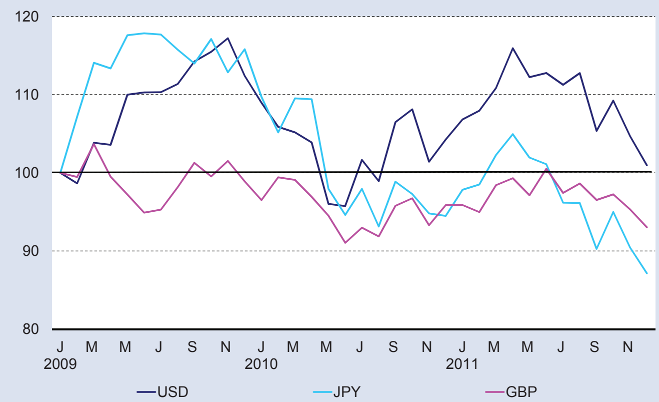
[4] The Euro OverNight Index Average (EONIA) is a measure of the effective interest rate prevailing in the euro interbank overnight market. The EONIA swap rate is the fixed rate that banks are willing to pay in exchange for receiving the average EONIA rate over the lifetime of a swap contract. The EONIA swap index is considered a measure of market confidence in the soundness of the banking system.

bonds widened considerably (refer to Chart 1.13).

Equity prices

Euro area equity prices, as measured by the Dow Jones EURO STOXX index, decreased during 2011, with the index dropping by 17.7% overall, compared with the marginal 0.1% fall observed during the previous year (refer to Chart 1.5). The decrease was driven by concerns about the sustainability of the global economic recovery and a decline in investor risk appetite as a consequence of the euro area sovereign debt crisis.

Chart 1.14
EXCHANGE RATE MOVEMENTS OF THE EURO AGAINST OTHER MAJOR CURRENCIES
(index of end of month rates; Jan. 2009=100; an increase in the index implies euro appreciation)



Source: Eurostat.

Exchange rates

During the first half of 2011, the euro appreciated against all major currencies, but changed course during the remainder of the year. It weakened by 7.8% against the Japanese yen, 3.2% against the US dollar, and 3.0% against the pound sterling over the year as a whole (see Chart 1.14). These developments were once more mainly driven by concerns relating to the sustainability of public finances in euro area countries, especially in the second half of the year.

Chart 1.15
EURO NOMINAL EFFECTIVE EXCHANGE RATE
(index of daily effective exchange rate; Q1 1999=100)

Source: ECB.

Similarly, the euro's nominal effective exchange rate (NEER), as measured against the currencies of 20 of the euro area's main trading partners, also depreciated during 2011, as the appreciation observed during the first five months was reversed during the remainder of the year. The overall loss of 2.1% in the nominal effective index was, however, smaller than the 8.2% fall registered in 2010 (see Chart 1.15).

2. MONETARY AND FINANCIAL DEVELOPMENTS

During 2011, the contribution of Maltese Monetary Financial Institutions (MFIs) to the euro area broad money stock expanded at a faster pace than in the previous year. Deposits held by Maltese residents grew less rapidly than they did in 2010, while credit extended to them increased at a slightly faster rate.[1]

Domestic money market rates rose for most of 2011 before declining in the final quarter. In the capital market, government bond yields generally rose during the first half of the year, but then somewhat eased and fluctuated quite sharply in the last three months of the year. Equity prices fell sharply over the year as a whole.

Contribution to euro area monetary aggregates

The contribution of Maltese MFIs to the euro area broad money stock (M3) stood at EUR10.2 billion at the end of December 2011. This was EUR849.5 million, or 9.1%, more than at the end of the previous year (see Table 2.1). The annual rate of growth of the M3 contribution thus accelerated from 5.5% in 2010.

The narrow money component (M1) expanded by 8.5%, down from 14.7% in 2010. At the same time, deposits with an agreed maturity of up to two years continued to fall, so that the intermediate money component (M2) expanded by a more modest 3.7% in 2011 compared with 5.3% in the previous year. During 2011 resident MFIs began making use of repurchase agreements to raise funds from other euro area residents, boosting M3. As a result, the gap between M3 and M2 widened.

Residents' deposits

Within the M1 category, the annual growth rate of residents' overnight deposits almost halved in 2011, sliding to 8.7% from 16.3% in 2010. In absolute terms, these deposits increased by EUR365.8 million (see Table 2.2). Growth was driven by deposits belonging to private non-financial companies and households. Nevertheless, such deposits expanded at a slower pace, which probably reflects shifts from overnight deposits into higher yielding assets outside M3.

At the same time, deposits redeemable at up to three months' notice contracted, falling by 0.8% in 2011, as against a 10.7% increase a year earlier. However, such deposits account for a small proportion of the total, so that in absolute terms the fall amounted to just EUR1.0 million.

After having declined by 5.2% in 2010, deposits with an agreed maturity of up to two years contracted at a slightly more moderate pace during the period reviewed, falling by EUR155.0 million, or 4.0%. This fall was

Table 2.1
CONTRIBUTION OF MALTESE MFIs TO EURO AREA MONETARY AGGREGATES[(1)]
EUR millions; annual percentage changes

	2009	2010	2011	Change	
	Dec.	Dec.	Dec.	Amount	%
Narrow money (M1)	4,359.5	4,999.0	5,424.4	425.4	8.5
Intermediate money (M2)	8,671.1	9,128.9	9,470.8	341.9	3.7
Broad money (M3)[(2)]	**8,883.3**	**9,370.5**	**10,220.0**	**849.5**	**9.1**

[(1)] Figures show the contribution of Maltese MFIs to the euro area totals. Data on monetary aggregates include deposit liabilities to both residents of Malta and other euro area residents.

[(2)] The difference between M3 and M2 comprises repurchase agreements and debt securities with up to two years' maturity issued by MFIs in Malta less holdings by MFIs in Malta of such securities issued by MFIs anywhere in the euro area. Figures also include MMFs' shares/units issued less holdings of such units by MMFs and credit institutions resident in the euro area.

Source: Central Bank of Malta.

[1] Unless otherwise specified, the term "residents" in this section refers to residents of Malta only. "Other euro area residents" include residents of all euro area countries except Malta.

Table 2.2
DEPOSITS OF MALTESE RESIDENTS
Annual percentage changes; EUR millions

	2009 Dec.	2010 Dec.	2011 Dec.	2011 Amount outstanding	2011 Absolute change
Total residents' deposits	**-1.3**	**5.1**	**2.6**	**8,406.4**	**209.7**
Overnight deposits	16.5	16.3	8.7	4,590.9	365.8
Deposits redeemable at notice up to 3 months	-2.3	10.7	-0.8	122.5	-1.0
Deposits with agreed maturity up to 2 years	-13.1	-5.2	-4.0	3,693.1	-155.0

Source: Central Bank of Malta.

mainly driven by a sizeable drop in holdings belonging to households. As mentioned above, the decline may have been due to portfolio flows into assets outside M3, such as long-term deposits and government bonds, as depositors sought higher yields.

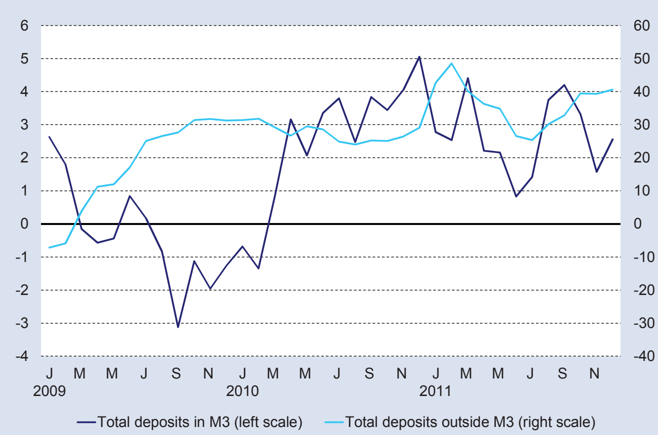
In fact, residents' deposits excluded from M3, principally those with a maturity exceeding two years, expanded by EUR343.5 million, or 40.6%, during the year following an increase of 29.0% in 2010 (see Chart 2.1). The rapid growth was stimulated by relatively attractive interest rates offered on these deposits.

Thus, total residents' M3 deposits, which had expanded by 5.1% during 2010, grew at a decelerating rate, adding 2.6% in 2011 (see Table 2.2). Growth was entirely driven by overnight deposits, which accounted for just more than half of total residents' deposits by the end of the year.

In general, movements in deposit rates were marginal in 2011 and appear to have had little impact on deposit movements. After having dropped by 7 basis points in 2010, the weighted average rate on all deposits increased by 4 basis points to 1.41% at the end of December 2011.

Changes in interest rates offered on new deposits were limited in 2011. In particular, those offered on overnight deposits and households' one-year time deposits remained broadly stable at end-2010 levels. The most significant interest rate changes involved rates paid to households on time deposits with an agreed maturity of between one and two years, which increased by 41 basis points to 3.41%. Similarly, rates paid to non-financial corporations on time deposits rose by 42 basis points to 1.93% (see Table 2.3).[2] In contrast, rates paid to households on time deposits with an agreed maturity of over two years declined by 21 basis points to 3.65%.

Chart 2.1
ANNUAL GROWTH IN DEPOSITS OF MALTESE RESIDENTS
(annual percentage changes)



Source: Central Bank of Malta.

[2] Data on interest rates on new business cover MFI euro-denominated deposits from, and loans to, households and non-financial corporations resident in Malta. 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, statistics on new deposit and lending business do not cover all institutional sectors, as is the case with weighted average interest rates on deposits and loans.

Table 2.3
MFI INTEREST RATES ON NEW DEPOSITS BELONGING TO RESIDENTS OF MALTA[(1)]
Percentages per annum; weighted average rates for the period

	2009 Dec.	2010 Dec.	2011 Dec.
New business			
Households and NPISH			
Overnight deposits[(2),(3)]	0.30	0.28	0.30
Savings deposits redeemable at notice up to 3 months[(2),(4)]	1.70	1.69	1.61
Time deposits with agreed maturity			
Up to 1 year	1.95	2.03	1.99
Over 1 and up to 2 years	3.00	3.00	3.41
Over 2 years	3.39	3.86	3.65
Non-financial corporations			
Overnight deposits[(2),(3)]	0.23	0.24	0.30
Time deposits with agreed maturity	0.85	1.51	1.93

[(1)] Annualised agreed rates (AAR) on euro-denominated deposits belonging to households and non-financial corporations held with credit institutions resident in Malta.

[(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.

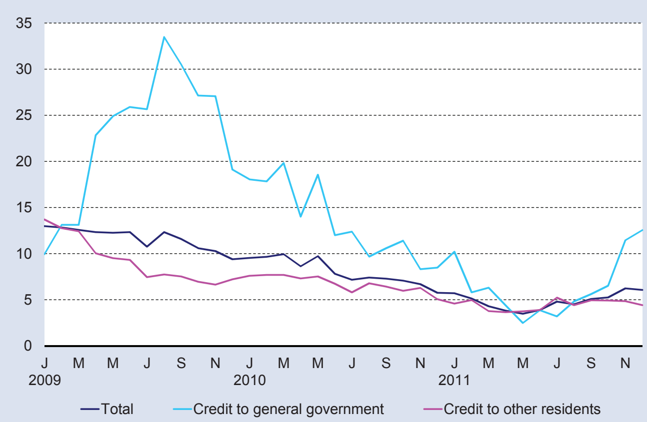
Source: Central Bank of Malta.

Credit

During 2011 credit to residents expanded at a rate of 6.1%, slightly faster than the 5.8% growth rate observed in 2010 (see Chart 2.2).

Growth in credit to general government accelerated during the year, from 8.5% in 2010 to 12.6%, driven by increased bank holdings of Malta Government Stock (MGS) (see Table 2.4). In contrast, credit to other residents, which include mainly households and non-financial corporations, expanded at a slightly slower pace during 2011, with the annual growth falling to 4.4% from 5.1%.[3] In this regard, the annual growth rate of credit to the non-bank private sector fell further, dropping by 1.4 basis points to 4.0% (see Table 2.5). On the other hand, credit to the non-bank public sector accelerated from 1.4% to 8.9%, driven by growth in the transport & storage and energy sectors.[4] The non-bank public sector, however, makes up less than 10% of total credit to other residents.[5] Loans, which accounted for almost all credit to residents of Malta, decelerated as their growth rate declined to 4.2% from 5.2% at the end of 2010.

Chart 2.2
CREDIT TO RESIDENTS OF MALTA
(annual percentage changes)



Source: Central Bank of Malta.

[3] The term "other residents" represents all economic sectors that are residents in Malta but do not form part of general government.
[4] The energy sector includes firms supplying electricity, gas, steam and air conditioning.
[5] The non-bank public sector includes government-owned entities that do not form part of the general government sector.

Table 2.4
CREDIT TO RESIDENTS OF MALTA
Annual percentage changes; EUR millions

	2009 Dec.	2010 Dec.	2011 Dec.	2011 Amount outstanding	2011 Absolute change
Total credit	**9.4**	**5.8**	**6.1**	**10,903.9**	**624.8**
Credit to general government	19.1	8.5	12.6	2,353.4	262.4
Credit to other residents	7.2	5.1	4.4	8,550.5	362.4

Source: Central Bank of Malta.

Table 2.5
CREDIT TO RESIDENTS OF MALTA OTHER THAN GENERAL GOVERNMENT[1]
Annual percentage changes; EUR millions

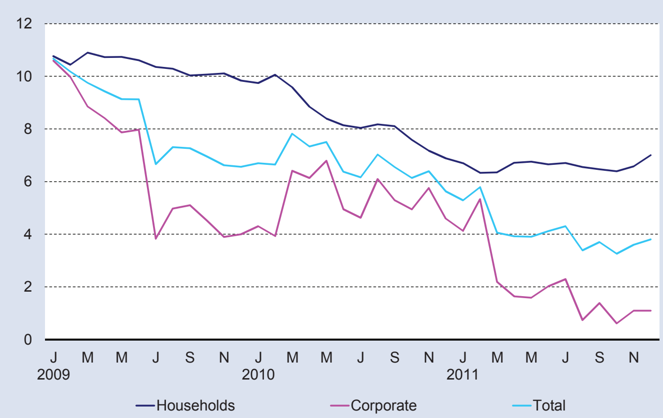
	2009 Dec.	2010 Dec.	2011 Dec.	2011 Amount outstanding	2011 Absolute change
Total credit to other residents	**7.2**	**5.1**	**4.4**	**8,550.5**	**362.4**
Credit to the non-bank private sector	6.6	5.4	4.0	7,805.2	301.6
Credit to the non-bank public sector	13.8	1.4	8.9	745.3	60.8
Total loans	**7.5**	**5.2**	**4.2**	**8,294.5**	**331.6**

[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.
Source: Central Bank of Malta.

Similarly, the annual rate of growth of loans to the non-financial private sector also eased to 3.8% from 5.6% over the same period (see Chart 2.3). Growth in loans to the non-financial private corporate sector dropped from 4.6% at the end of 2010 to 1.1% a year later. Chart 2.4 shows a further breakdown of lending to the five largest categories of corporate borrowers in the private sector. During the year, lending to firms in the wholesale & retail trades, in real estate and in accommodation & food service activities expanded by EUR22.7 million, EUR15.9 million and EUR13.4 million, respectively. In contrast, loans to the transport & storage sector decreased by EUR24.7 million, while those to construction firms fell by EUR21.5 million. Growth in loans to households, which remained the largest single category of bank borrowing, remained almost unchanged, rising by 0.1 percentage point to 7.0% during 2011. Mortgage lending, which makes up around four-fifths of loans to households, increased by 8.5%, the same rate as in 2010. The remaining one-fifth, which covers consumer credit and other lending to households, grew by 1.2% during 2011.

The weighted average interest rate charged by MFIs on loans to residents fell slightly by 1 basis point to 4.71% during 2011. Similarly, most MFI rates on new loans, considered much more volatile, declined. The

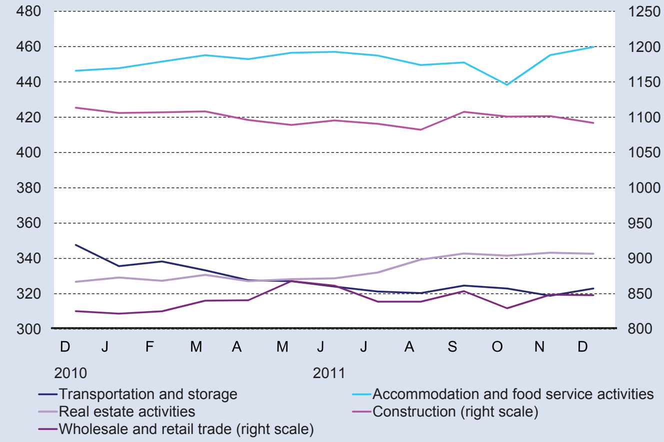
Chart 2.3
LOANS TO NON-FINANCIAL PRIVATE SECTOR
(annual percentage changes)



Source: Central Bank of Malta.

major declines were observed in rates charged on lending to households for house purchases, which dropped by 77 basis points to 5.04%, and on rates on loans to non-financial corporations, which declined by 58 basis points to 4.28%. In contrast, an increase was registered in overdraft rates charged to households, which rose by 37 basis points to 6.12%, while a smaller increase was also recorded in overdraft rates paid by non-financial corporations (see Table 2.6).

Chart 2.4
LOANS TO NON-FINANCIAL PRIVATE FIRMS
(EUR millions)



Source: Central Bank of Malta.

Credit market conditions continued to be monitored through the quarterly Bank Lending Survey (BLS).[6] Credit standards applied on loans to enterprises and to households remained virtually unchanged throughout 2011. No changes were reported except for a slight tightening in lending to enterprises in the first quarter, and a slight easing in the following quarter. Small declines in demand for business loans and consumer credit, with a concurrent increase in demand for mortgages, were generally reported during the year.

Meanwhile, credit granted by resident MFIs to other residents of the euro area expanded substantially during the year, rising by EUR983.1 million, or 23.5%, to EUR5.2 billion. This mainly reflected an increase in holdings of debt securities by internationally-oriented banks.

Table 2.6
MFI INTEREST RATES ON NEW LOANS TO MALTESE RESIDENTS[(1)]
Percentages per annum; weighted average rates for the period

	2009 Dec.	2010 Dec.	2011 Dec.
New business			
Households and NPISH			
Overdrafts[(2)]	6.44	5.75	6.12
Loans			
Lending for house purchases	3.52	3.43	3.38
Consumer credit[(3)]	6.02	5.81	5.04
Other lending	5.56	5.86	5.60
Non-financial corporations			
Overdrafts[(2)]	5.08	5.03	5.08
Loans	4.95	4.86	4.28

[(1)] Annualised agreed rates (AAR) on euro-denominated loans taken up by households and non-financial corporations.
[(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.
Source: Central Bank of Malta.

[6] The BLS gauges credit demand and supply conditions. The Central Bank of Malta began to survey a sample of Maltese banks in 2004. Since January 2008, the BLS is carried out as part of a quarterly exercise conducted by the Eurosystem across the entire euro area.

Table 2.7
EXTERNAL AND OTHER COUNTERPARTS[1]
EUR millions; percentage changes on the previous quarter

	2010	2011	Change	
	Dec.	Dec.	Amount	%
External counterparts	**8,184.1**	**7,839.4**	**-344.7**	**-4.2**
Claims on non-residents of the euro area	29,907.6	29,299.4	-608.2	-2.0
Liabilities to non-residents of the euro area	21,723.5	21,460.0	-263.5	-1.2
Other counterparts (net)[2]	**13,280.3**	**13,694.1**	**413.8**	**3.1**

[1] Figures show the contribution of Maltese MFIs to the euro area totals.
[2] Includes net interbank claims/liabilities.
Source: Central Bank of Malta.

Other counterparts

During 2011 resident MFIs' external counterparts, which consist of net claims on non-residents of the euro area, declined by EUR344.7 million, or 4.2% (see Table 2.7). This is a significant drop compared with the 23.1% rise recorded in 2010. Transactions carried out by internationally-oriented banks had a major impact on these developments.

MFI claims on non-residents of the euro area contracted by 2.0% during the year under review, as against the 20.4% increase registered in 2010 when one new credit institution began operations. On the other hand, resident MFIs' liabilities to non-residents of the euro area fell by 1.2%, considerably less than the 19.4% rise during the previous year.

Other counterparts (net), which tend to be heavily influenced by interbank transactions within the euro area, expanded by EUR413.8 million, or 3.1%, once again much lower than the 20.8% recorded during 2010.

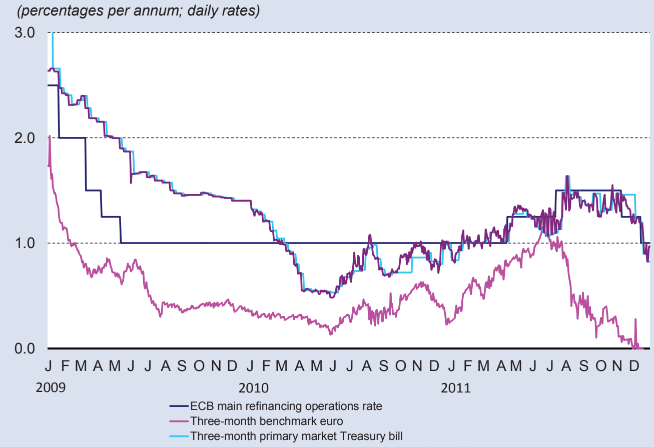
The money market

Trading in Treasury bills continue to dominate money market activity in Malta. During 2011 the Treasury issued EUR884.9 million worth of bills, down from EUR1.2 billion in the previous year. Three-month bills accounted for around 56% of total issues, while six-month and nine-month bills amounted to 21% and 15% of the total, respectively. One-month bills accounted for the remainder. Domestic banks took up approximately 80% of total issues, around the same proportion as in 2010, whereas money market funds (set up by Maltese banks) and insurance companies bought most of the remainder.

In the primary market, the yield on three-month Treasury bills rose during most of the year, reaching a peak of 1.64%. It fell sharply in December, mirroring a drop in primary market issuance, so that by the end of year it stood at 0.82%, 16 basis points below its end-2010 level (see Chart 2.5).

Turnover in the secondary market for Treasury bills declined sharply to EUR36.2 million, from EUR203.5 million in the previous year. This was

Chart 2.5
MONEY MARKET INTEREST RATES
(percentages per annum; daily rates)



Sources: Central Bank of Malta; ECB; Reuters.

partly a reflection of reduced primary market activity. However, the period under review saw a shift in investor behaviour as investors preferred to hold bills to maturity. Around 90% of all trades involved the Central Bank of Malta in its role as market-maker, with Bank purchases and sales amounting to EUR29.3 million and EUR3.0 million, respectively.

Secondary market yields during the year initially rose and then declined, largely mirroring changes in European Central Bank (ECB) official rates. The yield on domestic three-month bills ended December 3 basis points higher than in 2010, at 0.97%. On the other hand, the three-month benchmark euro area yield dropped sharply to close the year marginally above the zero level.[7] As a result, the difference between the two, which stood at 68 basis points at the end of 2010, widened to 112 points a year later (see Chart 2.5).

The capital market

Net issues of long-term debt securities on the domestic primary market during the year amounted to EUR495.3 million, down from EUR576.0 million in the previous year (see Table 2.8).

On a net basis, issues of long-term government debt increased by EUR52.4 million to EUR439.3 million. Together with the reduced issuance of Treasury bills mentioned above, this implies a shift towards long-term debt, in an environment of comparatively low yields. However, net issues by the corporate sector sharply declined to EUR56.0 million from EUR189.1 million in the previous year, partly in response to a tightening of listing requirements.

Total gross issues of long-term government debt amounted to EUR727.7 million. This includes debt issued in terms of a switch to convert bonds maturing in 2012 into longer-dated securities. In February, May and November, the Government issued bonds with maturities ranging from two to 20 years, for a combined value of EUR569.6 million. Over half was allotted to retail investors at fixed prices. In turn, nearly three-quarters of these were bought by resident households, reflecting strong demand for fixed income government securities at a time of relatively low bank deposit rates. Meanwhile, banks bought around 72% of bonds sold by auction, with the rest purchased mainly by insurance companies.

Table 2.8
ISSUES OF LONG-TERM DEBT SECURITIES[1]
EUR millions

	2009	2010	2011
Government			
Total issues [2]	456.2	578.0	727.7
Redemptions [3]	208.0	191.1	288.4
Net issues	248.2	386.9	439.3
Corporate sector			
Total issues	294.9	299.0	60.4
Redemptions [3]	30.0	109.9	4.4
Net issues	264.9	189.1	56.0
Total net issues	**513.1**	**576.0**	**495.3**

(1) 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 MGSs that were issued directly to the Foundation for Church Schools. These amounted to EUR13.7 million in 2009, EUR0.4 million in 2010 and EUR3.3 million in 2011. Total issues in 2011 include the creation of EUR158.1 million 4.3% MGS 2016 (IV) issue as part of the MGS Switch Auction Programme.
(3) Redemptions include debt securities bought back by the issuer. Data for 2011 include the cancellation of EUR159.9 million 5.7% MGS 2012 (III) issue as part of the MGS Switch Auction Programme.
Sources: Central Bank of Malta; MSE; Treasury.

[7] The benchmark euro area yield is a representative rate covering the main secondary market three-month securities issued within the euro area, including those issued by the German and French governments.

Table 2.9
SECONDARY MARKET TRADING IN MALTA GOVERNMENT STOCKS
EUR millions

	2009	2010	2011
Central Bank of Malta purchases	90.7	144.5	163.3
Central Bank of Malta sales	112.0	82.8	91.2
Other deals[(1)]	56.3	51.4	150.7
Total	**259.0**	**278.7**	**405.2**

[(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.

In December the Treasury launched a three-year MGS switch auction programme, through which stock maturing in 2012 was converted into a new EUR158.1 million MGS issue, offering a lower coupon rate and maturing in 2016. The programme attracted strong demand from investors, the overwhelming majority of whom were financial institutions.

The value of corporate debt securities in the primary market dropped to EUR60.4 million in 2011 from EUR299.0 million in the previous year, as only three bonds were launched compared with 15 in 2010. Issued by banks, these bonds have terms to maturity ranging between four and seven years and were overwhelmingly subscribed to by the public.

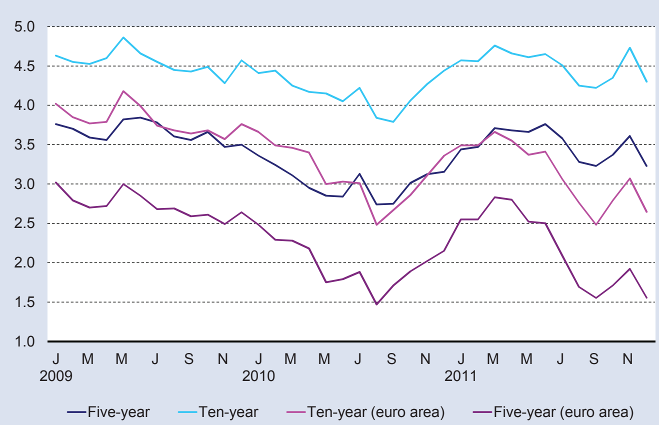
Following increased activity in the primary market, turnover in the secondary government bond market surged to EUR405.2 million in 2011 from EUR278.7 million in 2010 (see Table 2.9). The Central Bank of Malta, acting as market-maker, accounted for around 63% of the value traded, dealing mostly in securities with maturities up to five years.

Domestic government bond yields generally rose during the first half of 2011, extending the upward trend that had begun mid-way in 2010. They eased somewhat thereafter, before fluctuating quite sharply in the final quarter of the year.

The yield on five-year government securities rose by 7 basis points to 3.23% (see Chart 2.6). On the other hand, the corresponding benchmark euro area government bond yield dropped by 59 basis points, mainly reflecting developments in German bunds, ending the year at 1.56%.[8] As a result, the spread between the two increased by 67 basis points to 167 points.

Meanwhile, the yield on ten-year domestic government bonds reached a high of 4.76% in March 2011, before generally declining. By December it had fallen by 14 basis points from end-2010, to 4.30%. Similarly, the benchmark ten-year yield in the euro area declined, but at a faster pace, falling by 71 basis points and ending the year at 2.65%. Thus, the sovereign spread on ten-

Chart 2.6
GOVERNMENT BOND YIELDS
(percentages per annum; end of month)



Sources: Central Bank of Malta; ECB.

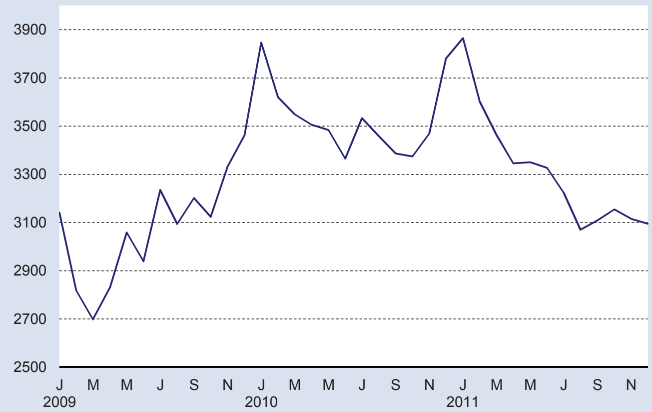
[8] Euro area yields are based on AAA-rated central government bonds.

year debt also widened, adding 57 basis points to 165 points.

Activity in the secondary market for corporate bonds declined during 2011, as turnover decreased by EUR6.2 million to EUR34.2 million. Around three-quarters of total trading was concentrated in 17 bonds, out of a total of 46 listed securities. On average, corporate bond yields increased over the year.

Turnover in the equity market increased to EUR37.6 million in 2011 from EUR36.2 million in 2010, with bank shares accounting for most of the transactions.

Chart 2.7
MALTA STOCK EXCHANGE SHARE INDEX
(end of month)



Source: MSE.

In January 2011, the Malta Stock Exchange share index reached its highest point since 2009, but then steadily fell back. As a result, over the year as whole, the index dropped by 18.2%, ending December at 3,094.80 (see Chart 2.7).

3. OUTPUT, EMPLOYMENT AND PRICES[1]

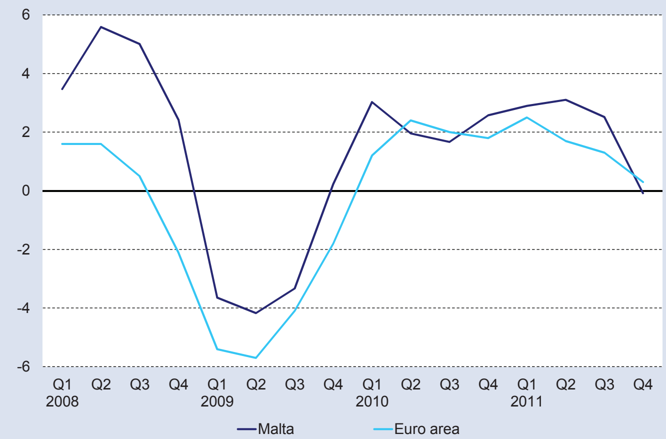
The Maltese economy continued to expand during 2011, though at a somewhat slower pace than in 2010. Net exports were the main driver of growth as domestic demand declined, reflecting lower investment and movements in the inventories component, which also includes the statistical error.

The production-based approach to gross domestic product (GDP) showed that gross value added (GVA) increased in most sectors, but particularly in services. The wholesale & retail sector and the financial services sector were the main contributors to this increase.

Gross domestic product

Real GDP growth decelerated slightly during the year to 2.1%, from 2.3% in 2010. Economic expansion was positive in the first three quarters of the year, with the annual growth rate peaking at 3.1% in the second quarter. In the last quarter of 2011 growth was marginally negative at 0.1%. As Chart 3.1 shows, the growth rate in Malta continued to broadly follow the same path as that of the euro area.[2] In 2011, however, Malta's growth rate exceeded that of the euro area by 0.7 percentage point.

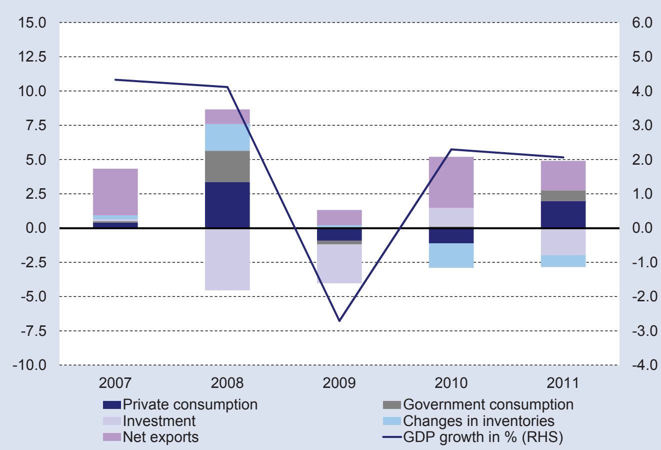
Chart 3.1
REAL GDP GROWTH
(annual percentage change)



Source: NSO.

Malta's net exports remained positive for the second consecutive year. In fact, their share of real GDP increased on a year earlier. Domestic demand contracted slightly, as a drop in private investment and a substantial fall in inventories offset the impact of an acceleration in private and government consumption expenditure (see Chart 3.2 and Table 3.1).[3]

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



Source: NSO.

Domestic demand

Private consumption recovered strongly, with an annual growth rate of 3.1% following two years of decline. The rate of growth was strongest in the first half of the year, but then fell to -0.3% in the last quarter. The overall contribution to real GDP growth turned positive in 2011, at 2.0 percentage points. The upturn in private

1 The cut-off date for data on GDP, industrial production and unit labour costs included in this Chapter is 9 March 2012.

2 Annual real GDP growth rates for the euro area reported in this Chapter differ from those provided elsewhere in this *Report*. To maintain comparability with data for Malta, euro area figures used in this Chapter are not seasonally adjusted.

3 The figure for inventories also includes acquisitions and disposal of valuables, as well as statistical discrepancies that arise from the reconciliation of the three methods of measuring GDP, namely the production, income and expenditure methods.

Table 3.1
GROSS DOMESTIC PRODUCT AT CONSTANT PRICES

	2008	2009	2010	2011
		Annual percentage changes		
Private final consumption expenditure	5.1	-1.4	-1.7	3.1
Government final consumption expenditure	12.3	-1.3	0.6	3.9
Gross fixed capital formation	-21.2	-17.5	9.8	-13.4
Changes in inventories (% of GDP)	-0.3	-0.1	-1.8	-2.6
Domestic demand	**3.0**	**-3.7**	**-1.4**	**-0.1**
Exports of goods & services	1.6	-10.5	17.7	1.0
Imports of goods & services	0.6	-11.3	13.7	-1.0
Gross domestic product	**4.1**	**-2.7**	**2.3**	**2.1**
		Percentage point contributions		
Private final consumption expenditure	3.4	-0.9	-1.1	2.0
Government final consumption expenditure	2.3	-0.3	0.1	0.8
Gross fixed capital formation	-4.5	-2.8	1.4	-2.0
Changes in inventories	1.9	0.2	-1.8	-0.9
Domestic demand	**3.0**	**-3.8**	**-1.4**	**-0.1**
Exports of goods & services	1.8	-10.9	17.0	1.1
Imports of goods & services	-0.7	12.0	-13.2	1.0
Net exports	**1.1**	**1.1**	**3.7**	**2.2**
Gross domestic product	**4.1**	**-2.7**	**2.3**	**2.1**

Source: NSO.

consumption appeared to be consistent with developments in real disposable income, which recovered from two years of decline mainly as a result of higher employee compensation.

Government consumption also expanded at a notable rate of 3.9% compared with 0.6% in 2010. It contributed 0.8 percentage point to real GDP growth. Nominal data suggest that the expansion emanated mainly from intermediate consumption in the health and education sectors and, to a lesser extent, from compensation to government employees.

Gross fixed capital formation (GFCF) dropped by 13.4% in 2011 after increasing by 9.8% in the previous year. Its contribution to real growth was a negative 2.0 percentage points, in contrast to the previous year when it boosted growth by 1.4 points.

Nominal data indicate that the drop in investment was mainly attributed to the private sector. This decline was particularly pronounced in the transport and energy sectors, which had recorded one-off transactions a year earlier. Construction investment was also lower on an annual basis. Meanwhile government investment increased during the year under review, predominantly in the construction category, mainly reflecting road works and further development of industrial zones.

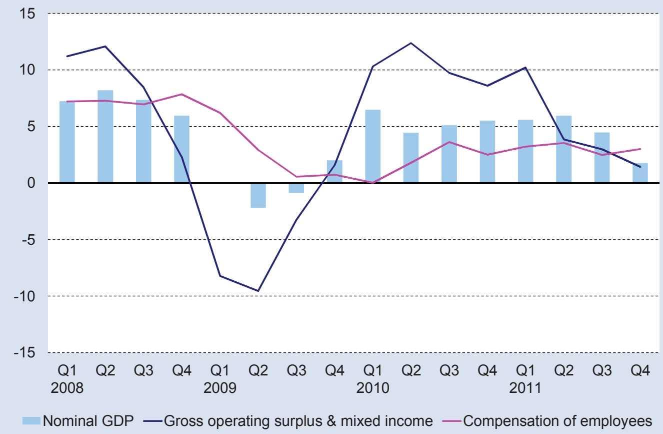
Changes in inventories, which are heavily influenced by the statistical discrepancy, became more negative. This item was equivalent to -2.6% of GDP, compared with -1.8% in 2010, and had an adverse impact on real GDP growth of 0.9 percentage point.

External demand

Export of goods and services slowed down to a growth rate of 1.0% following an increase of 17.7% in 2010. On the basis of nominal data, it was observed that re-exports of oil contributed significantly to the rise in exports in 2011. Machinery and miscellaneous manufactured articles also rose, while food products and chemicals registered a small decline. Export receipts were also boosted by the contribution of the service industries, including tourism, trade-related and financial services.

On the import side a decline of nearly 1.0% was registered over the year. In nominal terms imports increased across all categories, particularly that related to fuel. The divergent trend in real and nominal growth of imports reflected a notable rise in the import price index.

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



Source: NSO.

Nominal GDP

Nominal economic growth decelerated to 4.4% from 5.4% in the previous year. An analysis of GDP from the income side indicates that growth in compensation to employees accelerated to 3.1% in 2011 from 2.0% in the previous year. Higher levels of compensation were observed across all sectors, with the strongest gains in absolute terms recorded in public administration and manufacturing. Gross operating surplus & mixed income increased by 4.5%, following a 10.2% increase in 2010 (see Chart 3.3).

GDP based on output developments shows that nominal GVA grew at a decelerating pace of 3.8%, compared with 5.7% in 2010. GVA contributed 3.3 percentage points to nominal GDP growth, with the remaining 1.1 percentage points being attributed to taxation on products (see Table 3.2).

On a sectoral level, all major sectors contributed to nominal GDP growth, except mining & utilities, which registered negative growth, and the construction sector, where value added was broadly unchanged from the previous year's level. The manufacturing sector contributed half a percentage point to nominal GDP

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

	2008	2009	2010	2011
Agriculture, forestry & fishing	-0.4	0.2	0.0	0.1
Mining & quarrying; utilities	-0.2	0.8	0.0	-1.3
Manufacturing	1.1	-2.4	0.8	0.5
Construction	0.4	-0.3	-0.1	0.0
Wholesale & retail trade; repair of motor vehicles; transportation; accomodation & related activities	0.3	-1.1	1.1	0.9
Information & communication	0.4	-0.3	-0.1	0.4
Financial & insurance activities	0.0	1.3	1.4	0.9
Real estate activities	0.2	0.1	0.2	0.2
Professional, scientific, administrative & related activities	0.6	0.6	0.5	0.5
Public administration & defence; education; health & related activities	1.2	0.8	1.0	0.7
Arts, entertainment; household repair & related services	3.4	-0.6	0.2	0.5
Gross value added	**7.1**	**-0.9**	**4.9**	**3.3**
Net taxation on products	**0.1**	**0.6**	**0.4**	**1.1**
Annual nominal GDP growth (%)	**7.2**	**-0.3**	**5.4**	**4.4**

Source: NSO.

growth, somewhat less than in the previous year, as GVA growth in the sector eased to 4.6% from 7.1% in 2010.

Services remained the main driver of growth in GVA and contributed over 4 percentage points to nominal GDP growth. The categories comprising wholesale & retail trade, transportation & accommodation and finance & insurance were important contributors to growth with an overall contribution of 1.8 percentage points.

The arts & entertainment and the professional & scientific activity sectors recorded faster growth in GVA during the year and made a combined contribution of a percentage point. The level of GVA in the information & communication sector rebounded and increased by 8.9% after two consecutive years of decline. This upturn reflected stronger activity in computer programming, consultancy and related areas. Consequently, the contribution to nominal growth from this sector turned positive, reaching 0.4 percentage point.

The real estate sector continued to expand at a more moderate pace, with its contribution to nominal GDP growth remaining stable at 0.2 percentage point.

Industrial production[4]

After registering a strong recovery in 2010, industrial production grew at a relatively slow pace in 2011. Overall growth rate stood at 0.2% compared with 7.3% in the previous year (see Table 3.3). Production in manufacturing, which constitutes over nine-tenths of total industrial production, was unchanged in volume terms from the level registered in 2010. In the energy sector, production rose by 2.7% after having contracted in 2010. Reflecting the sluggish conditions in the construction sector, the volume of production recorded by the mining & quarrying sector continued to decline. It fell by a further 9.2% in 2011 after a substantial drop of 22.6% in 2010.

With regard to the various sub-sectors of manufacturing, rubber & plastic products and textiles increased, but at a slower pace than in 2010. Production of electrical components and food products, which together

Table 3.3
INDUSTRIAL PRODUCTION
Percentages; annual average percentage changes

	Shares	2009	2010	2011
Industrial production	**100.0**	**-14.6**	**7.3**	**0.2**
Manufacturing	**91.4**	**-15.4**	**8.3**	**0.0**
Of which:				
Computer, electronic & optical products	18.5	-16.0	27.8	0.1
Food products	10.2	-5.5	-12.1	0.9
Wearing apparel	6.5	-30.2	-12.3	-5.8
Rubber & plastic products	6.2	-26.6	17.4	7.5
Basic pharmaceutical products & pharmaceutical preparations	5.5	-7.5	23.8	-5.2
Textiles	5.2	-2.6	37.1	4.9
Repair & installation of machinery and equipment	5.0	-39.5	-16.6	-28.8
Beverages	4.6	-8.4	1.1	3.6
Energy	**8.0**	**-4.8**	**-2.4**	**2.7**
Electricity, gas, steam & air conditioning supply	7.4	-4.8	-2.5	2.6
Water collection, treatment and supply	0.6	-5.1	-1.6	3.1
Mining and quarrying	**0.6**	**-4.9**	**-22.6**	**-9.2**

Sources: NSO and Eurostat.

[4] Industrial production data are based on a sample of firms engaged in quarrying, manufacturing and energy production.

make up nearly three-tenths of the total, rose slightly with food production registering a gain after two consecutive years of contraction. On the other hand, production fell further in the wearing apparel and repair & installation of machinery and equipment sub-sectors. Production of pharmaceutical products also fell during 2011, after having increased markedly in the previous year.

Data on manufacturing sales show that turnover increased by an average of 0.4% in 2011, compared with a rise of 14.1% in 2010.[5] The growth in sales was primarily driven by exports, which were up by 1.0%. Domestic sales rose at a more modest rate of 0.2%. Both the number of employed persons in the manufacturing sector and average compensation levels recovered from the decline recorded in 2010, rising by 1.4% and 3.4% respectively. This was reflected in a 4.8% increase in the sector's overall wage bill.

Tourism

During 2011 the tourism sector maintained its positive trend, with a further increase in the number of arrivals and in the level of tourism earnings. Tourist arrivals, in fact, rose by 5.6%, reaching the highest level since the introduction of survey based statistics, although the growth rate was lower than that registered in 2010 when the sector had recovered strongly from the previous year's downturn.[6]

The improvement in tourist arrivals was especially apparent in the first four months of the year, followed by more moderate growth rates during the remainder of the year. The relatively stronger performance partly reflects the impact of developments in North Africa, which discouraged travel to a number of neighbouring destinations. It also reflects a base effect owing to the disruption to international travel caused by the eruption of an Icelandic volcano in April 2010. The growth in tourist arrivals to Malta fell below the 8.1% average growth registered in the Southern/Mediterranean Europe region as a whole.[7]

There was a moderate shift in the relative shares of Malta's tourist markets during 2011. However, the United Kingdom remained the largest source, accounting for almost a third of the year's total. Arrivals from that country rose by 5.9% over the previous year. The second largest market, Italy, saw visitors drop by 8.2%, with their share falling from 16.3% to 14.2% in 2011 as a result. At the same time, arrivals from Germany, another major source market, registered an increase of 6.7%. The number of tourists from France also rose strongly, by 19.8%. On the other hand, arrivals from Spain reversed the positive growth seen previously and dropped by 6.9%, in part reflecting a downward review by the Spanish Government of financial programmes to enable students to study English in foreign countries such as Malta (see Table 3.4).

Table 3.4
TOURIST AND CRUISE PASSENGER ARRIVALS
Thousands

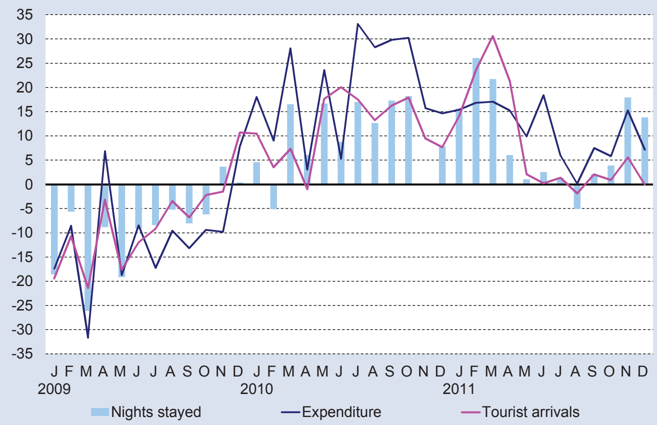
	2009	2010	2011
Tourist departures$^{(1)}$	**1,182.5**	**1,336.4**	**1,411.7**
UK	398.5	415.2	439.7
Italy	161.7	217.7	199.8
Germany	127.4	126.2	134.6
France	71.9	86.5	103.7
Scandinavia$^{(2)}$	66.8	92.8	93.0
Spain	45.3	67.8	63.1
Others	310.9	330.2	377.8
Cruise passengers	**419.6**	**474.9**	**541.6**

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

[5] Eurostat statistics on industrial sales, employment and wages & salaries are compiled from a representative sample of approximately 400 enterprises, which are then grossed up to represent the entire industrial population.
[6] The NSO introduced a survey of inbound tourists referred to as "Departing Tourists" in April 2004.
[7] See United Nations World Tourism Organisation, *World Tourism Barometer* January 2012.

Malta International Airport data (MIA) on passenger movements provide further evidence of the continued expansion in tourism activity in 2011: arrivals, which do not distinguish between residents and non-residents, and aircraft landings were, respectively, 6.0% and 9.2% higher than in 2010.

Chart 3.4
TOURISM INDICATORS
(annual percentage changes)



Source: NSO.

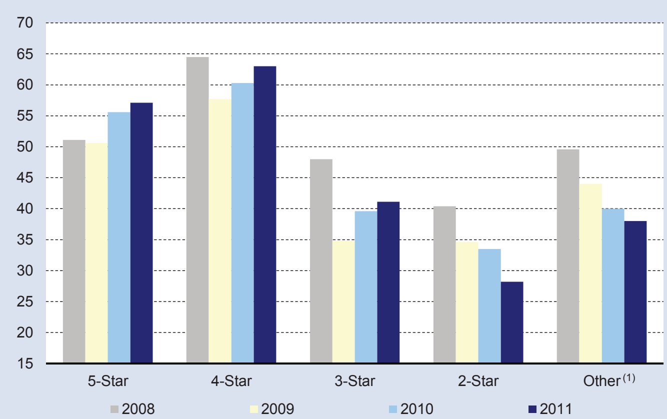
The growth in arrivals was accompanied by a higher level of tourism expenditure, although the latter increased to a lesser extent than in 2010 (see Chart 3.4).[8] Spending on package holidays increased by 13.1% and was the main contributor to the overall increase of 8.8%. Spending on non-package holidays, composed of accommodation and travel, rose marginally, by 1.5%. Meanwhile, the "other" component of tourist expenditure increased by 10.5%.

The number of nights stayed by tourists rose by 4.8%, broadly in line with the growth in numbers. As a result, the average length of stay was unchanged at 8.3 nights in 2011.

An industry survey covering the first three quarters of 2011 also reports an increase in guest nights stayed and additional income flows from accommodation services.[9] This, in turn, generated higher gross operating profit for hotels. According to the same survey, 4-star hotels reported the fastest rise in average achieved room rates, while the increase in 5-star hotels was more contained. In contrast, 3-star hotels registered a drop in averaged achieved room rates. In this context, Harmonised Index of Consumer Prices (HICP) data on prices of accommodation services also show a marginal rise during 2011.

The rise in nights stayed during the year translated into improved occupancy rates across all hotel categories. National Statistics Office (NSO) data indicate that overall hotel occupancy rates in 2011 grew by 2.1 percentage points over 2010, to 54.9%. The 4-star category continued to record the highest occupancy rate, which went up by 2.7 percentage points to 63.0% (see Chart 3.5). Meanwhile, occupancy in 5 and 3-star hotels were each up by 1.5 percentage points on their year-ago levels. On the other hand, occupancy in the lower end categories registered a drop. These data are largely supported by findings of the industry survey referred to earlier covering the first three quarters of 2011, which indicate slightly improved occupancy in all hotel categories, with the highest rates reported by 4-star hotels.

Chart 3.5
AVERAGE OCCUPANCY RATES
(per cent)



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

8 Total expenditure is composed of package, non-package and "other". Non-package spending is sub-divided into spending on accommodation and travel, while the "other" component captures any additional expenditure that tourists incur during their stay in Malta.
9 See *BOV MHRA Survey* – Q3 2011.

The year under review was also positive for cruise generated tourism activity. At 311, the number of port calls by cruise ships was 36 more than in 2010. Concurrently, cruise passenger arrivals rose by 14.0% to just below 542,000 (see Table 3.4).

Construction

In 2011, the output of the construction sector increased by 0.6%. Because of the rise of 1.6% in the sector's intermediate consumption, the sector's GVA dropped by 1.1% in nominal terms, compared with a decline of 3.3% in 2010. Consequently, the sector's share in nominal GDP contracted further (see Table 3.5).

The drop in the sector's GVA during 2011 was reflected in a contraction of 2.2% in the profit element, and an increase of 0.2% in employees' compensation.

Average employment in private sector construction was unchanged in the first nine months of 2011 compared with the corresponding period of 2010, when it had dropped by 5.1%. In the public sector, a drop of 4.7% in employment was registered. As a result, in the first nine months of 2011, total employment in construction fell by 1.5% (see Table 3.5). The industry's share of the total gainfully occupied population also declined, to 8.1%.

Nominal data on GFCF show an almost unchanged level of investment in construction during 2011, compared with a 2.4% increase in the previous year. Within the sector, the non-dwelling category showed a year-on-year rise of 2.9% over 2010. However, investment in this category was heavily influenced by work on the Valletta City Gate project. Government spending on non-dwelling investment during 2011 rose by 20.6%, while private sector expenditure in this category dropped by 6.1%.

In the housing sector, investment in construction was undertaken solely by the private sector. During the year it dropped by a further 5.4%, after recording a decline of 13.3% in 2010. Reflecting the weakness of the housing market, the number of dwelling permits issued by the Malta Environment & Planning Authority (MEPA) continued to decrease, registering a fall of 11.0% in 2011 following a decline of 16.1% in 2010. The reduction over the last two years probably reflects both a tightening of planning policy and a slowdown in construction activity.

Residential property prices[10]

The Bank's index of advertised residential property prices increased on average by 1.3% in 2011, after having risen by 1.1% in 2010. From the trough in the first quarter of 2009, the annual rate of change of property prices followed a generally upward path to peak in the last quarter of 2011 (see Chart 3.6).

Table 3.5
CONSTRUCTION ACTIVITY INDICATORS(1)

	2008	2009	2010	2011
Gross value added (EUR millions)	**244.9**	**228.7**	**221.1**	**218.7**
Share of gross value added in GDP (%)	4.2	3.9	3.6	3.4
Total employment	**11,979**	**12,739**	**12,235**	**12,051**
Private employment	8,811	8,901	8,449	8,444
Share in total gainfully occupied population (%)	8.2	8.8	8.4	8.1

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

10 The latest data available from the NSO relate to the first quarter of 2010. This analysis of property price movements is based on the Central Bank of Malta's residential property price index, which tracks movements in residential property prices compiled from newspaper advertisements sampled each month. The NSO publishes a separate quarterly index based on monthly information obtained from contracts of sale registered with the Inland Revenue Department. The Bank's index is divided into eight dwelling categories, while properties are sorted into three categories in the NSO statistics. The latest data available from the NSO relate to the first quarter of 2011.

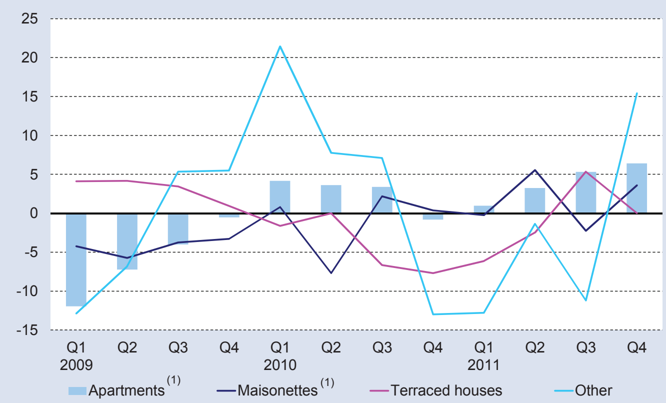
Property price inflation was negative in the first quarter of 2011, before turning slightly positive in the second. The index then accelerated through the second half of the year, rising by 6.1%, year-on-year, in the last quarter. At the end of the year, the index was at its highest level since 2008.

Chart 3.6
RESIDENTIAL PROPERTY PRICE INFLATION (BASED ON ADVERTISED PRICES)
(annual percentage change)

Source: Central Bank of Malta.

The rise in property prices over the year as a whole was due to higher asking prices for apartments and, to a lower extent, maisonettes, which enter the sample in both shell and finished form. In recent quarters, the rate of change in maisonette prices has fluctuated around a slightly rising trend. Prices of apartments, which made up around 60% of the sampled properties, recovered, rising by an average of 4.0% over 2010. Nonetheless, the price index for this category remains below that of 2007. In addition, the prices of maisonettes grew by an annual 1.7% (see Chart 3.7).

Chart 3.7
RESIDENTIAL PROPERTY PRICES BY CATEGORY
(annual percentage changes)



(1) Includes both units in shell form and finished units.
Source: Central Bank of Malta.

On the other hand, prices of dwellings in the "other" category, which consists of town houses, houses of character and villas, and which account for almost a fifth of sampled properties, dropped by 2.5%. Within this relatively volatile category, asking prices for houses of character and villas fell, while those of town houses increased. In addition, during 2011 asking prices for terraced houses fell marginally over their year-ago level.

An indication of activity in the housing market can be obtained from the number of advertised properties in the Bank's sample, which, in 2011, was practically unchanged from 2010.

The labour market[11]

The number of persons in employment increased progressively during 2011, while unemployment generally eased.

Employment

Labour Force Survey (LFS) data up to the third quarter of the year point to an average annual growth rate in employment of 2.7% between January and September. In the same period of the previous year the growth rate was lower at 1.8% (see Table 3.6). As a result, the employment rate increased by 1.5 percentage points

[11] This section draws mainly on labour market statistics obtained from two sources. The LFS is a household survey conducted by the NSO on the basis of definitions set by the International Labour Organisation and Eurostat, while Employment and Training Corporation (ETC)'s findings are computed from administrative records compiled according to definitions set by domestic legislation on employment and social security benefits.

Table 3.6
LABOUR MARKET INDICATORS BASED ON THE LABOUR FORCE SURVEY(1)
Persons; annual percentage changes

	2010 Jan.-Sep.	2011 Jan.-Sep.	Annual change %
Working age population	351,340	354,608	0.9
Labour force	**176,669**	**180,505**	**2.2**
Unemployed	12,282	11,601	-5.5
Employed	164,387	168,904	2.7
By type of employment:			
Full-time	143,729	146,295	1.8
Full-time with reduced hours	3,563	4,048	13.6
Part-time	17,095	18,560	8.6
Activity rate (%)	**60.3**	**61.6**	**1.3**
Employment rate (%)	**56.1**	**57.6**	**1.5**
Unemployment rate (%)	**6.9**	**6.4**	**-0.5**

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

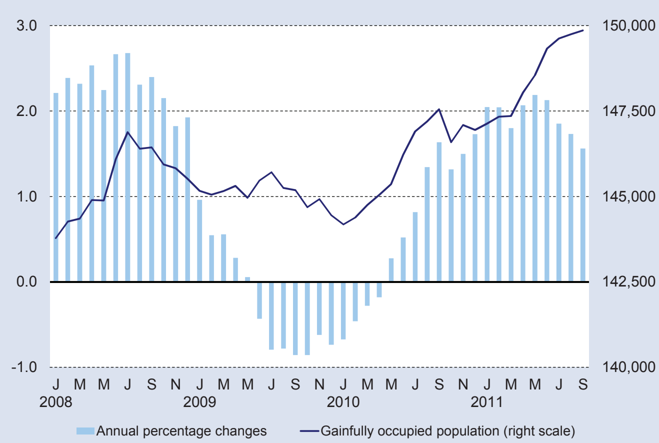
to 57.6%, with the female category, which benefitted from the introduction of tax related relief schemes, rising by 1.8 points.[12]

The increase in the number of jobs was broad based, but growth was strongest in full-time employment, which went up by 2,566 on an annual basis. In addition, part-time employment increased by 1,465 on a year earlier, while those working on reduced hours rose more moderately.

In the first three quarters of 2011, the labour force also increased on the same period of 2010, albeit at a more modest pace than employment, on account of a contraction in the number of unemployed. In turn, as the labour force expanded at a faster rate than the working age population, the activity rate edged up to 61.6%, thus adding 1.3 percentage points on a year earlier and reaching its highest level since the introduction of the survey in 2000.[13] According to the LFS, the average female activity rate increased by 1.8 percentage points, while the rate for males rose by almost a percentage point.

The administrative records of the ETC also point to growth in employment. The gainfully occupied population, which consists of persons in full-time employment, posted annual gains throughout the first nine months of 2011. The rate of job creation was on an upward trend in the first half of the year, decelerating slightly during the third quarter (see Chart 3.8). On average, full-time

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



Source: NSO.

12 The employment rate measures the number of persons employed as a share of the population aged between 15 and 64 years.
13 The activity rate measures the number of people in the labour force as a proportion of the working-age population.

employment rose by 1.9% in the first nine months of 2011, with growth in the private sector outpacing that in the public sector in both absolute and percentage terms (see Table 3.7). The number of jobs in the private sector increased by an annual 2.3%, whereas public sector employment rose by 1.0%.

The increase in full-time private sector employment occurred mostly in market services, which went up by around 1,800, or 2.5%. Within this category, the largest absolute gains were recorded in the real estate, renting & business activities sector, in particular the "other business activities" category, which comprises a broad range of business and professional services, and in the computer & related activities category. In addition, significant increases were registered in the land transport category within the transport, storage & communication sector, mainly reflecting the public transport reform. However, this was dampened by job losses in related supporting services, so that overall employment in the sector rose moderately. The financial intermediation sector continued to generate new employment, with a 3.6% rise in full-time employees. New jobs were also created in the recreational, cultural & sporting activities sector, which includes remote gaming, and which forms part of the "other" category in Table 3.7.

Also within the private sector, employment in direct production rose by 572, or 1.8%, primarily reflecting increases across firms engaged in the manufacturing of transport equipment, electrical machinery and rubber & plastic products.

In the public sector, the number of full-time workers increased in the areas of health & social work and education. These gains outweighed the impact of reductions in construction activity and in the air trans-

Table 3.7
LABOUR MARKET INDICATORS BASED ON ADMINISTRATIVE RECORDS[(1)]
Persons; annual percentage changes

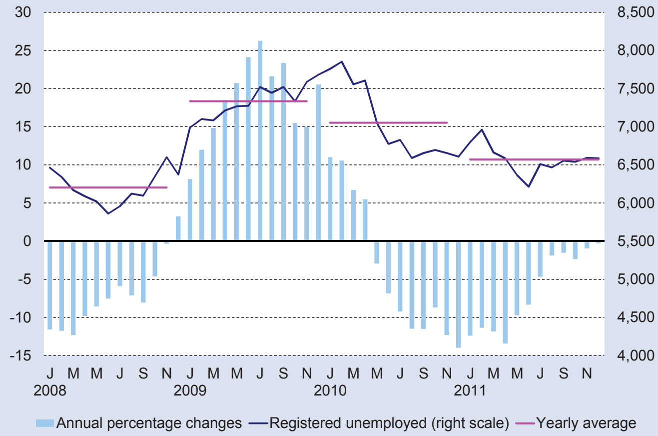
	2010 Jan.- Sep.	2011 Jan.- Sep.	Annual change %
Labour supply	**152,918**	**155,116**	**1.4**
Registered unemployed[(2)]	**7,186**	**6,564**	**-8.7**
Gainfully occupied	**145,733**	**148,553**	**1.9**
Public sector	**40,417**	**40,819**	**1.0**
Private sector	**104,684**	**107,065**	**2.3**
Private direct production[(3)]	**31,549**	**32,121**	**1.8**
Manufacturing	20,514	21,105	2.9
Construction	8,449	8,444	-0.1
Private market services	**73,135**	**74,945**	**2.5**
Wholesale & retail	22,330	22,339	0.0
Hotels & restaurants	9,457	9,467	0.1
Transport, storage & communication	9,078	9,134	0.6
Financial intermediation	5,664	5,868	3.6
Real estate, renting & business activities	14,030	14,966	6.7
Other	12,577	13,171	4.7
Temporary employed	**631**	**669**	**6.0**
Part-time employees	**50,199**	**52,561**	**4.7**
Part-time as a primary job	28,505	29,726	4.3
Part-time holding a full-time job	21,694	22,835	5.3

(1) Figures are based on averages for the first nine months.
(2) Statistics for all of 2011 are available for the number of registered unemployed. The average number declined by 6.9% between 2010 and 2011.
(3) This also includes employment in agriculture, fishing, mining & quarrying and electricity, gas & water supply.
Source: NSO.

port sector as the restructuring of the national airline got under way, along with the ongoing removal of former shipyard employees hitherto classified as workers within the public sector.

ETC data also show further growth in part-time employment. In the first nine months of 2011 this was around 2,360, or 4.7%, higher over year-ago levels. In this segment of the labour market, increases in employment were evenly spread across persons holding a part-time job in addition to their full-time job and those declaring part-time employment as their only job.

Chart 3.9
REGISTERED UNEMPLOYED
(annual percentage changes; persons)



Source: NSO.

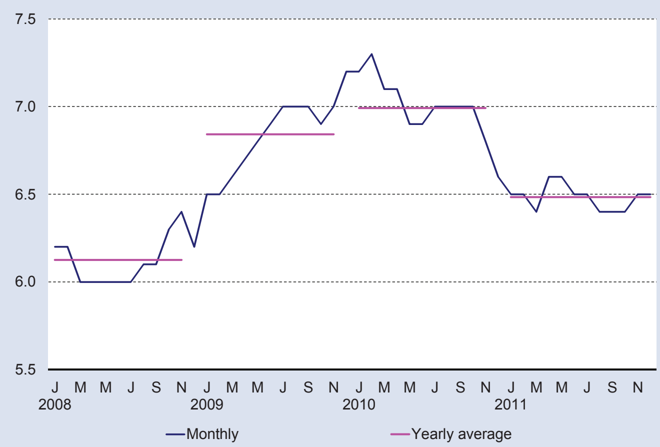
Unemployment

After having dropped significantly during most of 2010, the number of job seekers registered with the ETC declined further through June 2011, while the number increased slightly through most of the second half of the year. However, the decline on year-ago levels persisted, though at a decelerating pace (see Chart 3.9). Over the year as a whole, the average number of unemployed persons fell by 6.9% compared with 2010. The number decreased across all age brackets. In terms of the duration of registration, the drop was also broad based with the largest fall seen in long-term unemployment.

Similarly, LFS data for the first three quarters show a drop in the number of unemployed (see Table 3.6). The corresponding unemployment rate averaged 6.4%, half a percentage point below the level recorded in the same period of 2010.

On a seasonally-adjusted basis, Eurostat data for Malta show that the unemployment rate was fairly stable during 2011, fluctuating within a narrow band of 0.1 percentage point around the year's average of 6.5%, which was around half a percentage point below the previous year's level (see Chart 3.10).

Chart 3.10
UNEMPLOYMENT RATE
(seasonally adjusted; per cent)

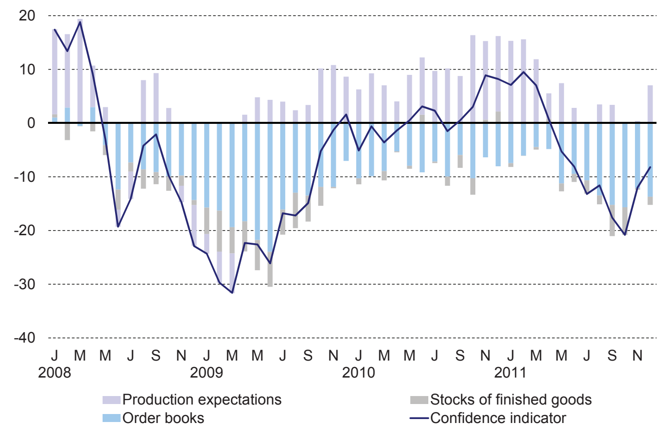


Source: Eurostat.

BOX 1: BUSINESS AND CONSUMER SURVEYS[1]

Business and consumers' confidence indicators generally declined in 2011, although there were signs of improved sentiment towards the end of year.

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



Source: European Commission.

Industrial confidence surveys[2]

After having improved during the previous two years, perceptions in the manufacturing sector declined during 2011 (see Chart 1). In fact, the seasonally-adjusted industrial confidence indicator turned negative in May and maintained a downward trend as the year progressed, although confidence levels improved once again in the final two months. Over the course of the year, the index lost 16 percentage points, falling to -8 in December.

The deterioration in confidence was evident in all the components of the index. In fact, production expectations decreased by 21 percentage points over the year, but nonetheless remained in positive territory for almost all of 2011. The decline also reflected an accumulation of stocks of finished goods, especially in the second half of the year. Meanwhile, order book levels decreased throughout the year.

Supplementary data show that employment growth expectations were much more optimistic in the first quarter of 2011 compared with the rest of the year. While in the first half of the year a relative majority of respondents said that there were no factors limiting their production, in the second half of the year weak demand was regarded as the primary factor inhibiting production. In addition, throughout the year respondents anticipated a decrease in their selling prices.

A breakdown of the main industrial groupings, available only in seasonally-unadjusted terms, shows that confidence worsened over the course of the year among producers of consumer and intermediate goods but improved among manufacturers of investment goods. A closer look points to a fall in sentiment among manufacturers of computer & electronic equipment, machinery & equipment, rubber & plastic products, and wearing apparel. On the other hand, there were confidence gains in the pharmaceutical sector.

Construction industry confidence surveys[3]

Sentiment among construction firms was practically unchanged in the first five months of the year under review, before generally falling through October. In the final two months of the year, however, the index improved somewhat, but remained in negative territory (see Chart 2). The confidence indicator stood at -34 in December, only marginally lower than -33 recorded a year earlier. This reflected a higher number of respondents expressing their intention to reduce the number of employees. On the other hand, a smaller

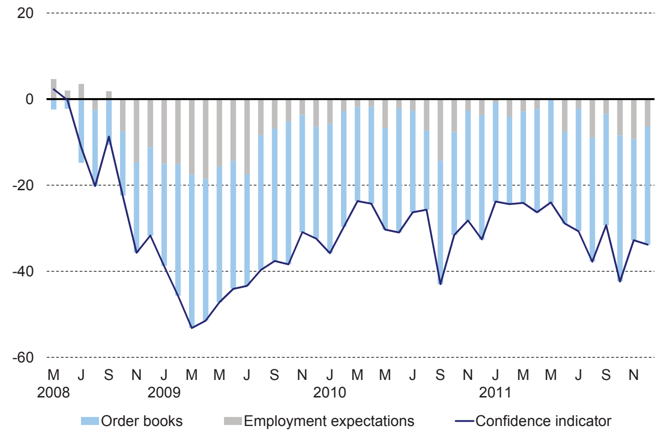
[1] Since May 2010, survey data for industry, construction and services are being compiled according to the NACE Revision 2 classification. However, aggregates for each category are unlikely to be affected by this change in methodology. The compilation of the consumer survey remained unchanged.

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

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

number of firms considered their current order books to be below normal. Operators in the industry cited weak demand as the main obstacle to a recovery in building activity.

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



Source: European Commission.

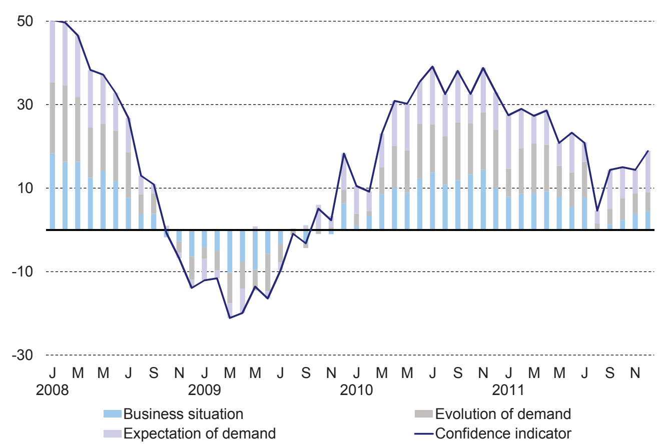
Services confidence surveys[4]

Within the services sector, after a general improvement during 2010, business optimism fluctuated in a narrow range in the first four months of 2011, before decreasing up to August (see Chart 3). Thereafter, the confidence level improved. Thus, while the balance of replies remained positive throughout the year, survey results show a decline in sentiment over the year as a whole, with a net loss of 14 points to reach 19 in December.

The overall decline in the index was propelled by a smaller balance of participants reporting an increase in current demand for services and a more favourable business situation. In contrast, with regard to future demand, the number of respondents expecting higher demand increased. This notwithstanding, survey data point to slower growth in employment.

Turning to a more detailed sectoral breakdown, available only in seasonally-unadjusted terms, firms operating in the accommodation sector, financial services, telecommunications, rental & leasing and the gambling & betting industry reported a worsening in business confidence compared with December 2010. Nonetheless, sentiment remained positive in financial services and improved among firms engaged in travel-related activities, programming & broadcasting activities and the real estate sector.

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



Source: European Commission.

Consumer confidence surveys[5]

The weakness in consumer sentiment evident in the previous two years persisted during 2011. Consumer confidence declined in the first four months of the year, before regaining some of its earlier losses (see Chart 4). As a result, the index

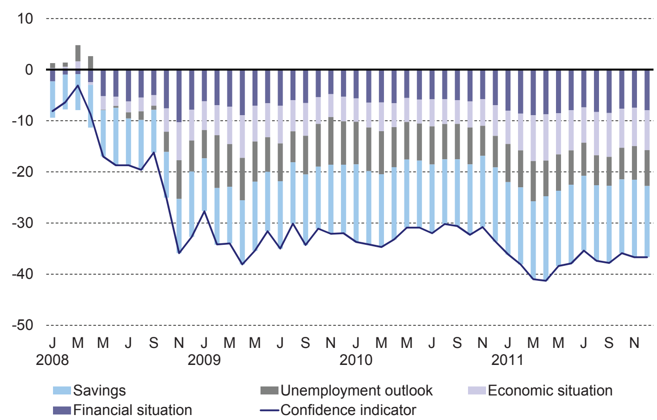
[4] The services confidence indicator is the arithmetic average of the balances (in percentage points) of replies to survey questions relating to the business climate, the evolution of demand in the previous three months and demand expectations for the subsequent three months.

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

fell to -37 in December 2011 as against -34 in December 2010.

At the end of 2011, consumers, on average, expected a deterioration in their own financial situation over the subsequent 12 months and were also more concerned about the general economic situation, compared with a year earlier. Furthermore, respondents' spending intentions regarding major purchases, such as new cars and homes, were on average lower than in 2010. Nonetheless, consumers were more optimistic about prospects in the labour market and their ability to save in the year ahead.

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



Source: European Commission.

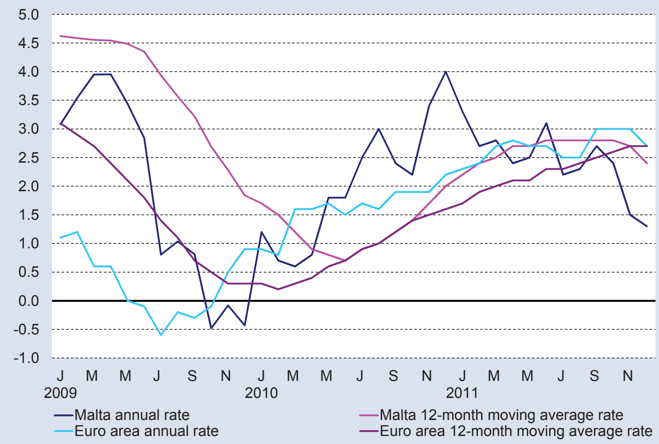
Consumer prices

HICP[14]

In 2011 the annual HICP inflation averaged 2.4%, compared with 2.0% in 2010. The average inflation rate moderated towards the end of the year. Indeed, the year-on-year inflation rate followed a generally downward path, reaching its lowest level in December at 1.3% (see Chart 3.11).

Prices rose at a slower pace in Malta that in the euro area during most of 2011. As a result the inflation differential turned negative, averaging -0.3 percentage point during the year as a whole.

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



Sources: NSO; Eurostat.

The increase in Malta's average inflation rate between 2010 and 2011 was mostly influenced by food prices and, to a smaller degree, by non-energy industrial goods. On the other hand, there was an easing in the contribution of energy and services.

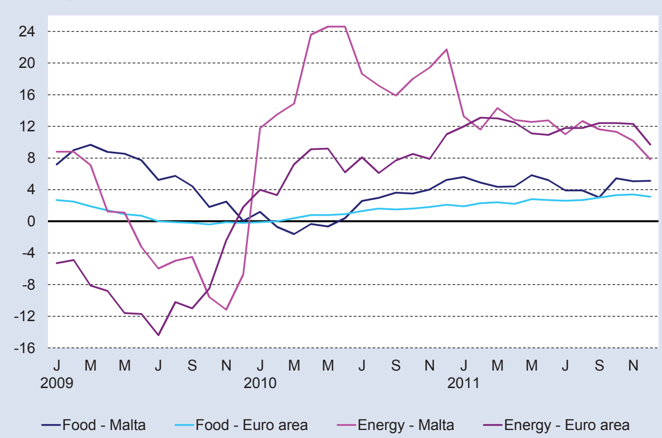
Nevertheless, energy remained the highest contributor to overall inflation in 2011, adding 0.8 point to the year's inflation rate. It remained elevated, averaging 11.8% during 2011 (see Chart 3.12).

Following the previous year's liberalisation measures, energy price inflation in Malta reflected more closely that in the euro area as a whole. Higher international oil prices affected the transport fuel component significantly. In addition, gas prices markedly increased, though their impact on overall energy inflation was quite small. Electricity and water tariffs remained unchanged from end-2010 levels.

Food prices, which account for just over a fifth of the HICP, registered an average annual growth rate of 4.7% during 2011, fluctuating in a narrow range during the year. While domestic and euro area food prices followed a similar pattern during the year, local food inflation remained higher than in the euro area (see Chart 3.12).

The processed and unprocessed food components showed annual aver-

Chart 3.12
FOOD AND ENERGY PRICE INFLATION IN MALTA AND THE EURO AREA
(annual percentage changes)



Sources: NSO; Eurostat.

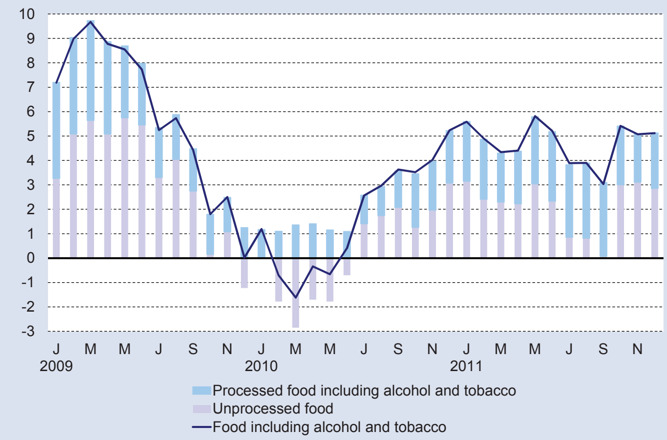
[14] In January 2011 the HICP weights were revised to reflect changes in household consumption patterns. The weight of food remained almost unchanged at 20.5%. In contrast, the share of non-energy industrial goods and services dropped by 0.1% and 0.2%, respectively, to 31.6% and 41.3%. On the other hand, the share allotted to energy rose from 6.3% to 6.6% in 2011.

age growth rates of 4.0% and 5.9%, respectively, in 2011. As can be seen in Chart 3.13, these contributed to food price inflation in broadly equal measures. Developments in the processed food category were mainly driven by prices of bread & cereals, as well as of milk, cheese & eggs. At the same time the prices of meat, vegetables and fish & seafood, which are included in the unprocessed category, also increased substantially.

Services, which account for two-fifths of the HICP, had an average inflation rate of 1.0% during the year as a whole (see Chart 3.14). Their contribution to the overall inflation rate declined to 0.4 percentage point compared with 0.6 point a year earlier, driven by developments in the prices of communication and recreation services. The drop in prices of communication services seen since 2009 persisted throughout 2011, driven by lower prices for telephony services. The prices of accommodation services and package holidays, which make up a substantial part of the recreation sub-index, also rose, but to a lesser extent than in 2010. On the other hand, the price of services related to transport and housing increased substantially.

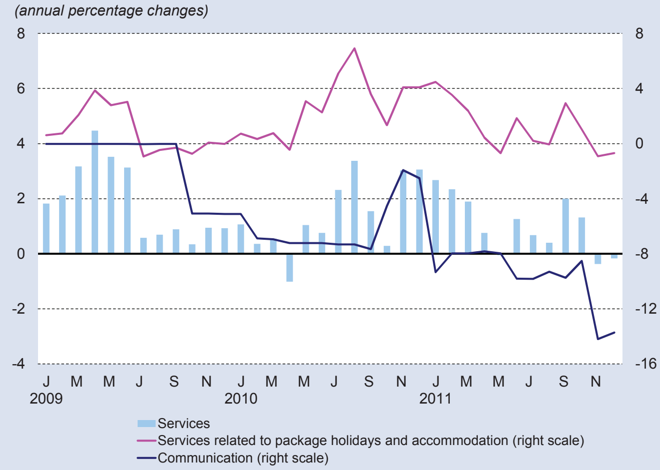
Meanwhile, the decline in the price of non-energy industrial goods seen in 2010 was reversed in 2011. As a result the contribution of this category to the overall inflation rate was 0.4 percentage point higher than in 2010 (see Table 3.8).

Chart 3.13
CONTRIBUTIONS TO YEAR-ON-YEAR CHANGES IN FOOD PRICES
(percentage points; annual percentage change)



Source: Eurostat.

Chart 3.14
INFLATION IN SERVICES
(annual percentage changes)



Sources: NSO; Eurostat.

Table 3.8
CONTRIBUTIONS TO HICP INFLATION[1]
Percentage points

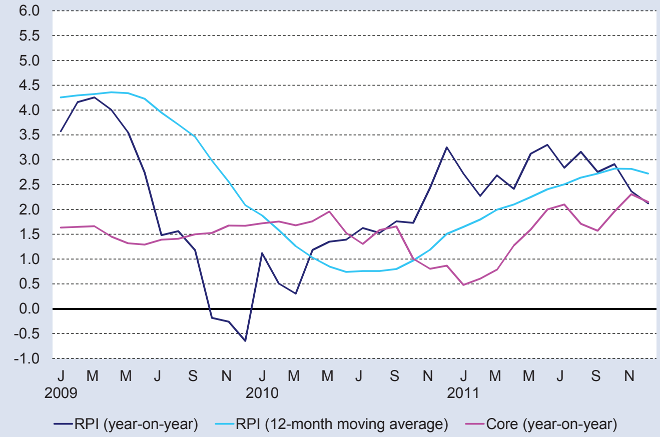
	2009	2010	2011
Unprocessed food	0.8	0.0	0.4
Processed food including alcohol and tobacco	0.6	0.3	0.5
Energy	-0.1	1.2	0.8
Non-energy industrial goods	-0.1	-0.1	0.3
Services (overall index excluding goods)	0.7	0.6	0.4
HICP (annual average inflation rate)	**1.8**	**2.0**	**2.4**

(1) Totals may not add up due to rounding.
Source: Eurostat.

RPI and core inflation

The path followed by the Retail Price Index (RPI) inflation broadly mirrored that of the HICP. Thus, the 12-month moving average inflation rate of the RPI rose from 1.5% in 2010 to 2.7% during the year under review. Furthermore, the year-on-year rate moderated in the course of the year and fell to 2.1% in December (see Table 3.9 and Chart 3.15).[15]

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



Sources: Central Bank of Malta estimates; NSO.

As in previous years, the divergence in the two indices was explained mainly by the exclusion of hotel accommodation prices from the RPI. Thus, the RPI inflation rate was below the HICP rate during the first quarter of the year, when room rates in hotels tended to exceed 2010 levels. Thereafter, room rates were on average below the previous year's levels and, as a result, RPI inflation exceeded the HICP measure.

During 2011, the food category became one of the main drivers of RPI inflation, contributing 0.8 point to the annual average inflation rate. The transport & communications category also played a larger role than in 2010, in part due to higher vehicle fuel prices, and contributed 0.7 point to headline RPI inflation in 2011.

Moreover, housing related prices continued to increase throughout 2011, contributing 0.4 point to inflation. Prices for "other goods and services" also rose, adding 0.3 percentage point to the change in the overall RPI. In addition, the clothing & footwear category had no impact on inflation after posting a negative contribution of 0.3 percentage point during 2010.

Table 3.9
CONTRIBUTIONS TO RPI INFLATION[(1)]
Percentage points

	Weights	2009	2010	2011
Food	21.23	1.5	0.2	0.8
Beverages & tobacco	6.09	0.3	0.1	0.1
Clothing & footwear	7.41	0.0	-0.3	0.0
Housing	7.61	0.2	0.2	0.4
Water, electricity, gas & fuels	3.36	0.4	0.8	0.1
Household equipment & house maintenance costs	6.59	0.0	0.0	-0.1
Transport & communications	22.76	-0.9	0.1	0.7
Personal care & health	8.57	0.2	0.2	0.1
Recreation & culture	9.28	0.1	0.2	0.1
Other goods & services	7.10	0.1	0.1	0.3
RPI (annual average inflation rate)	**100.00**	**2.1**	**1.5**	**2.7**

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

[15] Diverse patterns in inflation as measured by the HICP and the RPI reflect differences in the methodologies underlying the compilation of the two indices. For instance, whereas RPI weights are based on expenditure by Maltese households, HICP weights also reflect tourist expenditure in Malta. Thus, while the RPI excludes hotel accommodation prices, these have a significant weight in the HICP. The RPI also allocates a larger weight to the food component.

While the water, electricity, gas & fuels component added a marginal 0.1 percentage point to overall inflation compared with 0.8 point in 2010,[16] other categories showed little or no change during 2011.

Since the annual RPI inflation rate is strongly influenced by various volatile components, such as food and water & electricity charges, underlying price pressures are gauged by the Bank's core RPI inflation measure, which excludes such components.[17] On this basis, the annual rate of underlying inflation rose to a peak of 2.3% in November 2011 from 0.9% in December 2010. The rate eased to 2.2% by the year's end. The largest contributor to core inflation in 2011 was the housing and "other goods and services", which contributed 0.7 and 0.6 percentage points, respectively.

Costs and competitiveness

Producer prices[18]

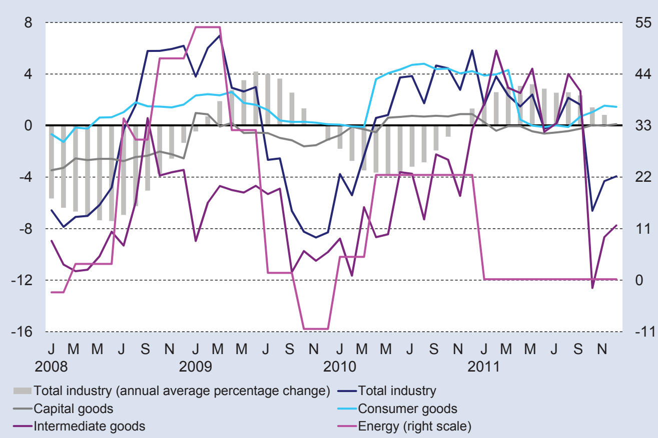
The industrial producer price index (PPI), which measures the price of goods at the factory gate, is commonly used to monitor inflationary pressures at the production stage. Over the year, in Malta as in the euro area, producer price inflation was more volatile than consumer price inflation, although it followed a general downward trend for most of the period.

In the last quarter the PPI inflation rate was negative, reaching a low of -6.6% in October before rising to -3.9% by the end of the year. Meanwhile the 12-month moving average rate of change was down to nil from 1.3% a year earlier (see Chart 3.16).

Turning to the components of the PPI, the drop in producer price inflation in 2011 largely resulted from a sharp easing in energy price inflation, which fell to 0.2% from 18.1% in 2010. This reflected the fact that energy tariffs were left unchanged compared with 2010, causing the contribution of this component to drop from 4.1 percentage points to 0.1 point in 2011. Consumer good prices also contributed to the drop in producer price inflation in 2011. Inflation in this category decelerated to 1.4% during 2011 from 3.2% a year earlier.

On the other hand, prices of intermediate goods tended to decline during 2011, although they fell more moderately than in the previous year. As a result, their contribution to overall producer price inflation became less negative, from -3.3 percentage points in 2010 to -0.3 point in 2011. Capital goods price inflation turned slightly negative. However, this had no effect on the overall headline rate in view of its small weight.

Chart 3.16
INDUSTRIAL PRODUCER PRICE INFLATION
(annual percentage changes; annual average percentage change)



Source: NSO.

[16] In the RPI, vehicle fuel prices are included only in the transport & communications component, whereas they form part of the energy component in the HICP.

[17] The core inflation rate, as measured by the Bank, excludes one-off fluctuations and reflects developments only in those sub-indices of the RPI that show persistent price changes. Currently, these are: housing, durable household goods, personal care & health, transport & communications and clothing & footwear.

[18] The PPI Index measures the prices of goods at the factory gate and is commonly used to monitor inflationary pressures at the production stage. It monitors the ex-work sale prices of leading products as reported by a sample of 77 large enterprises accounting for over 80% of total industrial turnover. The index covers three areas of economic activity: mining & quarrying, manufacturing and the supply of electricity, gas & water. Products are divided into five main groupings: intermediate goods, capital goods, consumer durables, non-durable consumer goods and energy. In turn, producer prices are divided between export and domestic markets for each of the groupings, with the bulk of the weight given to the export index.

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

	2008	2009	2010	2011
Private sector	3.8	3.8	4.2	2.3
Public sector	5.0	5.2	4.4	2.9
Overall	4.2	4.2	4.2	2.5

(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; Ministry of Finance, the Economy and Investment.

Labour costs

Most of the available indicators on labour costs point to more moderate increases during 2011.

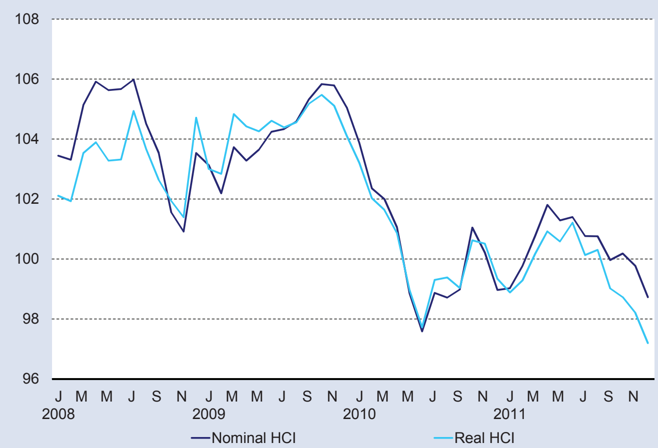
Central Bank of Malta estimates of wage inflation mainly based on data compiled from collective agreements show that wage growth on average slowed to 2.5% in 2011, after having remained generally stable at 4.2% over the previous three years (see Table 3.10).

Private sector wage growth was estimated to have eased to 2.3% in 2011 from 4.2% in 2010, while in the public sector it was estimated to have decelerated to 2.9% from 5.2% in 2009.[19] The surge in the latter had reflected notable pay increases received by civil servants and by University of Malta academic staff in that year.

National accounts data show that overall compensation per employee in 2011 increased by 0.5% in nominal terms, following a drop of 0.4% in 2010.[20]

Meanwhile, LFS results for the first three quarters, which are subject to a sampling error, reveal an increase in average annual salary per employee of 4.0% in 2011, following a rise of 4.5% registered in the same period of 2010.

Chart 3.17
HARMONISED COMPETITIVENESS INDICATORS
(May 2005 = 100)



Source: ECB.

External competitiveness

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

In 2011, the nominal and real HCI indices edged up in the first months, but declined in the subsequent

[19] These figures include only unionised employees covered by collective agreements. Since such employment constitutes less than 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 (COLA) but exclude overtime pay, production bonuses and all other allowances and income in kind.
[20] Compensation per employee is the total remuneration, in cash or in kind, that is payable by employers to employees, i.e. gross wages and salaries, as well as bonuses, overtime payments and employers' social security contributions, divided by the total number of employees.

period (see Chart 3.17).[21] The nominal increase in the index during the first part of the year reflected exchange rate movements, more specifically the appreciation of the euro. In real terms the HCI grew less rapidly, reflecting the impact of lower inflation in Malta relative to its main trading partners. The divergence between the real and nominal measures became more pronounced after August, owing to an increasingly favourable inflation differential in Malta compared with its trading partners.

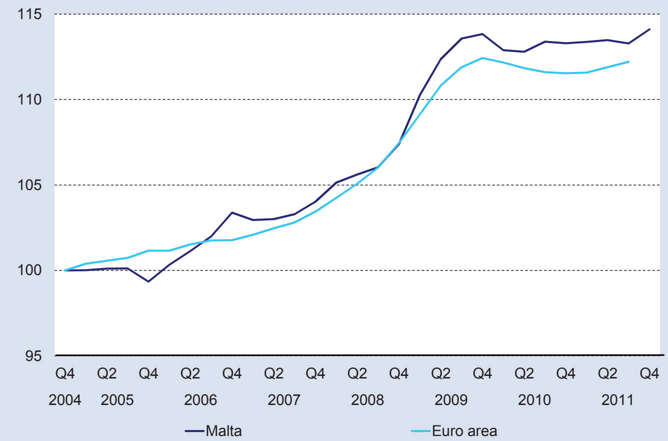
For the year as a whole, Malta's nominal HCI depreciated by 0.2%. With domestic inflation running 2.2 percentage points below that of its trading partners, the net effect was a drop in the real HCI of 1.9%. The drop in the real index implies that the overall improvement in Malta's external price competitiveness was a result of a favourable inflation differential.

Unit labour costs[22]

Meanwhile, Malta's ULC, measured as a four-quarter moving average, increased slightly in 2011, edging up at an annual rate of 0.7%, following a drop of 0.5% in 2010 (see Chart 3.18).

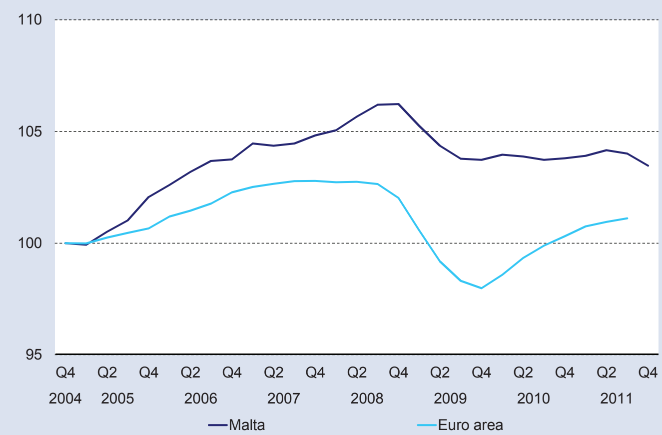
The increase during 2011 resulted from a drop of 0.3% in productivity and an increase of 0.5% in compensation per employee. The slight decline in productivity arose as growth in employment outpaced real GDP growth, while the small increase in compensation per employee was due to a percentage rise in total compensation which outpaced growth in the number of employees (see Charts 3.19 and 3.20).

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



Sources: Eurostat; Central Bank of Malta workings.

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



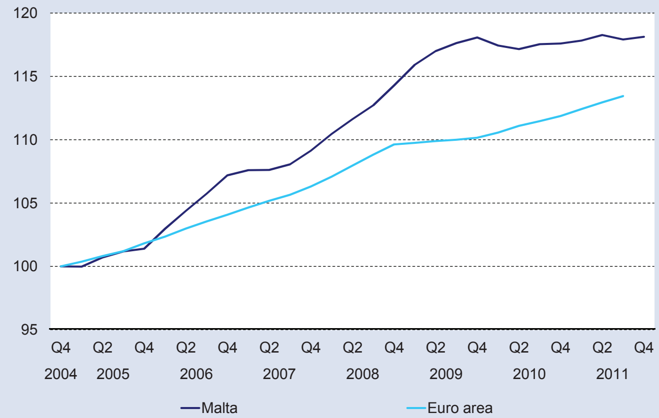
Sources: Eurostat; Central Bank of Malta workings.

[21] The European Central Bank computes and publishes HCI data. A higher (or lower) score in the HCI indicates a deterioration (or improvement) in a country's international competitiveness. The nominal HCI tracks movements in the country's exchange rate against the currencies of its main trading partners, while the real HCI incorporates both exchange rate changes and the relative inflation of a country vis-à-vis its main trading partners. In the computation of the indices, exchange rate and price changes are weighted according to the direction of trade in manufactured goods only. Therefore, the HCI should only be considered as a partial measure of Malta's international competitiveness. Changes in the HCI should be interpreted with caution.

[22] ULC measure the labour costs of producing a unit of output. ULC are measured as the ratio of the nominal compensation per employee and labour productivity. In turn, the latter is defined as real GDP per person in employment. A drop in ULC indicates an improvement in competitiveness. In this *Report*, ULC and their components are measured on the basis of a four-quarter moving average, in order to dampen volatility in the data.

A comparison with the euro area reveals that Malta's ULC continued to track those in the euro area quite closely.[23] Between 2004 and the third quarter of 2011, labour productivity growth in Malta exceeded that in the euro area by 2.9 percentage points.[24] However, compensation per employee grew faster in Malta, increasing by 4.5 percentage points more rapidly than in the euro area. Consequently, the resulting increase in ULC in Malta was slightly faster than in the euro area, with the former rising by 13.3% compared with 12.2% in the latter.

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



Sources: Eurostat; Central Bank of Malta workings.

[23] Regarding the selection of 2004 as the starting point, see "Box 2: A revised base year for calculating unit labour costs", Central Bank of Malta *Quarterly Review* 2011: Q3, page 34.
[24] Data for the euro area were incomplete at the time this *Report* went to print. Euro area data in this section thus cover the period up to September 2011.

BOX 2: ECONOMIC PROJECTIONS FOR 2012 AND 2013[1]

The Bank's latest economic projections indicate that after having slowed down in 2011, real GDP growth is expected to decelerate further in 2012, before picking up again in 2013. Economic expansion during both this year and next is forecast to be driven by domestic demand, as a weakening in external demand coupled with a recovery in imports are expected to weigh down on net exports. The Bank projects inflation to decline in 2012, reflecting lower price pressures across all components of the HICP except services. In 2013 inflation is expected to ease further on account of a drop in international oil prices. The projected GDP growth and inflation rates for 2012 have been revised slightly downwards from the Bank's previous projections,[2] mostly as a result of a weaker outlook for economic activity in Malta's main trading partners.

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA

	2011	2012(1)	2013(1)
Real economic activity (% change)			
GDP	2.1	1.6	2.0
Private consumption expenditure	3.1	1.5	2.0
Government consumption expenditure	3.9	1.3	1.1
Gross fixed capital formation	-13.4	5.1	5.6
Changes in inventories (% of GDP)	-2.6	-2.4	-2.2
Exports of goods and services	1.0	1.3	4.0
Imports of goods and services	-1.0	1.8	4.5
Contribution to real GDP growth (in percentage pts)			
Final domestic demand	0.8	1.9	2.3
Net exports	2.2	-0.5	-0.4
Changes in inventories	-0.9	0.2	0.2
Balance of payments (% of GDP)			
Goods and services balance	4.9	3.7	2.4
Current account balance(1)	-3.3	-3.5	-4.9
Labour market (% change)			
Total employment	2.4	0.7	1.5
Unemployment rate (% of labour supply)(1)	6.4	6.3	6.1
Prices and costs (% change)			
Overall HICP	2.4	1.9	1.6
HICP excluding energy	1.8	1.8	1.7
RPI	2.7	1.9	1.6
Compensation per employee	0.4	1.0	2.0
ULC	0.8	0.1	1.6
Public finances (% of GDP)			
General government balance(1)	-2.7	-2.4	-2.4
Government debt(1)	70.0	69.4	69.4
Technical assumptions			
EUR/US$ exchange rate	1.392	1.314	1.316
Oil price (USD per barrel)	111.0	115.1	110.2

(1) Central Bank of Malta projections

[1] The Bank's outlook for the Maltese economy is based on information available up to 9 March 2012 and is conditional on technical assumptions indicated in Table 1.

[2] These projections were published in the *Quarterly Review 2011:4* pp. 64-67.

Economic growth

After having been adversely affected by a contraction in gross fixed capital formation in 2011, real GDP growth is expected to decelerate to 1.6% in 2012, before picking up to 2.0% in 2013 (see Table 1). In both years growth in economic activity is expected to be propelled by domestic demand, initially through a recovery in gross fixed capital formation and, subsequently, by a rebound in private consumption.

Having risen substantially during 2011, government investment is expected to slow down in 2012, before contracting slightly in 2013. More significantly, in terms of its contribution to overall economic activity, private gross fixed capital formation is anticipated to recover gradually from the substantial decline recorded in 2011. Private investment growth is expected to be supported by progress on a major construction project, but the underlying determinant of its gradual recovery is expected to be increased spending on machinery and equipment. Investment in dwellings is projected to remain subdued as conditions in the property market remain weak.

Though still remaining a major driver of economic growth, private consumption in 2012 is expected to rise at a slower pace than in the previous year. This deceleration is anticipated in view of slower growth in employment and disposable income. However, growth in private consumption should pick up in 2013, on the back of a gradual recovery in employee compensation in real terms and a slight pick-up in labour demand. Consumer sentiment is also expected to improve as international economic conditions get better.

After a considerable rise in 2011, the Bank projects that public consumption will slow down over the forecast horizon, reflecting the Government's commitment to reduce the fiscal deficit through further expenditure savings that will reinforce the impact of expenditure cuts announced in January 2012. Expenditure savings may emanate from slower growth in the wage bill as government employment is gradually reduced in light of only partial replacement of retiring public sector staff. Wage increases in the sector are also expected to be restrained.

Despite the anticipated weakness of foreign demand, due to continuing sluggish conditions in Malta's main trading partners, exports are expected to increase at a modest rate in 2012, reflecting the increased diversification in Malta's export industries and the resilience that the export sector as a whole has shown in recent years. In 2013 exports are projected to grow more strongly as foreign demand, particularly in the euro area, is anticipated to rebound. Within the export sector, tourism earnings are expected to increase slightly over the forecast horizon, after their exceptionally strong performance over the past two years.

The decline in imports in 2011 was partly caused by the significant drop in investment in equipment. Consequently, the rebound in gross fixed capital formation anticipated for 2012 and 2013 is expected to boost the level of imports significantly over the forecast horizon. In addition, the faster level of import growth in 2013 is attributed to more robust private consumption and to an increase in industrial demand as the volume of merchandise exports expands.

External account

After significant growth in 2011, partly due to an improvement in the terms of trade, the surplus on the goods and services account of the balance payments is set to narrow during 2012. This reflects the anticipated slowdown in demand from Malta's main trading partners, and, to a lesser extent, the projected rebound in imports of capital goods. Moreover, despite the projected acceleration in export growth in 2013, the trade surplus is anticipated to decline further to 2.4% of GDP, in part reflecting the expected recovery in imports of industrial supplies and consumer goods.

As the declining positive trade balance will continue to be offset by net outflows on current transfers and income,[3] the deficit on the current account is expected to widen to 3.5% and 4.9% of GDP in 2012 and 2013, respectively.

[3] The current account balance for 2011 shown in Table 1 is an estimate based on balance of payments data published on 16 December 2011.

The labour market

The deterioration in external demand and the associated increased economic uncertainty are anticipated to result in a slowing down of employment growth in 2012, with a gradual pick-up taking place in 2013.[4] Despite this deceleration in job creation, the unemployment rate is forecast to edge down to close to 6%.[5] This is consistent with an anticipated deceleration in labour supply growth, as the overall working age population is projected to start declining over the forecast horizon. The impact of this on the labour supply is being countered by a steady rise in female participation in the labour market.

Meanwhile, compensation per employee is expected to recover gradually as it returns to slightly positive real growth in 2013. However, developments in unit labour costs are anticipated to remain fairly restrained, as productivity gains should be broadly in line with wage growth.

Inflation

After rising to 2.4% in 2011 mainly in response to hikes in prices of food and, to a lesser degree, of industrial goods, annual average HICP inflation is projected to decelerate to 1.9% in 2012. This is partly due to anticipated trends in international commodity prices combined with a moderation in the rate of inflation in food and industrial goods prices. In contrast, inflation in the services sector is set to pick up slightly, as part of the increase in input costs (namely food and energy prices) observed in 2011 is expected to be passed on to consumers. In 2013 inflation is forecast to drop further, to 1.6%, since it is envisaged that slower annual growth in prices of processed food and energy will more than offset a marginal increase in prices of industrial goods.

Public finance[6]

Having fallen below the 3% threshold in 2011, the general government deficit-to-GDP ratio is forecast to decline further in 2012 and to remain stable in 2013. The Government's fiscal consolidation plans envisage further efforts to restrain public consumption expenditure and to make structural adjustments that should result in additional savings. Meanwhile, an expansion of Government investment in the infrastructure is largely expected to be co-financed from EU funds. Faster growth in revenue, particularly indirect taxes, is also expected to contribute to a narrowing of the fiscal deficit over the projection horizon.

Partly reflecting additional borrowing to finance a loan to Greece in coordination with other European Union Member States, the debt-to-GDP ratio rose slightly in 2011. It is expected to decline in 2012 and remain stable in the following year, in line with anticipated nominal GDP growth and the path of the fiscal deficit.

Risks to the projections

The projections have been prepared against a backdrop of high uncertainty in the international economic and financial environment, particularly where the euro area countries are concerned.

On balance, risks to the GDP projections are slightly tilted to the downside, particularly for 2012. The main negative risk for Malta's economic outlook is the debt crisis in the euro area, since this has implications for the economic well-being of Malta's major trading partners. While the Maltese economy's growing diversification has underpinned its recent high degree of resilience, the economic situation in the euro area poses downside risks, should activity contract by more than is currently foreseen. In particular, the projected recovery in private investment may not materialise if the export-oriented corporate sector does not foresee an amelioration in business conditions in the euro area. This effect could, however, be partly countered by the impact on exports of a further weakening of the euro, which could boost Malta's exports to non-euro area trading partners.

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[4] Employment data are compatible with the definitions used in the national accounts and the historical series published by Eurostat.

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

[6] These fiscal projections may differ from the Government's forecasts partly owing to differences between the macroeconomic projections on which they are based. In addition, the Bank's projections include an independent assessment of revenue and expenditure developments in the light of measures announced by the Government.

Furthermore, upside risks to growth could also emanate from a decisive resolution of the euro area sovereign debt crisis. This could lead to an improvement in business and consumer sentiment and possibly to a stronger rebound in external demand, thus boosting Malta's exports.

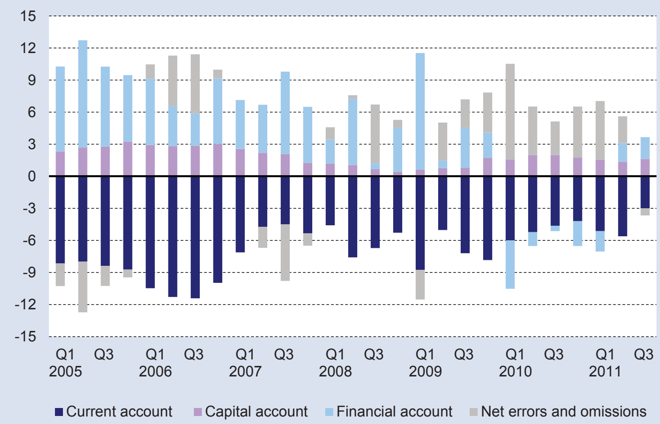
With regard to inflation, risks are judged to be broadly balanced. The main upside risk relates to the magnitude of wage increases awarded to the civil service under collective agreements currently under negotiation, which would have an impact on labour costs and consumer prices. Another risk lies in possible increases in oil prices in view of the continued political tensions in the Middle East. A weakening of the euro could also pose an upside risk to the inflation outlook.

On the other hand, if the contraction in output envisaged for the euro area during 2012 is stronger and more prolonged, it could dampen imported inflation and lead to weaker domestic price pressures.

4. BALANCE OF PAYMENTS

During the year to September 2011, the deficit on the current account of the balance of payments narrowed to 3.0% of gross domestic product (GDP), down by 1.6 percentage points from the rate registered in the four quarters to September 2010, and by 1.2 percentage points from 2010 as a whole (see Chart 4.1). This marked improvement stemmed from higher net receipts on services and from a substantial rise in net inward current transfers. Together, these outweighed a pronounced increase in net income outflows and a wider merchandise trade gap.

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



Source: NSO.

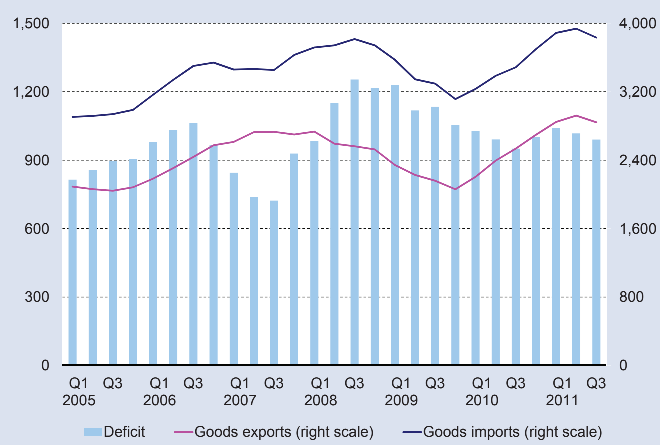
Meanwhile, net inflows on the capital and financial account stood at 3.7% of GDP, up by 2.2 percentage points compared with the year to September 2010. This was entirely attributable to large net inflows on the financial account, as the surplus on the capital account decreased. On a four-quarter cumulative basis, negative net errors and omissions were recorded.[1]

More recent GDP data covering the year as a whole point towards a surplus on external trade in goods and services. This positive balance went up by EUR230.6 million compared with 2010 to EUR315.1 million, with exports and imports rising by 7.4% and 3.5%, respectively.

The current account

Turning to developments in the period from January to September 2011, the deficit on the current account narrowed to EUR64.0 million, less than half of the negative gap reported for the same period of 2010 (see Table 4.1). This drop was spurred by substantially higher net receipts on services, a marginal fall in the merchandise trade deficit and a reversal in the balance on current transfers. These developments were partly offset by higher net outflows in the income component.

Chart 4.2
GOODS DEFICIT
(four-quarter moving sums in EUR millions)



Source: NSO.

Goods

Balance of payments data indicate that, in the first three quarters of 2011, both exports and imports increased on the same period of 2010.[2] Since

[1] Negative net errors and omissions imply an underestimation of the current account deficit and/or overestimation of the net inflows on the capital and financial account.

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

Table 4.1
BALANCE OF PAYMENTS
EUR millions

	2008	2009	2010	2010 Q1-Q3	2011 Q1-Q3
Current account	**-307.2**	**-455.4**	**-256.9**	**-130.8**	**-64.0**
Goods	-1,216.6	-1,053.5	-1,001.0	-702.7	-692.2
Services	1,115.4	1,025.8	1,202.1	936.7	1,063.1
Income	-199.6	-470.4	-486.6	-356.5	-449.2
Current transfers	-6.5	42.6	28.6	-8.3	14.4
Capital and financial account	**265.5**	**238.3**	**-36.0**	**-147.6**	**121.4**
Capital account	24.5	100.6	106.3	56.3	53.6
Financial account	241.0	137.7	-142.3	-203.9	67.8
Direct investment	362.5	523.0	702.9	537.0	192.3
Portfolio investment	367.5	-1,914.8	-3,229.8	-2,654.2	-1,151.5
Financial derivatives	-343.0	-70.4	31.0	66.2	23.1
Other investment	-254.6	1,602.3	2,377.2	1,887.8	957.4
Reserve assets	108.7	-2.4	-23.7	-40.8	46.4
Errors and omissions	41.8	217.1	292.9	278.4	-57.4

Source: NSO.

the rise in the value of exports marginally outpaced that of imports, the merchandise trade deficit narrowed by EUR10.4 million from a year earlier. The improvement was primarily driven by a rise in exports of manufactured goods, particularly aircraft parts, published materials and toys. At the same time, import growth was mainly driven by higher foreign purchases of vehicles, pharmaceutical products and plastic materials.

On a four-quarter moving sum basis the visible trade gap widened by EUR39.8 million, or 4.2%, when compared with the balance over the year to September 2010 (see Chart 4.2). This reflected an expansion of EUR346.8 million in imports that outweighed a EUR307.0 million increase in exports.

BOX 3: MERCHANDISE TRADE DEVELOPMENTS IN 2011

On the basis of Customs data, the merchandise trade gap increased by 0.7% to EUR1,531.6 million in 2011, following a widening of 11.1% in the previous year. A large increase in trade in fuels led to a marked expansion in both imports and exports, with the former rising by more in absolute terms (see Table 1).

Over the year as a whole, the value of imported goods rose by EUR944.6 million, or 21.8%. Although all the main import categories increased when compared with 2010, over nine-tenths of the rise was attributable to a surge in the value of imported fuels, reflecting higher volumes.

On an annual basis, imports of industrial supplies increased by EUR22.5 million, as a rise in semi-finished supplies outweighed declines in imports of primary and finished industrial goods. Meanwhile, imports of capital and consumer goods rose by EUR24.3 million and EUR26.7 million, respectively. The latter were mostly driven by higher food imports.

At the same time, the value of exports during 2011 increased by EUR933.6 million, or 33.3%, on the previous year. Fuel re-exports accounted for most of the increase, with the remaining exports of goods rising by almost 4%.

Table 1
MERCHANDISE TRADE
EUR millions; annual percentage changes

	2009[1]	2010[1]	2011[1]	2010	2011
		Amount		%	
Imports	**3,453.9**	**4,326.4**	**5,271.0**	**25.3**	**21.8**
Industrial supplies	1,214.0	1,499.3	1,521.8	23.5	1.5
Capital goods & others	692.3	838.5	862.8	21.1	2.9
Consumer goods	890.3	933.1	959.8	4.8	2.9
Fuel & lubricants	657.3	1,055.5	1,926.6	60.6	82.5
Exports	**2,085.9**	**2,806.0**	**3,739.4**	**34.5**	**33.3**
Trade deficit	**-1,368.0**	**-1,520.4**	**-1,531.6**	**11.1**	**0.7**

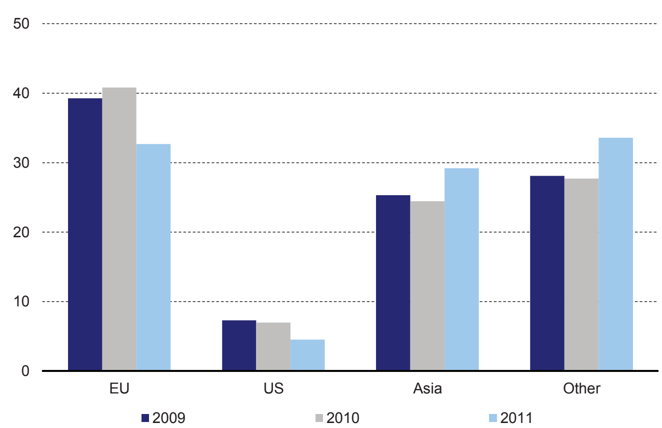
[1] Provisional.
Source: NSO.

During 2011, the European Union (EU) remained Malta's most important trading partner, accounting for 62.4% of total imports and 32.7% of exports (see Charts 1 and 2). The value of trade with the EU rose considerably in both 2010 and 2011. Trade with the euro area alone accounted for 49.6% and 25.6% of imports and exports, respectively.

In absolute terms, the largest increases in exports to EU countries were registered with Germany and the United Kingdom. Exports to both these countries continued to be positively affected by strong demand for electrical machinery and equipment and other manufactured goods. Exports to Greece and Spain also rose markedly, reflecting trade in fuels and pharmaceuticals, respectively.

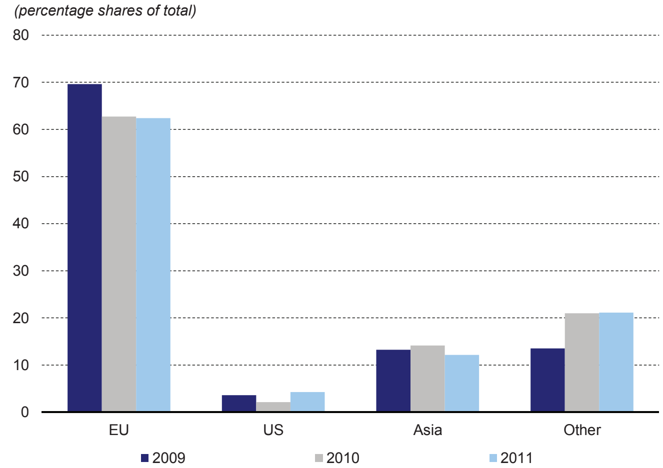
At the same time, a rise in fuel imports from Italy, combined with increased demand for intermediate goods from France and Germany, boosted imports.

Chart 1
DIRECTION OF EXPORTS
(percentage shares of total)



Source: NSO.

Chart 2
DIRECTION OF IMPORTS
(percentage shares of total)



Source: NSO.

Although trade with EU countries expanded, given that commerce with countries outside the EU grew even more rapidly, the share of the former in Malta's total trade declined.

Meanwhile, Malta's exports to Asia increased significantly, both in absolute terms, as well as a share of the total. This largely stemmed from higher fuel re-exports to the region, as well as from a rise in exports of semiconductors to Hong Kong. Imports from Asia also increased reflecting purchases of electronic components from the region, whereas the Asian share of the total edged down slightly.

On the other hand, both the value and the proportion of exports to all other trading partners notably rose, primarily driven by higher fuel re-exports to a number of countries, including Egypt. A significant part of higher fuel re-exports was recorded as exports to ships & aircraft stores.

In the meantime, the value of imports from these countries also surged, albeit to a lesser extent. This was spurred by a rise in oil imports from Russia and Azerbaijan, as well as imports of yachts from the Caribbean.

Services

The surplus on services between January and September 2011 stood at EUR 1,063.1 million, up by EUR126.5 million, or 13.5%, on the corresponding months of 2010. This gain reflected a 4.3% rise in receipts and a 1.7% drop in payments.

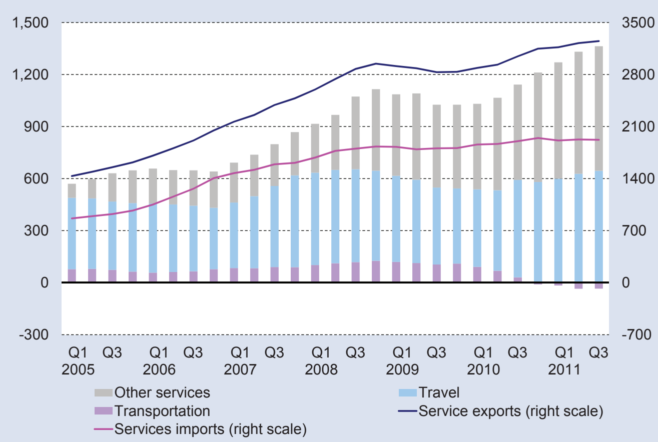
Favourable developments on the services component were mainly attributable to increased net receipts from "other services'' and to higher net tourism earnings. The former rose by EUR86.6 million, mirroring significant increases in receipts from trade-related services, which mainly include commissions on trade outside Malta, and finance, predominantly driven by fees and commissions earned by banks and other financial institutions. In addition, payments on business, professional and technical services dropped.

At the same time, continued buoyancy in the tourism industry's performance resulted in an expansion of EUR64.9 million in net receipts from travel related services. During the period under review, spending by inbound tourists increased by EUR78.5 million, while expenditure by Maltese residents travelling abroad was up by EUR13.7million.

In contrast, during the first three quarters of 2011, the net balance on transportation swung to a deficit of EUR15.4 million as opposed to a positive balance of EUR9.6 million in the same period of the previous year. This was mainly due to a considerable rise in freight payments, which in turn reflected the expansion in merchandise trade flows referred to earlier. In addition, payments for passenger transport services increased.

As a result, on a four-quarter moving sum basis, the upward trend in the

Chart 4.3
SERVICES BALANCE
(four-quarter moving sums in EUR millions)



Source: NSO.

surplus on services persisted and the balance reached EUR1,328.6 million in September 2011, up by 16.3% on the previous 12-month period (see Chart 4.3).

Income account

During the first three quarters of 2011, net outflows on the income component of the current account surged by EUR92.8 million, or 26.0%, compared with the same period a year earlier. Higher net outflows were mainly attributed to an EUR83.4 million rise in profits recorded by non-resident owned corporations operating in Malta, notably banks and manufacturers. Furthermore, net outflows in connection with borrowing and lending activities increased by EUR38.5 million on the corresponding quarters of 2010, entirely reflecting a drop in interest inflows from loans to non-residents. During 2010 such loans had contracted significantly. In contrast, an increase of EUR37.1 million in net interest earnings on portfolio investment abroad, reflecting growth in holdings of such assets, dampened net outflows on the income component.

On a four-quarter cumulative basis, net income outflows amounted to EUR579.4 million, up by EUR105.8 million on the year to September 2010.

Current transfers

In the first three quarters of 2011, the positive balance on current transfers stood at EUR14.4 million, as against net outward transfers of EUR8.3 million in the corresponding quarters of 2010. As a result, during the year to September 2011, the balance on the current transfers component increased substantially over the previous 12-month period. This component is heavily influenced by the timing of tax payments and refunds related to companies engaged in international business. It also includes Malta’s contribution to the EU budget.

The capital and financial account

During the first nine months of 2011, the capital and financial account registered net inflows of EUR121.4 million as opposed to net outflows of EUR147.6 million a year earlier (see Table 4.1). The sharp reversal on the balance was entirely due to financial transactions, since net inflows on the capital account fell by EUR2.7 million.

In the period under consideration, net inflows of EUR67.8 million were recorded on the financial account as against net outflows of EUR203.9 million in the January to September period of 2010. Net inflows on the financial account during the first three quarters of 2011 were driven mainly by inflows on the other investment account and, to a lesser extent, by foreign direct investment inflows, by a drop in reserve assets and by movements related to financial derivatives. These inflows outweighed continued portfolio investment outflows. Movements on this account were heavily influenced by transactions involving internationally-oriented banks.

Net inward direct investment amounted to EUR192.3 million, considerably lower than the EUR537.1 million a year earlier. The exceptionally high inflows recorded in January-September 2010 were due to substantial injections of equity capital into internationally-oriented banks, whereas during the first three quarters of 2011 these inflows were predominantly driven by investment in manufacturing.

In contrast, net outflows continued to be recorded on the portfolio investment account. Nevertheless, at EUR1,151.5 million, these were EUR1,502.7 million less than in the previous corresponding period. It seems that there was a shift away from the accumulation of foreign debt securities in favour of short-term loans and deposits with banks abroad, which are recorded in the “other investment” category.

Indeed, the drop in net outflows on portfolio investment was mirrored in a reduction in net inflows on the “other investment” component. During the first three quarters of 2011 the latter amounted to EUR957.4 million, almost half the amount recorded for the corresponding 2010 period. This happened as although inflows on this component increased to EUR1,818.2 million, reflecting a rise in bank liabilities in the form of deposits, outflows on this account also increased to EUR860.7 million, mirroring a pick-up in short-term loans to, and deposits placed with, non-residents.

In addition, lower net inflows on transactions involving financial derivatives, which fell to EUR23.1 million, were recorded.

Movements in reserve assets also contributed to the overall positive balance on the financial account during the first three quarters of 2011. Reserve assets decreased by EUR46.4 million, leading to financial inflows, whereas they had grown in the corresponding period of 2010.

International investment position

The international investment position (IIP) statement showed Malta's overall net creditor's position standing at EUR253.1 million as at end-June 2011, substantially lower than the stock of EUR721.3 million registered a year earlier (see Table 4.2).[3]

The decline predominantly mirrored the impact of market valuation changes and exchange rate movements on the value of Malta's external assets and liabilities. For example, swings in the value of the Turkish lira and the US dollar against the euro exert a significant impact on the positions reported by internationally-oriented banks. To a lesser extent, it also reflected the deficit on the current account of the balance of payments, which was partly matched by net inflows on the financial account.

The drop in the net creditor position stemmed from a decline in foreign assets, which was only partly offset by a contraction in liabilities. Banks predominantly engaged in international business accounted for most of these changes.

By end-June 2011, external assets fell to EUR45.1 billion, down by EUR0.5 billion from a year earlier. This was largely driven by a decline in banks' foreign holdings of portfolio debt securities.

At the same time, external liabilities stood at EUR44.9 billion, down by only EUR71.4 million compared with the position recorded at end-June 2010. A drop of EUR0.6 billion in currency and deposits (including loans) was mostly matched by a rise of EUR0.5 billion in foreign direct investment, in the form of equity capital injections.

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

	2009 June	2009 Dec.	2010 June	2010 Dec.	2011 June
Net international investment position	**429.0**	**662.7**	**721.3**	**421.3**	**253.1**
Total assets	**35,748.0**	**36,132.5**	**45,649.8**	**44,795.0**	**45,110.2**
Direct investment abroad	1040.2	1071.8	1129.7	1137.0	1151.7
Portfolio investment	10,397.4	12,444.5	15,139.9	15,597.6	14,702.2
Financial derivatives	113.7	138.1	218.5	217.3	166.5
Other investment	23,834.8	22,104.3	28,871.4	27,438.3	28,717.5
Reserve assets	361.8	373.7	290.2	404.9	372.2
Total liabilities	**35,318.9**	**35,469.8**	**44,928.5**	**44,373.7**	**44,857.1**
Direct investment in Malta	6,175.9	6,648.8	11,867.3	12,524.3	12,383.6
Portfolio investment	533.7	498.5	632.7	478.4	490.2
Financial derivatives	202.9	177.8	337.0	307.3	219.0
Other investment	28,406.4	28,144.6	32,091.6	31,063.8	31,764.2

Source: NSO.

[3] The IIP statement shows the stock of external assets and liabilities of residents vis-à-vis the rest of the world as at the end of a particular period. Developments in the IIP reflect financial transactions but also other adjustments to cater for exchange rate movements and changes in market valuation.

5. GOVERNMENT FINANCE[1]

The general government deficit continued to decline in 2011, and is expected to have fallen below the threshold stipulated in the European Union's fiscal rules. The deficit is estimated to have narrowed to 2.7% of gross domestic product (GDP) in 2011, from 3.6% in the previous year. According to the Budget Speech, in 2012 it is projected to fall further to 2.3% of GDP.[2] Meanwhile, the general government debt-to-GDP ratio is estimated to have peaked at 70.0% in 2011 and is set to decline in the coming years.

According to the *Financial Estimates 2012*, the deficit in the Consolidated Fund in 2011 is expected to have decreased from its 2010 level, with revenue increasing by more than expenditure. Indeed, actual data for the first 11 months show a reduction in the Consolidated Fund deficit.

General government projections

By the end of 2011 the deficit is estimated to have decreased to 2.7% of GDP from 3.6% in 2010, while the debt ratio is expected to have gone up slightly to 70.0% (see Chart 5.1).

The Government aims to reduce the deficit even further in 2012 and 2013 by restraining growth in current expenditure, as well as by clamping down on abuse of the tax and social security systems. Further revenue boosting measures include the introduction of a new scheme announced in November 2011, offering reduced penalties and interest on overdue value added tax (VAT) payments. These measures are planned to be undertaken in the context of a projected rate of nominal GDP growth of 4.8% in 2012 and 4.7% in 2013, as shown in Chart 5.1.

As a result, the deficit is expected to narrow to 2.3% of GDP by 2012 and to 1.8% in 2013. Meanwhile, the debt ratio is set to gradually decline to 67.0% by 2013.

In January 2012 the Government announced a partial review of the expenditure targets outlined in the 2012 budget. Savings are envisaged to be made from recurrent expenditure, including through recruitment restrictions and a decrease in overtime.

General government balance outcome

Actual data for the first three quarters of 2011 show that the general government deficit was higher than in the same peroid of 2010, as expenditure increased more than revenue. The deficit widened by EUR28.1 million, to EUR194.7 million (see Table 5.1). The primary deficit, which excludes interest payments from expenditure, also expanded, adding EUR1.7 million to reach EUR46.4 million.

Chart 5.1
GENERAL GOVERNMENT BALANCE AND DEBT TRENDS
(percentage of GDP)

(1) Central Bank of Malta estimate.
(2) MFEI forecast.
Sources: NSO; MFEI.

During the first three quarters of 2011 revenue grew by EUR110.2 million, or 6.3%. Receipts from taxes on produc-

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

[2] The figures for 2011 are Central Bank of Malta estimates. The official projections regarding developments in general government finances for 2012 and 2013 are sourced from the Minister of Finance, the Economy and Investment's (MFEI) *Budget Speech 2012* and from the *Financial Estimates 2012*, published by the MFEI in November 2011.

tion and imports increased by EUR78.6 million, owing to higher VAT receipts and increased inflows from customs and excise duties. In part, this reflected rising domestic consumption and tourism expenditure, as well as higher excise duties on specific products.

Concurrently, intakes from social security contributions grew by EUR24.4 million, in part owing to favourable labour market conditions. In addition, the second phase of an amnesty scheme introduced in July 2010, which had offered reduced penalties and interest charges on overdue income tax payments, led to a significant rise in receipts in the period reviewed.

“Other” revenue increased by EUR8.1 million, led by higher receipts for government services. Inflows from taxes on income and wealth, which had been boosted by the proceeds from the amnesty scheme a year earlier, rose by just EUR1.8 million.

Meanwhile, capital and current transfers receivable declined by EUR2.7 million, as a result of a drop in European Union (EU) funds that mirrored a similar fall in expenditure on EU-financed capital projects.

Concurrently, general government expenditure in the first three quarters of 2011 expanded by EUR138.3 million, or 7.2%, on the same period a year earlier.

Around half the increase stemmed from higher spending on gross fixed capital formation, which went up by EUR65.7 million. While the period under review featured higher spending on road infrastructure, the increase was also partly due to a base effect resulting from the exceptionally low level of public investment outlays in the second quarter of 2010.

Meanwhile, intermediate consumption rose by EUR37.5 million mainly on the back of additional expenditure on health. Interest payments rose by EUR26.3 million, partly reflecting the timing of coupon payments, which

Table 5.1
GENERAL GOVERNMENT BALANCE
EUR millions

	2010 Q1-Q3	2011 Q1-Q3	Change Q1 - Q3 Amount	%
Revenue	**1,742.2**	**1,852.4**	**110.2**	**6.3**
Taxes on production and imports	569.8	648.5	78.6	13.8
Current taxes on income and wealth	604.5	606.4	1.8	0.3
Social contributions	327.5	351.9	24.4	7.5
Capital and current transfers	92.1	89.4	-2.7	-3.0
Other (1)	148.2	156.3	8.1	5.4
Expenditure	**1,908.8**	**2,047.1**	**138.3**	**7.2**
Compensation of employees	631.3	648.4	17.0	2.7
Intermediate consumption	263.6	301.1	37.5	14.2
Social benefits	623.3	651.9	28.5	4.6
Subsidies	41.4	45.3	4.0	9.6
Interest	122.0	148.3	26.3	21.6
Current transfers payable	88.6	83.4	-5.2	-5.9
Gross fixed capital formation	75.4	141.2	65.7	87.1
Capital transfers payable	58.3	28.5	-29.8	-51.1
Other (2)	4.9	-1.0	-5.8	-
Primary balance	**-44.6**	**-46.4**	**-1.7**	**-**
General government balance	**-166.6**	**-194.7**	**-28.1**	**-**

(1) "Other" revenue includes market output as well as income derived from property and investments.
(2) "Other" expenditure reflects changes in the value of inventories and in the net acquisition of valuables and other assets.
Source: NSO.

should even out over the entire year. At the same time, spending on social benefits went up by EUR28.5 million, while outlays on employee compensation increased by EUR17.0 million.

In contrast, capital transfers payable declined substantially, owing to the completion of the sewage treatment project, which had boosted such expenditure during the first three quarters of 2010. Furthermore, the financial contribution of the Maltese government to the EU-backed JEREMIE initiative was not repeated.

Consolidated Fund

According to the *Financial Estimates 2012*, the Consolidated Fund deficit for 2011 amounted to EUR195.6 million, or EUR83.6 million less than in 2010 (see Table 5.2). Revenue was set to have grown by 6.8%, while expenditure was estimated to have gone up by 2.9%.

Actual data up to November 2011 show revenue growth of 3.9%, with a concurrent increase in expenditure of 2.1%. Hence, the cumulative deficit up to that month amounted to EUR278.2 million, a fall of EUR29.6 million compared with the same period a year earlier.

A significant part of the increase in revenue stemmed from indirect tax receipts, which went up by 9.3%, aided by favourable economic conditions and by a number of indirect tax increases as outlined above.

Table 5.2
CONSOLIDATED FUND BALANCE
EUR millions

	2010	2011[1]	2010	2011	Change	
			Jan-Nov	Jan-Nov	Amount	%
Revenue	**2,341.5**	**2,500.3**	**2,002.1**	**2,080.8**	**78.7**	**3.9**
Direct tax	**1,169.4**	**1,212.2**	**962.5**	**961.5**	**-1.1**	**-0.1**
Income tax	801.2	821.4	648.9	620.7	-28.2	-4.3
Social security contributions[2]	368.2	390.8	313.7	340.8	27.1	8.6
Indirect tax	**889.2**	**976.2**	**805.9**	**880.6**	**74.7**	**9.3**
Value Added Tax	482.5	536.7	455.5	491.0	35.5	7.8
Customs and excise duties	187.7	207.9	150.8	179.3	28.5	18.9
Licences, taxes and fines	218.9	231.6	199.6	210.2	10.7	5.3
Non-tax[3]	**282.8**	**311.9**	**233.6**	**238.7**	**5.1**	**2.2**
Expenditure	**2,620.7**	**2,695.9**	**2,309.9**	**2,359.0**	**49.1**	**2.1**
Recurrent[2]	**2,309.2**	**2,392.9**	**2,047.1**	**2,109.8**	**62.7**	**3.1**
Personal emoluments	571.8	586.7	483.3	492.7	9.4	1.9
Programmes and other operational expenditure[4]	1,335.8	1,376.5	1,222.4	1,245.6	23.2	1.9
Contributions to entities	204.9	216.1	158.6	178.8	20.2	12.8
Interest payments	196.8	213.6	182.8	192.7	9.9	5.4
Capital	**311.5**	**303.0**	**262.8**	**249.2**	**-13.6**	**-5.2**
Primary balance[5]	**-82.5**	**18.0**	**-125.1**	**-85.5**	**39.6**	**-**
Consolidated Fund balance	**-279.2**	**-195.6**	**-307.9**	**-278.2**	**29.6**	**-**

[1] Data for 2011 are estimates, as shown in the *Financial Estimates 2012* and the *Budget Speech 2012* published in November 2011.
[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 including interest payments.
Sources: MFEI; NSO.

Meanwhile, inflows from direct taxes decreased by 0.1%, as a rise in revenue from social security contributions only partly offset lower income tax takings. The latter were previously boosted by inflows from an amnesty scheme launched in 2010.

Recurrent expenditure increased by 3.1%, with spending on programmes and operations rising by 1.9%, mainly owing to higher outlays on health. Contributions to government entities went up by 12.8%, mostly in connection with transfers to the University of Malta. Interest payments rose by 5.4%, reflecting increased levels of government debt, as well as a shift in the public debt structure away from Treasury bills towards longer-term debt. Outlays on personal emoluments went up by 1.9%.

At the same time, capital expenditure decreased by 5.2%, owing to lower spending on EU-backed projects as mentioned above.

Central government debt

Between January and November 2011, gross government debt increased by EUR385.8 million so that the outstanding amount at the end of November stood at EUR4,555.7 million (see Table 5.3). Borrowing by the Government over this period exceeded the deficit on the Consolidated Fund, as additional loans were raised to finance support to the national airline and to Greece, the latter as part of an EU initiative to provide bailout funds to the Greek Government.

The increase in the debt reflected Government borrowing mainly in the form of medium to long-term Malta Government Stocks (MGS), which thus increased by EUR444.8 million. Consequently, by November 2011, MGS accounted for 88.9% of total debt, up from 86.5% at the end of 2010. Meanwhile, Treasury bills in issue declined by EUR52.4 million, so that their share of the total went down to 7.1% from 9.1%. Over the same period, the Government continued to repay external debt, so that foreign loans decreased by EUR10.4 million. In contrast, the value of euro coins in issue, which represent a liability for the Government, increased by EUR3.7 million.

Table 5.3
CENTRAL GOVERNMENT DEBT
EUR millions

	2010 end-Dec	2011 end-Nov	Change in 2011 Jan-Nov
Gross government debt[1]	**4,169.9**	**4,555.7**	**385.8**
Euro coins issued in name of the Treasury	41.0	44.7	3.7
Treasury bills	377.8	325.3	-52.4
Malta Government Stocks	3,607.1	4,051.9	444.8
Local loans	56.4	56.4	0.0
Foreign loans	87.7	77.4	-10.4

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

PART II

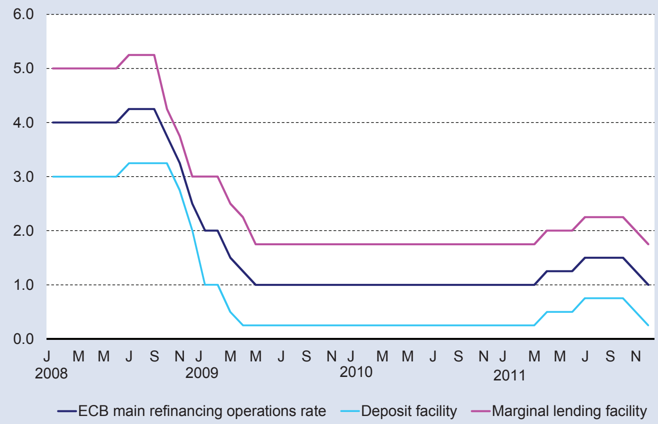
BANK POLICIES,

OPERATIONS AND ACTIVITIES

1. THE CONDUCT OF MONETARY POLICY

As a member of the Eurosystem, the Central Bank of Malta contributes to the formulation of monetary policy in the euro area through the Governor's participation in the Governing Council of the European Central Bank (ECB). The Bank is also responsible for the implementation of the Council's monetary policy decisions in Malta.

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



Source: ECB.

In the euro area, the primary objective of monetary policy is the maintenance of price stability, defined as annual consumer price inflation in the euro area of below, but close to, 2% over the medium term. Price stability is essential for a stable business environment and thus contributes to sustainable economic growth and to a high employment level.

The Governing Council of the ECB changed key interest rates on four occasions during 2011 (see Chart 1.1). In April and July, key interest rates were raised by 25 basis points, with the rate on the main refinancing operations (MROs) reaching 1.50% in the latter month. Subsequently, two rate cuts of 25 basis points each took place in November and December, thus bringing key ECB rates to the same level as at the beginning of the year. At the end of 2011 the MRO stood at 1.00%, while the interest rates on the deposit facility and on the marginal lending facility stood at 0.25% and 1.75%, respectively.

Monetary policy operations

The Central Bank of Malta implements the single monetary policy of the Eurosystem in Malta in accordance with guidelines laid down by the ECB's Governing Council. Thus, during the year, the Bank regularly conducted open market operations with domestic credit institutions, offered standing facilities and administered the minimum reserve system.

Open market operations

Open market operations are used to manage the level of liquidity in the money market and to steer short-term market interest rates close to the ECB's official rates. The Eurosystem has various types of open market operations at its disposal. It signals its monetary policy stance by changing the rate on the MROs. The latter are short-term liquidity-providing reverse transactions with a weekly frequency and a normal maturity of one week, which are executed according to a pre-specified calendar. The Eurosystem undertakes long-term refinancing operations (LTROs), which consist of reverse transactions at a monthly frequency and with a normal maturity of three months. The Eurosystem also makes use of fine-tuning operations to deal with unexpected liquidity fluctuations in the market. They can be either liquidity-providing or liquidity-absorbing.

Similar to the previous year, 2011 was characterised by the Eurosystem's efforts to address persistent market tensions in the euro area, supporting bank lending and money market activity through non-standard measures.

Table 1.1

PARTICIPATION OF ELIGIBLE RESIDENT CREDIT INSTITUTIONS IN EUROSYSTEM OPEN MARKET OPERATIONS

EUR millions

Type of operation	Amount bid	Amount allotted
Main refinancing operations	16,520	16,520
Longer-term refinancing operations		
Maintenance period	120	120
3-month	1,860	1,860
6-month	50	50
12-month	70	70
36-month	150	150
Fine-tuning operations		
Liquidity-providing fine-tuning operations	1	1
Liquidity-absorbing fine-tuning operations	1,580	1,580
Liquidity-absorbing operations (SMP-related)	1,000	140

Source: Central Bank of Malta.

During 2011 the Eurosystem continued to provide the financial system with liquidity through fixed rate tender procedures with full allotment in its main and longer–term refinancing operations. A total of 52 MROs were conducted during the year, all at a fixed rate and with full allotment. Eligible domestic credit institutions participated in all these weekly operations, bidding for a total of EUR16.5 billion worth of funds (see Table 1.1). This compared with a total of EUR18.3 billion in the previous year.

During the year the ECB also conducted 27 operations providing liquidity at longer horizons with different maturities. These included 12 special-term refinancing operations with a duration equivalent to the length of the relevant reserve maintenance period. A fixed rate tender procedure with full allotment was adopted in these operations.

Moreover, the ECB conducted 12 regular three-month LTROs and a six-month LTRO. In addition, in October the ECB conducted a 12-month LTRO, while in December it conducted an LTRO with a maturity of 36 months, with the option of early repayment after one year. All these operations were conducted using the fixed rate tender procedure with full allotment, with the rate fixed at the average rate of the MROs over the life of the respective operation. Furthermore, counterparties had the possibility to shift all outstanding amounts received in the 12-month LTRO allotted in October into the 36-month LTRO allotted in December.

In all, during 2011 local credit institutions obtained longer-term liquidity at various tenors to the tune of EUR2.3 billion, with 83% of this funding through three-month LTROs.[1] The corresponding amount for 2010 was of EUR1.1 billion.

On 20 December a single one-day liquidity providing operation was conducted in order to bridge the maturing MRO with the aforementioned 36-month LTRO allotted in the same month. The fixed rate tender procedure with full allotment was used, with the rate being the same as the MRO rate.

The Securities Markets Programme (SMP), launched by the ECB on 10 May 2010, continued during 2011. Through the SMP the Eurosystem intervenes in the euro area debt securities market to ensure depth and liquidity in those market segments that are dysfunctional and so impair the monetary policy transmission mechanism. To neutralise the impact on liquidity of bond purchases carried out through the SMP, the Eurosystem conducted weekly seven-day liquidity-absorbing operations with an intended volume equivalent to the value of securities purchased by the end of the previous week. As from November, counterparties were

[1] This amount includes a shift from a 12-month LTRO to a 36-month LTRO.

given the possibility of placing bids at up to four different interest rates instead of two in these liquidity-absorbing operations.

To absorb excess liquidity on the last day of each reserve maintenance period, the Eurosystem conducted liquidity-absorbing fine-tuning operations in the form of variable rate tenders with a maximum bid rate and without predetermined amounts. Maltese credit institutions deposited EUR1.6 billion in these overnight fine-tuning operations, while the rest of the liquidity surplus was deposited in the overnight deposit facility. However, on 8 December 2011 the Governing Council decided to discontinue these fine-tuning operations as from the maintenance period starting on 14 December 2011.

In October 2011 the ECB announced a new covered bond purchase programme.[2] The purchases, which started in November, were for an intended nominal amount of EUR40 billion and were conducted in both the primary and secondary market. This programme was expected to be fully implemented by the end of October 2012.

The Eurosystem also took measures in conjunction with other major central banks. In June the ECB extended the liquidity swap arrangements with the Federal Reserve and decided to continue conducting US dollar liquidity-providing operations with a maturity of seven days. Moreover, in September the ECB decided to conduct three US dollar liquidity-providing operations with a maturity of approximately three months covering up to the end of 2011. These operations were conducted in addition to the ongoing weekly operations and were carried out as fixed rate tenders with full allotment.

In November the ECB reduced the initial margin for the three-month US dollar operations from 20% to 12% and introduced weekly updates of the EUR/USD exchange rate. Moreover, the pricing on the existing temporary US dollar liquidity swap arrangements was lowered by 50 basis points, bringing the rate down to the US dollar Overnight Index Swap (OIS) rate plus 50 basis points.

Furthermore, the Governing Council of the ECB decided, in cooperation with other central banks, to establish a temporary network of reciprocal swap lines. The objective was to enable the Eurosystem to provide euro to these central banks when required, and to provide liquidity, should the need arise, in Japanese yen, pound sterling, Swiss francs and Canadian dollars.

Standing facilities

During 2011 the Eurosystem also offered standing facilities. Credit institutions with temporary liquidity needs may use the marginal lending facility on their own initiative to obtain overnight liquidity from their national central bank (NCB) against eligible assets. Conversely, institutions with surplus liquidity may use the deposit facility to place overnight deposits with their NCB. Standing facilities are used to steer market rates and to regulate liquidity in the banking system. They are administered in a decentralised manner by euro area NCBs.

The interest rates on the marginal lending facility and on the deposit facility form a corridor, providing an upper and lower boundary, respectively, for euro area interbank overnight rates. Throughout 2011 the width of the interest rate corridor was maintained at 150 basis points.

Domestic banks continued to place excess liquidity with the Central Bank of Malta through the overnight deposit facility. In fact, total recourse to this facility increased to EUR81.8 billion from EUR49.3 billion deposited a year earlier. At the same time, domestic banks borrowed EUR0.7 billion in 2011 through the marginal lending facility, only slightly less than the amount borrowed in 2010.

The Eurosystem requires the presentation of collateral for all its liquidity-providing operations. To ensure equal treatment of counterparties and to enhance operational efficiency and transparency, the collateral

[2] A covered bond is a debt security that is backed by cash flows from mortgages or public sector loans and which entails a claim on the issuer.

framework sets out certain criteria. Changes in these criteria were announced by the ECB on 28 July 2010 and came into effect on 1 January 2011. These related to a schedule of graduated valuation haircuts to assets rated in the BBB+ to BBB- range. Moreover, the definition of liquidity categories for marketable assets and the application of additional valuation markdowns for theoretically-valued assets were fine-tuned.

Furthermore, the provisions announced on 16 December 2010 on the acceptance of fixed-term deposits as collateral and the treatment of certain categories of covered bank bonds became applicable as from 1 January 2011 and 1 February 2011, respectively. In September 2011 the ECB announced further special measures applicable from 1 January 2012 to ease restrictions pertaining to specific elements of collateral demanded.

The ECB announced the suspension of the application of the minimum credit rating threshold in collateral eligibility requirements for the purposes of the Eurosystem's credit operations for marketable debt instruments issued or guaranteed by the Irish and Portuguese governments.

Moreover, in December 2011, two measures were introduced to increase the collateral availability for euro area counterparties. First, asset-backed securities (ABSs) having a second-best rating of at least single-A in the Eurosystem's harmonised credit scale at issuance, and subsequently at all times, will also be eligible for use as collateral in Eurosystem credit operations. The underlying assets must consist of residential mortgages and loans to small and medium-sized enterprises and must satisfy a set of specific requirements. In addition, NCBs were temporarily allowed to accept as collateral additional performing credit claims that satisfy specific eligibility criteria for Eurosystem credit operations.

The Central Bank of Malta is responsible for determining the eligibility of domestically-issued debt instruments and for reporting them to the ECB for inclusion in the Eurosystem's Eligible Assets Database. As at end-December 2011, the nominal amount outstanding of eligible domestic marketable assets amounted to EUR4.4 billion, compared with EUR4.0 billion as at end-December 2010.

The market value, after haircuts, of securities that domestic counterparties actually pledged in their pool of collateral with the Central Bank of Malta stood at EUR1.0 billion as at end-December 2011. This amount comprised both domestic and cross-border securities.

During 2011 the Bank continued to contribute to the determination of the Eurosystem's liquidity needs through daily forecasts of autonomous factors. These consist of items on the Eurosystem balance sheet that are not related to monetary policy instruments, such as banknotes in circulation, government deposits with NCBs and net foreign assets.

Reserve requirements

The ECB requires credit institutions established in the euro area to hold reserve deposits with NCBs. The objective of the Eurosystem's minimum reserve system is to stabilise money market interest rates and to help ensure that the Eurosystem operates efficiently as a liquidity supplier. From a conceptual point of view, this requirement increases the demand for central bank refinancing which, in turn, makes it easier for the ECB to steer money market rates to the desired level through its open market operations.

Each credit institution in Malta is accordingly obliged to hold minimum reserve deposits with the Bank. The reserve ratio, which is applied to certain categories of deposits and debt securities issued by banks, remained unchanged at 2% throughout 2011. However, in December 2011 the ECB announced that the reserve ratio would be reduced from 2% to 1% as from the maintenance period starting on 18 January 2012, as part of its measures to support bank lending and money market activity.

The minimum reserve framework allows credit institutions to apply averaging techniques. Thus, compliance is determined on the basis of average closing balances in the relevant accounts over the maintenance period of approximately one month. The remuneration paid on holdings of required reserves is linked to the interest rate charged on the MROs.

Reserve management

The Central Bank of Malta manages a portfolio of financial assets denominated in both euro and foreign currencies, which has two components.[3] One forms part of the Eurosystem's reserves. The other is the Bank's own portfolio, consisting of euro as well as non-euro denominated holdings. The Bank adopts a prudent approach to managing its own portfolio, with the main objective being the preservation of the value of the assets.

The Bank's own portfolio is managed within the parameters approved by the Bank's Board of Directors and the Investments Policy Committee (IPC). The Committee, which is chaired by the Governor and includes the Deputy Governor and other senior officials, is responsible for formulating the appropriate investment strategy relating to the Bank's own portfolio. Throughout the year, the IPC monitored the performance of the Bank's financial assets, evaluated the implementation of investment strategies, reviewed the operational and risk framework of investment management practices and assessed the overall investment policy. The IPC met every month and three additional *ad hoc* meetings were also convened to discuss strategic asset allocation and other matters concerning portfolio management.

Within the framework governing the foreign reserve assets of the ECB, the Bank managed its portion of US dollar holdings on behalf of the ECB by way of a pooling mechanism, administered jointly with the Central Bank of Ireland. During the year the Bank's dealers worked closely with their Irish counterparts to review strategy, discuss operational modalities and analyse the portfolio's performance.

During the year the Bank continued to transmit to the ECB information on its foreign exchange transactions and holdings, as well as on the euro-denominated portion of the investment portfolio. It also continued to provide advisory services on external financing and debt management to the Government and to public non-financial corporations.

In terms of the Exchange Rate Mechanism (ERM) II agreement, and as an NCB acting on behalf of the ECB, the Bank is authorised to conduct interventions in those currencies participating in the ERM II regime. However, no such interventions were necessary during 2011.[4]

During 2011 the Central Bank of Malta effected foreign currency spot purchases amounting to EUR452 million, a decrease from the level of EUR580 million reported in 2010. Concurrently, spot foreign currency sales declined to EUR489 million from EUR574 million in the previous year. These transactions mainly related to management of the Bank's own portfolio.

The Bank uses foreign exchange swaps to hedge its foreign currency exposures and to enhance income. Spot sales of euro in terms of foreign exchange swaps in 2011 increased to EUR1.3 billion, significantly higher than the EUR803 million reported during 2010. A total of EUR2.1 billion worth of spot purchases of euro in terms of foreign exchange swaps were also undertaken in 2011 in managing the portfolio, whereas no such purchases were recorded in the previous year.

The Bank monitors developments in the foreign exchange market in Malta. During the year foreign exchange transactions effected locally between resident credit and financial institutions amounted to EUR35.7 million, significantly below the EUR77.7 million reported in 2010.

At the same time, the value of foreign exchange transactions between resident credit and financial institutions and unrelated third parties stood at EUR18.8 billion, down from EUR23.8 billion in the previous year. This turnover partly stemmed from spot transactions, and, to a lesser extent, new swaps. In turn, just under half of the spot deals transacted in 2011, amounting to EUR2.9 billion, involved the corporate and house-

[3] The Bank's financial assets are largely euro-denominated and include a variety of investment instruments, including money market instruments, government paper and other fixed income securities.

[4] ERM II is an exchange rate arrangement that provides the framework for exchange rate policy cooperation between euro area countries and those EU Member States that have not adopted the euro but participate in this arrangement. These countries, which include Denmark, Latvia and Lithuania, peg their currencies to the euro at a central exchange rate, limiting exchange rate volatility.

hold sectors as counterparties and largely reflected transactions relating to payments in respect of trade, tourism, personal transfers and financial portfolio flows. The remaining spot transactions were carried out with credit institutions in the euro area and in the rest of the world and were worth a total of EUR2 billion in each case. Although the main domestically-oriented banks continued to report the largest share of the transactions, new foreign-owned banks in Malta steadily increased their share of the turnover with the non-bank private sector.

Throughout the year the Bank published reference rates of exchange for the euro that the ECB established daily, as well as other indicative exchange rates.

Market-making operations

During 2011 the Central Bank of Malta continued to act as market-maker in the secondary market for Malta Government Stocks (MGS) and Treasury bills by ensuring adequate market liquidity and enhancing investor confidence in market trading. In line with the Central Bank of Malta Act, and with provisions of the Treaty on the Functioning of the European Union,[5] the Bank did not participate in the primary market for government securities and did not provide any other form of financing to 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 quoted International Securities Market Association (ISMA) redemption yields on MGS on a daily basis.[6]

The Financial Markets Committee (FMC), which provides a forum for the Bank and all credit institutions operating in Malta to exchange views and information on various market-related issues, held three meetings during 2011. Discussions revolved mostly around the Eurosystem monetary policy operations framework as well as on the Eurosystem collateral and risk control frameworks, in light of the financial turmoil in international markets and the non-standard measures taken by the Eurosystem to alleviate liquidity pressures in the euro area. The Committee also discussed developments in the domestic primary and secondary markets and issues related to the foreign exchange markets. In October the FMC held a special session to discuss the financial market turmoil in the euro area, as well as the covered bond market.

[5] Articles 123 and 124 of the Treaty prohibit the monetary financing of governments, EU bodies and institutions as well as their privileged access to finance.

[6] ISMA yields are annualised yields-to-maturity. ISMA yields on MGS, which pay interest semi-annually, are comparable with those on bonds that pay interest annually.

2. FINANCIAL STABILITY

In line with its mandate, during 2011 the Central Bank of Malta continued to monitor the financial system to evaluate potential systemic risks and vulnerabilities. As in previous years, the Bank published, on its website, the annual *Financial Stability Report* in June, which was followed by an update in October. In order to enhance its effectiveness in undertaking the financial stability function, the Bank restructured its Financial Stability Department to place more emphasis on the formulation of policy measures, management of financial crises and stress testing exercises.

As part of its surveillance activity, the Bank continued to monitor key indicators and trends in the financial, corporate and household sectors. Developments which were considered to pose systemic threats to financial stability were closely followed and analysed. They were also discussed by an internal committee on financial stability issues chaired by the Governor and composed of senior Bank officials. Meanwhile, in terms of a Memorandum of Understanding (MoU) between the Central Bank of Malta and the Malta Financial Services Authority (MFSA), both institutions continued to liaise closely and share information on bank regulatory developments, especially through regular meetings of their technical experts.[1] A number of issues related to the management of crisis situations were also discussed within the Domestic Standing Group (DSG), which is chaired by the Deputy Governor and includes senior officers from the Bank, the MFSA and the Ministry of Finance, the Economy and Investment.

For the third year in a row, the Bank, together with the MFSA, played a leading role in the preparatory work related to the 2011 EU-wide stress testing exercise in which a Maltese credit institution was selected for inclusion in a sample of 91 European banks. The resilience of these banks was assessed in terms of an adverse but plausible scenario. The local credit institution performed strongly in this test and it comfortably surpassed the 5% Core Tier 1 capital threshold. In a subsequent recapitalisation exercise conducted by the European Banking Authority (EBA), which sought to establish a list of banks whose Core Tier 1 ratio exceeded the established 9% threshold, the local bank was classified as having sufficient core capital, since its capital ratio exceeded this level.

As part of its financial stability toolkit, the Bank continued to carry out biannual top-down stress tests focusing on domestically-oriented institutions, the results of which were published on an aggregated basis in the *Financial Stability Report* and its update. In addition, surveillance operations constantly ensured the identification at an early stage of any possible situations of stress which could trigger systemic risk, not only from domestic banks, but also from internationally-oriented banks operating in Malta. The Bank also further enhanced its interest rate and credit risk models and continued to develop a macro-stress-testing model.

During 2011 the Bank established a Forum for Financial Stability, which is composed of representatives of the relevant authorities and major stakeholders in the financial services sector. The Forum aims to foster a structured dialogue on issues of common interest, with a particular emphasis on the identification and management of risks that could have a negative impact on the financial system. The Forum was launched in May and held two further meetings during the year. These meetings focused on both international and national financial stability issues, in particular the functions and work of the European Systemic Risk Board (ESRB). It also discussed specific risks identified in the *Financial Stability Report*.

During the year, the Central Bank of Malta actively participated in the decision-making bodies of the ESRB, its Advisory Technical Committee and its substructures. Senior staff members were also observers at meetings of the EBA, which took over all tasks and responsibilities of the former Committee of European Banking Supervisors from the beginning of 2011.

Bank staff also participated in a working group established by the European Commission for the preparation of the proposed Directive for Bank Recovery and Resolution. Furthermore, a tripartite task force was

[1] The MoU can be viewed on the Bank's website at www.centralbankmalta.org/updates/downloads/pdfs/exchange_of_Information.pdf

mandated by the DSG to review the domestic resolution and insolvency regime for banks and to recommend appropriate measures, including the monitoring of the implementation process of the proposed Directive.

In conjunction with the MFSA, the Bank is also participating in the work related to the Quantitative Impact Study conducted by the Bank for International Settlements, in relation to the future introduction of the new Basel III global regulatory standard on bank capital adequacy, stress testing and market liquidity risk.

3. CURRENCY, PAYMENT SYSTEMS AND BANKING SERVICES

The Central Bank of Malta issues euro banknotes and coins in accordance with the legal framework governing the European System of Central Banks (ESCB) and the European Central Bank (ECB). In addition, the Bank acts as the authority responsible for the regulation and oversight of the payment and securities settlement systems in Malta. Meanwhile, it provides various banking services to the Government and to the banking system.

Currency operations

The Bank continued to supply the banks with their currency needs, while ensuring the authenticity of banknotes and coins and that they remained fit for circulation.

Circulation of notes and coins

The value of euro currency issued by the Bank increased by 8.6% to EUR913.7 million during 2011, from a 5.1% rise in the previous year. This was substantially less than the currency growth in the euro area (see Table 3.1). Net issuance during the year generally followed the seasonal pattern, with contractions in January and expansions in December, related to the increase in consumer spending over the Christmas period. Currency in issue increased in every month of the year, apart from the drop in January, a negligible decline in May and a somewhat sharper fall in August.

During 2011 the Bank examined a total of 76.6 million banknotes with a value of EUR1.7 billion. Although this was less than the 78 million banknotes examined in 2010, the value of the notes examined in 2011 was EUR0.1 billion higher. Slightly more than 10% of the number of banknotes that were examined by the Bank were deemed unfit for reissue and subsequently destroyed, a lower proportion than the 13.2% recorded in the previous year.

In this context, the Bank brought its Directive No. 10 on the authenticity, fitness checking and recirculation of euro banknotes into effect in January 2011. This obliges banks to ensure that banknotes placed by them in circulation meet specific Eurosystem quality standards. As a result, the Bank carried out a number of tests to ensure that the provisions of the Directive were being followed.

Table 3.1
CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE BANK IN 2011
EUR thousands

	Notes and coins			Issued and
	Issued	Paid in	Net issue	outstanding
Jan.	131,466	136,832	-5,365	841,363
Feb.	129,053	127,521	1,532	842,895
Mar.	155,205	138,779	16,425	859,320
Apr.	153,655	143,744	9,912	869,232
May	153,048	153,068	-19	869,213
June	158,063	144,783	13,281	882,493
July	167,834	164,331	3,503	885,996
Aug.	163,713	176,220	-12,507	873,489
Sep.	157,566	154,885	2,682	876,171
Oct.	153,561	151,116	2,445	878,616
Nov.	154,202	147,668	6,535	885,151
Dec.	182,811	154,239	28,572	913,723
2011	1,860,179	1,793,184	66,995	913,723

Source: Central Bank of Malta.

Apart from banknotes, 65.1 million euro coins with a value of EUR32.9 million were examined during 2011. These figures were significantly higher than the corresponding figures for 2010, when seven million coins with a value of EUR4.6 million were examined. The surge in coin processing reflected a growing tendency, from the later part of 2010, for credit institutions to deposit at the Bank all their euro coins for authentication prior to their reissue. The overall issue of Maltese euro coins was subject to a limit of just over EUR44 million in 2011.

During the year, the Bank embarked on the introduction of a new cash management system – the Cash Single Shared Platform (SSP), which is designed for cash operations. It makes extensive use of modern information technology to handle the exchange of notes and coins with commercial banks and to automate related processes. It also supports a number of ESCB functions, including reporting and data exchange. Several events to assist in the implementation process were held during the year, including training of Bank officials, information meetings and a workshop dealing with legal matters.

In 2011 the Bank continued its participation in the ECB Security Working Group dealing with security considerations relating to the production, processing, storage and transport of banknotes. It also took part in an informal National Central Bank Forum focusing on cross-border transportation of euro currency, as well as on ECB inspections at manufacturers of items related to the production of euro banknotes. The Bank regularly updated the ECB with local circulation statistics through the Eurosystem's Currency Information System. In May the Bank was involved in cross-border transactions, which involved other Eurosystem national central banks and which were successfully carried out, as part of the ECB's delivery schedule.

Collection and disposal of the Maltese lira

During 2011 the Bank continued to collect and dispose of Maltese lira banknotes. In total, over 140,000 banknotes denominated in Maltese lira with a face value of over Lm1.3 million (equivalent to EUR3.2 million) were collected during the year. By the end of the year, the value of Maltese lira banknotes still in circulation amounted to Lm20.0 million, equivalent to EUR46.7 million.

Numismatic and commemorative coins

In April 2011 the Bank issued a numismatic coin depicting a ship used by the Phoenicians. The coin, available in silver and in gold, was issued under the Europa Programme 2011, bearing the Europa Star as the official logo of the programme on its reverse side.

In October the Bank also issued a new euro coin set dated 2011, incorporating the eight Maltese euro coins. This set also included a EUR2 commemorative coin, bearing the inscription "First Elected Representatives – 1849". This was the first in a series of five coins depicting landmarks in Malta's constitutional history. A replica of a coin of the Punic period, the original of which is currently exhibited in the Bank's museum, also formed part of this set.

Anti-counterfeit measures

During 2011 the Bank's Currency Surveillance Unit, which is responsible for the promotion of counterfeiting awareness and the analysis of suspected counterfeit currency, continued to examine banknotes and coins and reported its findings to the ECB. The total amount of counterfeit banknotes withdrawn from circulation in 2011 was 1,543, or 36.3% less than the 2010 level. The counterfeited value was EUR49,860. The Unit also participated in workshops at an ESCB level and collaborated with local authorities. It also provided information on the counterfeiting situation to the general public.

Payments and securities settlement systems

In terms of the Central Bank of Malta Act, the Bank is responsible for the regulation and oversight of the payments and securities settlement systems in Malta. From the regulatory perspective, the Bank verifies whether credit and payment institutions are adhering to the provisions of the relevant legislation. In carrying out its oversight role, the Bank assesses various payments and securities settlement systems and payment instruments against international standards and recommendations.

During 2011 the Bank initiated, through an ESCB-coordinated exercise, an assessment of MALTACLEAR, which is the securities settlement system operated by the Malta Stock Exchange, against the ESCB standards for Eurosystem credit operations. In October it initiated another exercise to assess the link between MALTACLEAR and Clearstream Banking in Frankfurt after this became operational earlier in the year.

During 2011 the Bank continued to chair the Malta Clearing House Committee, which oversees the clearing and settlement of cheques issued in Malta. The use of cheques by the public declined further, with the number of cleared cheques decreasing by 2.5% to 5.4 million in 2011, even though their value increased by 3.6% to EUR7.6 billion.

With regard to the operation of electronic payments, during 2011 the Bank continued to participate in the TARGET2, which is the payment system used in the Eurosystem for the settlement of central bank operations, large-value interbank transfers and other euro payments.

In 2011 two credit institutions, namely Bank of Valletta and Mediterranean Bank, joined the TARGET2 system as direct participants. This resulted in an increase in volume and value of payments processed locally, which rose to 18,437 with a value of EUR105.0 billion, from 16,885 in 2010 with a value of EUR76.5 billion. The increase is the result of a rise in the value of overnight deposits placed with the Bank by credit institutions.

The Bank also participated in Eurosystem projects relating to securities settlement systems and collateral management services. As regards the former, the TARGET2-Securities (T2S) project provides a single integrated securities market for financial services through one pool of pan-European securities, as well as a state-of-the-art settlement process. In the area of collateral management services, the current correspondent central banking model will be enhanced to cater for requests made by market participants.

Furthermore, the Bank also supported the implementation of the Single Euro Payments Area (SEPA) project, which is designed to increase efficiency of retail payments in the euro area through the adoption of a single standard for credit transfer, direct debits and payment cards. SEPA also makes retail cross-border payments as safe as domestic payments, and with similar charges. In this regard, the Bank chairs the Payment Systems User Group, which is responsible for the implementation of SEPA in the local banking sector.

During 2011 the Bank enhanced its own SEPA payment processing operations and continued to analyse system requirements for the implementation of SEPA direct debits. It also commenced the processing of Treasury pensions through SEPA credit transfers. As a result, total SEPA payments processed by the Bank increased to 151,894 for the value of EUR135.4 million in 2011 from 9,677 for the value of EUR7.0 million in 2010.

Banker to the public sector

The Bank acts as banker to Government, maintaining accounts for the Treasury, for other government departments and for a number of public sector corporations.

During 2011 the number of government cheques drawn on the Bank and presented for settlement by the rest of the banking system decreased by 15.5% from the 2010 level. The drop reflects the base effect of a one-off payment as compensation to all households by Government for a rise in energy costs. The total value of cheques presented also declined by 0.5%, to EUR800.2 million. The Bank continued to cash government cheques drawn on it and presented by the general public.

The number of payments effected on behalf of Government by traditional direct credits fell by 10.2% to 1.8 million in 2011. This drop mainly reflected a shift to payments carried out through SEPA credit transfers. Conversely, their value increased by 1.4% over the 2010 level, to stand at EUR1.2 billion in 2011. Interest payments on Malta Government Stock (MGS) were the main driver of the increase in value, followed by salaries. On the other hand, pensions and social security payments declined when compared with the previous year.

The Bank continued to offer foreign exchange services to Government and public sector entities. These included documentary letters of credit, inward and outward bills for collection, guarantees and interbank transfers. Additionally, the Bank continued to buy and sell foreign currency and to purchase foreign cheques. Foreign exchange transactions were carried out using SWIFT transfers.

The value of foreign exchange receipts processed by the Bank on behalf of Government and public sector entities increased to EUR347.2 million in 2011 from EUR337.3 million in the previous year. On the other hand, the value of foreign exchange payments effected on behalf of Government and public sector entities was almost unchanged from the previous year at EUR315.2 million.

During 2011 the Bank continued to effect payments in connection with the servicing of the Government's external debt. Capital repayments amounted to EUR13.1 million, with the associated interest totalling EUR3.9 million, the latter being slightly lower than in 2010.

Banker to the banking system

The Bank acts as banker to the rest of the banking system by providing deposit and lending facilities to credit institutions. As described in more detail elsewhere in this *Annual Report*, credit institutions maintain balances at the Bank to meet their reserve deposit requirements.

Other financial services

Throughout 2011 the Bank continued to provide portfolio management services to the Investor Compensation and Depositor Compensation Schemes according to parameters set by the respective committees which were established to manage these schemes.[1] The Bank also provides the two schemes with accounting and other support services. During the year, the Bank began to hold margin call accounts and pledged accounts in favour of the Depositor Compensation Scheme.

As the custodian of assets held abroad under the Insurance Business Act, the Bank also held in its name, on behalf of insurance companies, certain specified assets representing guaranteed funds. The Bank continued to report regularly on the position of such holdings to the competent authorities.

[1] The Investor Compensation Scheme, which was set up by Legal Notice 368 of 2003, protects clients of licensed investment service providers that are unable to satisfy their obligations towards investors. The Depositor Compensation Scheme, which was established by Legal Notice 369 of 2003, compensates 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 and the exercise of powers related to tasks of the European System of Central Banks (ESCB), which are conferred exclusively on the Governor in terms of the Central Bank of Malta Act (Cap. 204).

Until 30 June 2011, the Board was composed of Mr Michael C. Bonello, Governor and Chairman, Mr Alfred DeMarco, Deputy Governor, and Mr Victor Busuttil, Ms Antoinette Caruana and Professor Josef Bonnici, as non-executive Directors. Dr Bernadette Muscat acted as Secretary to the Board of Directors.

Professor Bonnici was appointed Governor of the Central Bank with effect from 1 July 2011, on the retirement of Mr Bonello.

During the year the Board met 11 times.

Audit Committee
The Audit Committee of the Board, which is established in terms of the Central Bank of Malta Act, reports and makes recommendations on financial reporting, internal audit and control, external audit and risk management. During 2011 the Committee was chaired by Mr Victor Busuttil, with Mr Alfred DeMarco and Professor Josef Bonnici as members. Professor Bonnici resigned from the Committee on his appointment as Governor.

The Committee met on nine occasions during the year and addressed various topics, including internal audit operations, exposures to risk, particularly at a macro level, and other related policy matters. The Committee also met the Bank's external auditors.

Following a major restructuring of the Bank's internal organisation (see Box 4), the Bank's Internal Audit function started reporting directly to the Governors and to the Audit Committee.

Management and internal organisation
The Policy Advisory Committee, set up under the new Bank structure, acts as an advisory body to the Board of Directors on policy and general administration. The Committee is composed of the Governors, Director General and executive Directors of the Bank. It held its first meeting on 8 February 2011. The Management Committee, which was set up at the same time, is composed of the Bank's Heads of Department. It is mandated to ensure that the Bank's operations are carried out effectively and efficiently.

During the year a number of senior appointments were made. Mr René G. Saliba, a Senior Director with effect from 17 January 2011, was appointed Director General (Financial Policy and Special Projects) with effect from 1 October 2011. The Financial Markets, Financial Services and Financial Stability & Information Systems Directorates report directly to him in his new position. Mr Raymond A. Bonnici was appointed Director Corporate Services with effect from 31 July 2011, replacing Mr John Agius who retired at the end of July on reaching pensionable age. Meanwhile, Mr Anthony P. Cortis was appointed Director of the newly structured Directorate entitled Statistics and Risk Management, with effect from 1 October 2011. On that same date Dr Bernard Gauci was appointed Advisor to the Governor and is responsible for the Governors' Office.

Governors' activities in Malta
In April the Governor gave a public presentation of the Bank's *Annual Report 2010* and in May he launched the Forum for Financial Stability. In June he delivered a speech on policy challenges of euro adoption in small open economies during a seminar on macroeconomics organised by the National Bureau of Economic

Research, a private organisation, based in the United States, dedicated to promoting a better understanding of how the economy works. He also gave the concluding address at a symposium organised by the Bank, in June, to introduce a series of numismatic coins featuring milestones in Malta's constitutional history.

In September the Governor gave a presentation on developments in the Maltese economy to the Malta Chamber of Commerce and Industry. He was a speaker at the Biennial Financial Services Conference organised by KPMG in November. On 15 November he gave a presentation on economic and financial developments in the euro area and Malta to the Public Accounts Committee of the House of Representatives. The Governor was the keynote speaker at the annual dinner of the Institute of Financial Services in November during which he delivered a speech entitled "Lessons from the Crisis".

During the year the Governor attended a number of meetings of the Malta Council for Economic and Social Development. He also gave various interviews to the local media and to business organisations on matters related to the Maltese economy, the financial system, the sovereign debt crisis and the monetary policy of the ESCB.

Governors' activities overseas

In the course of the year, the Governor participated in meetings of the Governing Council and General Council of the European Central Bank (ECB) and of the European Systemic Risk Board. The Governor also attended the informal Economic and Financial Affairs Council (ECOFIN) meetings in April and September.

In May the Governor attended a conference organised by the Bank of Finland on "Monetary policy under resource mobility". In June he attended the annual meeting of the Bank for International Settlements and later participated in a high-level seminar of central banks of the East Asia-Pacific Region and the euro area organised by the ECB and De Nederlandsche Bank in Amsterdam.

In September the Governor attended the International Monetary Fund (IMF) and World Bank Annual Meetings in Washington, while in October he participated in a seminar organised by the Banca d'Italia on "Italy and the World Economy 1861-2011". Later in the month, he attended an event in Frankfurt to mark the end of the term of office of Mr Jean-Claude Trichet as President of the ECB.

During the year the Deputy Governor accompanied the Governor to meetings of the ECB's Governing Council and to the Annual Meeting of the IMF and World Bank. He also participated in meetings of the Economic and Financial Committee (EFC).

The Director General accompanied the Governor and the Deputy Governor to the Governing Council and the General Council meetings on a number of occasions. He also attended meetings of the EFC and EFC alternates in Brussels. In May he represented the Maltese Authorities at the annual meeting of the European Bank for Reconstruction and Development (EBRD), which was held in Astana, Kazakhstan.

Legal issues

During 2011 the Bank was involved in the preparation of several changes to Maltese legislation that involved the Bank's functions and responsibilities or the activities of the financial system in general.

Act No. XIX of 2011, which amended the Malta Membership of the International Monetary Fund Act (Cap.209), updated the definition of "Fund Agreement" to enable changes in the Articles of Agreement of the IMF to be automatically incorporated in the Act.

A Bill (No. 95) to amend the Central Bank of Malta Act (Cap.204) was also introduced in Parliament in 2011. This will bring into effect certain EU Regulations on payment systems and currency matters while updating the law to bring it in line with current developments in the central banking field. The legislative process to amend the Act is expected to be finalised during 2012.

The Bank was also involved in the amendment of the Financial Collateral Arrangements Regulations (Subsidiary Legislation 459.01), primarily to include credit claims within the scope of these Regulations.

The Central Bank of Malta Act also empowers the Bank to issue directives governing activities falling under its responsibility. During 2011 a number of directives were amended to implement guidelines issued by the ECB. These included Directive No. 6 to harmonise conditions for participation in TARGET2 and Directive No.7 on the provision of intraday credit.

The Bank also amended Directive No. 8 regarding documentation on monetary policy instruments and procedures. A number of changes reflected ECB Guideline ECB/2010/30, amending Guideline ECB/2000/7 on monetary policy instruments and procedures of the Eurosystem. These modified certain provisions on fixed-term deposits and the close links involving counterparties to monetary policy operations. Another change to Directive No. 8 involved the updating of its provisions to take into account the Pledge Agreement for Marketable Securities.

The Bank also initiated the formulation of a Legal Risk Management Framework to identify, assess and mitigate legal risks within each business area of the Bank, while creating awareness of its legal obligations.

The Bank is represented on the Board of Governors of the Financial Intelligence Analysis Unit, which is responsible for the analysis of information to combat money laundering and funding of terrorism. It also participates in the work of the Sanctions Monitoring Board, which implements international sanctions imposed by the European Union (EU) and ensures the implementation of those laid down by the Security Council of the United Nations.

Economic analysis and research

The Bank analyses economic and financial developments in Malta and abroad on a regular basis. It publishes an analysis of economic developments in its *Quarterly Review* and *Annual Report* and also issues a monthly commentary on monetary developments in Malta.

During 2011 the Bank contributed to ECB studies on potential output and to a Eurosystem project on the labour market, focusing on developments in the aftermath of the international financial crisis. The Bank continued to participate in a harmonised survey of bank lending conditions, which is carried out on a quarterly basis across the euro area. Other analytical work was undertaken on a number of economic and financial issues.

The Bank regularly participates in the preparation of euro area macroeconomic projections. A comprehensive exercise is carried out twice a year as part of the Eurosystem's Broad Macroeconomic Projection Exercise, while a more detailed short-term projection of inflation developments is prepared on a quarterly basis. Another macroeconomic projection exercise is also undertaken for the Bank's *Annual Report*. The Bank also prepares detailed fiscal forecasts as part of the ESCB forecast exercises. Further work was carried out during the year to strengthen the Bank's short-term forecasting capability, to review its structural econometric model and to develop a small scale dynamic stochastic general equilibrium model.

Statistics

The Bank collects and compiles a wide range of monetary, financial and economic statistics for internal policy decisions and for analytical, research and advisory purposes. While fulfilling its legal obligations, the Bank also adheres to the IMF's Special Data Dissemination Standard (SDDS). It also ensures that the processing of statistics is in line with the ESCB's Public Commitment on European Statistics, which requires statistics to be communicated clearly and disseminated regularly and comprehensibly.

During 2011 the Bank stepped up its efforts to enhance the quality of its data on non-financial companies and households, in cooperation with the National Statistics Office (NSO). This is an important input into the EU Commission's recently introduced "Scoreboard for the Surveillance of Macroeconomic Imbalances", which consists of specific economic indicators that facilitate an early identification of potential macroeconomic imbalances in any EU Member State.

The Bank also continued to strengthen the collection of information on local households' finances and consumption behaviour. By February 2011, the Bank had concluded the fieldwork related to the ESCB's Household Finance and Consumption Survey. It will publish the results in 2012.

During 2011 the Bank broadened the range of statistical data that it released for public information. It published quarterly net external debt figures for Malta for the period 2004-2011 and released historic monetary and financial statistics, going as far back as the 1960s.

During the year the Bank undertook a technical consultation process with the Malta Financial Services Authority (MFSA) to revise the statutory reporting requirements for investment service providers, which will become mandatory in March 2012. This is part of an international initiative by monetary and regulatory authorities in the aftermath of the financial crisis to extend coverage of statistical collection. To reduce the reporting burden, the Bank integrated the balance of payments returns within this new set of returns. This is part of a broader exercise to streamline the regulatory reporting frameworks.

Meanwhile, the Bank continued its preparation, together with the MFSA, for the implementation of a forthcoming ECB Regulation on statistical requirements related to insurance corporations and pension funds.

The Bank continued to contribute to securities holding statistics and in the further development of the full system of quarterly integrated sector accounts for the euro area. Moreover, the Bank also worked on the statistical implications of improvements in financial stability statistics and revisions to International Financial Reporting Standards.

At national level, the Bank was represented on a Steering Committee, which also includes officials from the NSO and the Ministry of Finance, the Economy and Investment (MFEI), and which oversees a programme leading to an improvement in the quality of Malta's national accounts and of other economic statistics.

Moreover, the Technical Committee on Financial Statistics continued to meet during the year. This Committee, which is chaired by the Bank and includes representatives from credit and financial institutions, the MFSA, the NSO and the Malta Bankers Association, coordinates the smooth transition to new reporting systems while seeking to enhance existing ones.

Internal audit

Governed by the Internal Audit Charter, the Bank's internal audit function provides an independent assurance and consultancy service to the Bank's management, to the Audit Committee and, ultimately, to the Board of Directors. As a result of the Bank's restructuring process, the Audit Committee Charter and the Internal Audit Charter were both reviewed. The relative amendments required to keep the charters aligned to the new reporting lines were approved by the Board in September 2011.

The internal audit function is also responsible for undertaking assignments on behalf of the ESCB Internal Auditors Committee (IAC), consequently providing the necessary assurances to the ECB Governing Council. In fulfilling its ESCB responsibilities, the Bank continued to participate in the IAC and completed four audits on behalf of the ESCB. As from the second quarter of 2011, all ESCB audits included a review of the general IT controls supporting the audited business area.

In accordance with the Internal Audit Plan for 2011, the Bank's internal auditors conducted 12 risk-based audit engagements, focusing on evaluating and reporting on the adequacy and effectiveness of governance, risk management and control processes deployed in a number of critical business areas. Several procedural and *ad hoc* audits were also undertaken.

The Bank's internal audit function continued to provide support to other business areas within the Bank, particularly in connection with the implementation of controls, project management and issues relating to policy deployment.

Risk assessment

Following the approval of the operational risk management (ORM) framework and the ORM Tolerance Policy by the Board of Directors in 2010, the ORM was rolled out across a number of business operations in the Bank during 2011. This process is expected to continue during 2012.

As part of its ongoing continuity management process, the Bank reviewed and tested several continuity plans for critical business processes. The Bank also worked on the implementation of an incident reporting policy, which was approved in February 2011. Moreover, several *ad hoc* risk assessment exercises were carried out, following specific requests by management.

The Bank participated in the development of risk management processes at ESCB level by forming part of the operational management task force, which is mandated to roll out the ESCB's ORM framework across the Eurosystem committees.

In addition, the Bank carried out an annual exercise to verify and update the data protection register, which includes all personal data processing operations of the Bank.

Human resources

By end-2011 the Bank employed a total of 314 full-timers, 14 fewer than a year earlier, while the number of part-timers stood at five, three less than at end-2010. The staff complement in terms of full-time equivalents dropped to 294 from 314 a year earlier. The contraction in staff numbers was due to the retirement of five employees on reaching pensionable age and to the departure of a further 15 persons under a voluntary severance scheme.

During 2011 the Bank recruited 12 staff members to strengthen its complement in the economic research, portfolio investment, legal, auditing and security areas of the Bank. At the same time, nine employees resigned from the Bank. In 2011 the Bank once again seconded two employees to other institutions within the public sector. In addition, two employees took up short-term contracts with the ECB in the areas of economic research and librarianship.

During summer the Bank offered temporary employment to seven University of Malta students majoring in economics, law, mathematics and statistics. In addition, it participated in a scheme administered by the Malta College of Arts Science and Technology by offering a five-week work placement to five students. In 2011 the Bank continued an internship scheme that was initially introduced in 2009 to encourage young graduates from Malta and other EU countries to obtain practical experience at the Bank and to enhance their analytical skills. In this respect, the Bank granted a seven-month internship to a French national. It also granted an eight-week bursary to a South Korean national under the bursary scheme.

Training and development

During the year the Bank continued to invest in staff training, both within the Bank 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	
	2010	2011	2010	2011
In-house	32	52	521	1021
External	197	156	336	213
Local	125	72	262	120
Overseas	72	84	74	93

Source: Central Bank of Malta.

Table 4.2
ACADEMIC AND PROFESSIONAL COURSES
Number of employees

Type of programme	Courses completed		Courses being pursued	
	2010	2011	2010	2011
Postgraduate courses	11	2	13 [1]	19 [1]
Honours first degree courses	3	5	8	4
Diploma courses			1	7

[1] Includes two employees on unpaid study leave abroad to pursue postgraduate courses under the Bank's Learning, Research and Development Study Programme.
Source: Central Bank of Malta.

An active in-house training programme covered 27 areas, offering 52 different programmes, mainly on IT, antifraud and confidentiality, sexual harassment, staff well-being, along with induction programmes for new employees. Courses were also offered on examination techniques, leadership and teambuilding. The number of staff members taking in-house courses almost doubled during 2011.

As Table 4.1 shows, the number of staff members who participated in external courses dropped by over a third compared with 2010. This was due to a decline in courses taken in Malta, which fell by one-fifth, while, in contrast, the number of overseas courses grew by a quarter. Topics ranged across a variety of issues relevant to central banking, including statistics, risk management, economics and financial stability. Other subjects included investment, IT, and accounting. Foreign courses were organised by a number of central banks and the ECB, among others.

The Bank once again hosted two ESCB training courses in leadership, which several central bankers from the ESCB attended.

During the year a number of employees benefited from the Bank's various study programmes (see Table 4.2). A total of seven beneficiaries successfully completed their studies, while 30 were enrolled in approved courses, mostly at postgraduate level.

In addition, the Bank continued to make available, to qualified members of the staff, a funding facility under its Learning, Research and Development Study Programme. The programme provides financial support to selected staff members wishing to pursue academic studies at postgraduate or doctorate level at foreign universities in areas of relevance to the Bank's work. During 2011 two staff members were selected to pursue studies in economics under this programme.

Sexual harassment policy
In 2011 the Bank presented its updated policy on sexual harassment to all employees. The aim is to ensure that sexual harassment at the workplace does not occur and, if it does, to ascertain that adequate procedures are readily available to deal with the problem and prevent its recurrence.

Health and safety
In 2011 the Bank continued to meet its obligations related to various health and safety issues. Refresher courses on first aid were also given to various staff members.

Premises and procurement
To alleviate a growing need for office space, the Bank leased additional premises in Valletta to house its Economics and Research Department. This led to an internal relocation of other offices within the main premises and in the Bank's St James Counterguard Annex. Meanwhile, preliminary planning procedures on a project related to the development of unoccupied space adjacent to the Bank's Annex continued during 2011.

Throughout the year, the Bank continued to participate in a Eurosystem Procurement Coordination (EPCO) initiative. This is designed to enable central banks of the Eurosystem to benefit from efficiencies in the procurement of supplies and services.

Corporate Social Responsibility

Environmental initiatives

As in previous years, the Bank pursued its strategy of encouraging waste separation, energy efficiency, water consumption reduction and environment-friendly procurement. Measures included the recycling of paper. An Energy Management Audit was started in 2011 to provide more efficient use of electrical power.

Social commitments

The Bank continued to provide financial support to a number of institutions in areas connected to its functions. In this regard, assistance was channelled to the NSO and a number of constituted bodies to part-finance projects in which the Bank had a direct interest. Furthermore, the Bank also decided to sponsor the Central Bank of Malta Chair in Economics at the University of Malta beginning in 2012.

The Bank continued its support of various philanthropic organisations through donations and sponsorships. In particular, in the cultural sphere, it assisted the *Fondazzjoni Patrimonju Malti*, among others. It also provided assistance to various charities, including the Community Chest Fund, the Emigrants' Commission, *Dar tal-Providenza*, the Little Sisters of the Poor and the Sisters of the Good Shepherd. Moreover, one staff member was seconded to a charity, while another was allowed to work on a part-time basis with another voluntary organisation. For the second consecutive year a number of trees were donated to the 34U campaign.

Information and public relations

During the year the Bank continued to provide information to the public on its policies, operations and activities through its website, the issue of press and statistical releases and its official publications. It also replied promptly to requests for related information from the media and the public in general. In addition it organised corporate events and a number of educational visits for local and foreign visitors to inform them about the role and functions of the Bank and the Eurosystem.

In June the Bank organised a numismatic symposium to introduce the first of a series of five EUR2 commemorative coins featuring milestones in Malta's constitutional history. On the first Saturday of October 2011 the Bank opened its premises to the public during the *Notte Bianca* night event organised by the public authorities in Valletta.

A corporate publication entitled *Art and Architecture – the Central Bank of Malta* was issued by the Bank in June. This focussed on the architecture of the Bank's premises and its collection of paintings, furniture, silverware and other *objets d'art*.

In the course of the year the Bank hosted six ESCB meetings, as well as an international seminar on macroeconomics organised by the National Bureau of Economic Research.

Information systems and knowledge management

During the year the Bank continued to enhance its knowledge management capabilities by fostering better collaboration in the sharing and managing of information within the Bank.

It also launched various pilot projects to enhance electronic messaging applications and to develop a number of collaborative portals for every department. The Bank commenced preliminary work on a Business Applications Architecture project to replace its major IT systems, spanning a range of areas including market trading, banking services, accounting, statistics and payroll.

In the course of the year, the SWIFT communications infrastructure was upgraded, while the Single Euro Payments Area (SEPA) application system was extended to cater for transfers between internal and external accounts.

The Bank also introduced a new software engineering methodology and continued to develop in-house software solutions to meet internal and ESCB/ECB related demands. These include applications for Collateral Management, Human Resources and the Daily Financial Systems.

As part of its knowledge management strategy, both the Library and Records Management Services were integrated within the Information Systems Department during the year. As in previous years, the Bank's library offered its services to the staff and met requests by external users pursuing economic and financial research. It continued to enhance its print and electronic collections in the fields of economics and finance, and acquired new books, periodicals, and other specialised publications related to central banking. It also continued to maintain a collection of publications issued by international financial institutions.

BOX 4: CHANGES TO THE BANK'S NEW ORGANISATION STRUCTURE

Changes to the new organisation structure at the Bank

A new organisational structure came into effect in mid-January 2011. Following a review by the Board of Directors, further changes were introduced in late 2011 to strengthen the structure and ensure better coordination and synergy within the Bank.

Following these changes the Bank's five Directorates now consist of:

1. The Financial Stability & Information Systems (IS) Directorate, which is composed of the Financial Stability Department and the IS & Knowledge Management Department;
2. The Market Operations Directorate, comprising the Reserves Management Department and the Monetary Operations & Government Securities Department;
3. The Financial Services Directorate, which is composed of the Currency Services & Security Department and the Payments & Banking Department;
4. The Statistics & Risk Management Directorate, which is made up of the Statistics Department and the Strategy, Planning & Risk Department;
5. The Corporate Services Directorate, which comprises the Financial Control Department and the Human Resources & Administration Department.

To strengthen the support function relating to the Governor's activities and external commitments, a Governors' Office was established for the preparation of reports, background papers and speeches for the Governor.

Four Departments report directly to the Governors. These are Economics & Research, Internal Audit, Communications & Legal and EU & International Relations. The Strategy, Planning & Risk Department, formerly reporting to the Governors, is now located within the newly established Statistics & Risk Management Directorate.

5. INTERNATIONAL RELATIONS

As a member of the Eurosystem the Central Bank of Malta continued to cooperate with the European Central Bank (ECB) in all tasks and activities involving the participation of National Central Banks (NCBs). The Bank also maintained a close relationship with other international institutions, including the European Commission, the International Monetary Fund (IMF), the World Bank Group and the European Bank for Reconstruction and Development (EBRD).

Table 5.1
EUROSYSTEM/ESCB COMMITTEES

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

European System of Central Banks

During 2011 the Governor participated regularly in the proceedings of the Governing Council of the ECB, which is composed of the ECB's Executive Board and of Governors of NCBs of euro area Member States. The Council formulates monetary policy and takes decisions related to implementation of tasks assigned to the Eurosystem across the euro area. The Governor is also member of the General Council of the ECB, which mainly performs an advisory role and comprises the President and Vice-President of the ECB, and central bank Governors of all European Union (EU) Member States.

Senior Bank officials participated in 17 Eurosystem/European System of Central Banks (ESCB) committees (see Table 5.1) while technical experts contributed to the activities of 72 working groups and task forces that provide support to these committees.

During the year the Bank was a signatory to several agreements regulating the operations of the ESCB, including the Eurosystem's real-time gross settlement system (TARGET 2) and a TARGET 2 Securities (T2S) Framework Agreement. The latter sets out the contractual rights and obligations of the Eurosystem and of each contracting Central Securities Depository, covering the development and operation of T2S. Another agreement related to the connection of the National Bank of Romania to TARGET 2.

With regard to the Bank's shareholding in the ECB, pursuant to the Governing Council's decision of 13 December 2010 to increase the subscribed capital of the ECB to EUR10.76 billion in three annual instalments, the Bank paid the second instalment of EUR1.1 million on 28 December 2011, bringing its paid-in capital to EUR5.8 million. The final instalment of EUR1.0 million will be paid at the end of 2012.

European Systemic Risk Board

The European Systemic Risk Board (ESRB), which was established in December 2010 with a mandate to oversee risk in the European financial system as a whole, held its first meeting on 20 January 2011. The Governor participated in meetings of the General Board of the ESRB as member, while senior Bank officials took part in the ESRB's Advisory Technical Committee and in its substructures.

In its inaugural meeting, the General Board decided on a number of issues related to its operations, including the establishment of the ESRB rules of procedure, election of the Steering Committee and Chair of the Advisory Technical Committee, and the selection of members of the ESRB's Advisory Scientific Committee.

Other EU institutions

During 2011 the Governor attended two informal meetings of the Economic and Financial Affairs Council (ECOFIN), while the Deputy Governor and other senior Bank officials participated in meetings of the Economic and Financial Committee (EFC) and two of its sub-committees, one on IMF and related issues and the other on EU government bills and bonds.

The EFC continued to play a key role in recommending measures to address the negative impact of the sovereign debt crisis in Europe. In particular, the Bank participated in EFC discussions on issues relating to the reinforcement of economic governance, the implementation of the EU semester and the new financial supervisory framework, crisis management, and the monitoring of financial sector developments.[1]

The Bank also participated in discussions in EU fora on Malta's Update of Stability Programme prepared by the Ministry of Finance, the Economy and Investment (MFEI), covering the period 2011-2014. The Bank also discussed projections for the Maltese economy with the European Commission as part of the latter's economic forecasting process.

Bank officials participated in meetings of working groups under the auspices of the European Commission. These related to anti-counterfeiting measures, euro coins, payment systems and financial stability.

In 2011 the National Bank of the Former Yugoslav Republic of Macedonia submitted a request to the ECB for technical assistance under the European Commission's Instrument for Pre-Accession Assistance programme. The ECB invited NCBs to contribute towards technical assistance once an agreement between the ECB and the European Commission was concluded. The Central Bank of Malta committed itself to assist in the field of balance of payments statistics and in the compilation of the international investment position.

European Bank for Reconstruction and Development

The Bank monitors developments at the EBRD and collaborates with the MFEI on issues relating to Malta's membership in this institution. Together, they examined resolutions that required a decision by the EBRD's Board of Governance, including amendments to a number of agreements. These included the agreement establishing the Bank, the geographic expansion of the Bank's region of operations to the Southern and Eastern Mediterranean, membership of Tunisia and Jordan and the net income reallocation for additional funding for Chernobyl projects.

Moreover, during 2011, a 50% increase in the EBRD's capital base became effective following subscription to the transaction by over half of the bank's shareholders. As a result, the EBRD's capital will rise to EUR30 billion from EUR20 billion through a temporary increase in callable capital of EUR9 billion and a transfer from reserves to paid-in capital of EUR1 billion.

International Monetary Fund

The Governor continued to represent Malta on the Board of Governors of the IMF, while the Deputy Governor acted as his alternate. In consultation with the Minister of Finance, the Economy and Investment, the Governor voted on resolutions proposed by the Fund's Executive Board. These included membership of South Sudan in the IMF and the rollback of the expanded New Arrangements to Borrow (NAB) credit arrangements with the Fund.

In November 2011 the Maltese Parliament approved a minor amendment to the Malta Membership of the International Monetary Fund Act I to facilitate the ratification process where changes to the Articles of Agreement of the IMF were involved. Following the changes to legislation the Maltese Government ratified the amendments to the IMF's Articles of Agreement related to the Reform of its Executive Board in February 2012.

On 29 December 2011, the Central Bank of Malta notified the IMF of Malta's consent to the change in its quota following the adoption by the IMF's Board of Governors of a resolution concerning an increase in quo-

[1] The EU semester is a procedural framework designed to improve the coordination of budgetary and economic policies across the EU and the euro area.

tas under the 14th General Review of Quotas. As a result, Malta's quota in the IMF will increase by SDR66.3 million to SDR168.3 million.

Malta's SDR allocation remained unchanged in 2011 at SDR95.4 million. On the other hand, the Bank's SDR holdings declined from SDR95.9 million at end-2010 to SDR90.7 million at end-2011 as a result of SDR sales under the Bank's two-way voluntary arrangement with the Fund.

The Bank also continued to carry out transactions related to the IMF's operational budget. Contrary to the previous year, the amount extended in new loans exceeded repayments of amounts from previous loans. Consequently, Malta's reserve tranche rose from SDR20.8 million to SDR31.7 million as the Fund's holdings of the national currency with the Bank decreased from SDR81.2 million to SDR70.3 million by the end of 2011.

Meanwhile, the Bank's bilateral lending commitment of up to EUR120 million (approximately SDR106 million) with the Fund remained in force during 2011. By the end of 2011, the Fund had withdrawn a total of EUR16.6 million (around SDR14 million) under this facility.

On 9 December 2011, in a statement by EU Heads of State or Government, euro area and other Member States agreed to raise the resources available to the IMF in the form of bilateral loans. The terms and conditions of the loan agreement are still to be determined.

World Bank Group

The Bank assists the MFEI in monitoring developments in the World Bank Group, offering advice on relevant issues proposed mainly by the International Bank for Reconstruction and Development.

The Bank also continued to provide administrative support to the Small States Network for Economic Development, and to act as fiduciary agent for the account of the Network's Board of Trustees.

Other matters

The Bank continued to monitor developments related to initiatives endorsed by the Financial Stability Board and by the Bank for International Settlements (BIS). It also 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.

A senior Bank official participated in 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. Meanwhile, another senior official of the Bank contributed to the work of MONEYVAL as a scientific expert, providing advice on preventive and financial matters.

ECONOMIC AND FINANCIAL POLICY CALENDAR 2011

This calendar lists important policy developments in the monetary, fiscal and financial fields during the year.

Monetary policy measures of the Eurosystem

7 April: The Governing Council of the European Central Bank (ECB) decided to increase the interest rate on the main refinancing operations (MROs) of the Eurosystem by 25 basis points to 1.25%. The interest rate on the marginal lending facility was increased by 25 basis points to 2.00%, while the interest rate on the deposit facility was raised by 25 basis points to 0.50%.

7 July: The Governing Council of the ECB decided to increase the interest rate on the MROs of the Eurosystem by 25 basis points to 1.50%. Similarly, the interest rate on the marginal lending facility was raised by 25 basis points to 2.25%, while that on the deposit facility was increased by 25 basis points to 0.75%.

4 August: The Governing Council of the ECB decided to conduct a liquidity-providing supplementary longer-term refinancing operation (LTRO) with a maturity of approximately six months. The operation was conducted as a fixed rate tender procedure with full allotment. The rate on this operation was fixed at the average rate of the MROs over the life of the supplementary LTRO.

15 September: The ECB decided, in coordination with the Federal Reserve, the Bank of England, the Bank of Japan and the Swiss National Bank, to conduct three US dollar liquidity-providing operations with a maturity of approximately three months covering the period to the end of the year.

6 October: The Governing Council of the ECB decided to conduct two LTROs: one with a maturity of approximately 12 months (in October 2011), and the other with a maturity of approximately 13 months (in December 2011). The operations were to be conducted as fixed rate tender procedures with full allotment. The rate to be applied for both operations was fixed at the average of the rates of the MROs over the life of the relevant LTRO.

3 November: The Governing Council of the ECB decided to launch a new covered bond purchase programme (CBPP2), involving purchases of euro-denominated covered bonds issued in the euro area, for an intended nominal amount of EUR40 billion.

3 November: The Governing Council of the ECB decided to lower the interest rate on the MROs of the Eurosystem by 25 basis points to 1.25%. The interest rate on the marginal lending facility was reduced by 25 basis points to 2.00%, while that on the deposit facility was lowered by 25 basis points to 0.50%.

8 December: The Governing Council of the ECB decided to reduce the interest rate on the MROs of the Eurosystem by 25 basis points to 1.00%. The interest rate on the marginal lending facility was decreased by 25 basis points to 1.75%, while the interest rate on the deposit facility was lowered by 25 basis points to 0.25%.

The Governing Council of the ECB also decided on additional measures to support bank lending and liquidity in the euro area money market. In particular, the Governing Council decided to conduct two LTROs with a maturity of 36 months, with the option of early repayment after one year. The allotment dates for these operations were set at 21 December 2011 and 29 February 2012. Moreover, it decided to reduce the reserve ratio from 2% to 1% from the reserve maintenance period starting on 18 January 2012. It also decided to broaden the range of acceptable collateral for use in monetary policy operations.

Institutional developments regarding financial stability in Europe

1 January: Three new European Authorities for the supervision of financial activities – for banks, markets, and insurance firms and occupational pensions, respectively – started their operations. These institutions are the European Banking Authority (EBA), the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority.

20 January: The European Systemic Risk Board (ESRB), which is chaired by the President of the ECB, held its first official meeting in Frankfurt. The ESRB is an independent EU body which forms part of the European System of Financial Supervision and is responsible for the macro-prudential oversight of the financial system within the EU. It contributes to the prevention or mitigation of systemic risks to financial stability in the Union through the implementation of the appropriate macro-prudential tools and policies.

18 March: The General Board of the ESRB discussed risks and vulnerabilities of a dynamic nature in the EU. In addition, it explored the role the ESRB could play – together with the EBA – in implementing counter-cyclical capital buffers. It also considered how the ESRB would be fully involved in the stress tests carried out by the European Supervisory Authorities.

22 June: The General Board of the ESRB reviewed the systemic risks to which the financial system of the EU is exposed. It called for a clear and rigorous assessment of the resilience of banks through the EU-wide stress test. It also highlighted the importance that remedial measures be applied to those institutions that would fail the test or that would be perceived to be vulnerable.

21 September: The ESRB noted that the high interconnectedness in the EU financial system had led to a rapidly rising risk of significant contagion. This threatened financial stability in the EU as a whole and adversely impacted the economy in Europe and beyond. It called on supervisors to coordinate efforts to strengthen bank capital, taking also into account the need for transparent and consistent valuation of sovereign exposures.

Economic governance in the EU

11 March: The Heads of State or Government of euro area Member States agreed that the European Stability Mechanism would have an overall effective lending capability of EUR500 billion. They also agreed that the introduction of a financial transaction tax should be explored and developed further in the euro area and at EU and international levels. The Heads of State or Government also endorsed the Pact for the Euro, which established stronger economic policy coordination for competitiveness and convergence.

24 and 25 March: The European Council endorsed the priorities for fiscal consolidation and structural reform. The Council also endorsed proposals on economic governance including amendments to the Stability and Growth Pact, new provisions on national fiscal frameworks and a new surveillance of macroeconomic imbalances. The euro area Heads of State or Government, together with those of a number of other European Union (EU) Member States, agreed on the Euro Plus Pact to further strengthen the economic pillar of the Economic and Monetary Union (EMU).

17 May: The Economic and Financial Affairs Council (ECOFIN) reached agreement on draft legislation governing short selling and credit default swaps and approved a statement setting out guiding principles on backstop measures to support financial institutions that failed the 2011 EU-wide stress tests. The Council also adopted a decision granting financial assistance to Portugal.

12 July: The ECOFIN Council agreed on a strategy for the communication of remedial and backstop measures envisaged by Member States to support vulnerable banks following the EU-wide stress tests, the

results of which were published in July. The Council reviewed the availability and soundness of the backstop measures in place to decisively address any remaining pockets of vulnerability in the EU banking sector.

21 July: The Heads of State or Government of the euro area and EU institutions agreed to support a new programme for Greece. This would also involve the IMF and would include a voluntary contribution from the private sector to fully cover the financing gap. The total official financing would amount to an estimated EUR109 billion. This programme would be designed, notably through lower interest rates and extended maturities, to decisively improve the debt sustainability and refinancing profile of Greece.

13 October: The amendments to the European Financial Stability Facility's (EFSF) Framework Agreement were ratified by all 17 Member States of the euro area. The new EFSF would have an effective lending capacity of EUR440 billion through guarantee commitments from euro area Member States.

26 October: Euro area leaders made further progress on a financial package to support Greece. They noted that private sector involvement in the restructuring of Greek debt would ensure the decrease of the Greek debt-to-GDP ratio to 120% by 2020. The euro area Member States were expected to contribute up to EUR30 billion to this package. On that basis, the official sector stood ready to provide additional programme financing of up to EUR100 billion until 2014.

8 November: The Council adopted a package of six legislative proposals to strengthen economic governance in the EU – and more specifically in the euro area – as part of the EU's response to developments in sovereign debt markets. The measures regarded the surveillance of Member States' budgetary and economic policies, the EU's excessive deficit procedure, the enforcement of budgetary surveillance in the euro area, the prevention and correction of macroeconomic imbalances and a directive on requirements for Member States' budgetary frameworks.

9 December: The euro area Heads of State or Government agreed to move towards a stronger economic union, including a new "fiscal compact", strengthened economic policy coordination and the development of stabilisation tools particularly where these referred to the general government deficit and public debt. As a rule, annual structural budget deficits were not to exceed 0.5% of nominal gross domestic product (GDP). They also agreed that the European Stability Mechanism should enter into force in July 2012.

Central Bank of Malta announcements

23 May: The Bank launched the Forum for Financial Stability to broaden the discussion of issues affecting financial stability. The Forum, which is composed of representatives of the relevant authorities and of the major stakeholders in the financial services industry, is designed to foster a structured dialogue on issues of common interest, with a particular emphasis on the identification and management of risks that could have a negative impact on the financial system.

1 July: Professor Josef Bonnici commenced his appointment as Governor of the Central Bank of Malta for a five-year term. Professor Bonnici had been serving as a non-executive Director on the Board of the Bank since the beginning of the year.

Fiscal policy

The Pre-Budget Document 2012

1 August: The Minister of Finance, the Economy and Investment launched the Pre-Budget Document 2012. The Document, which served as an input to subsequent discussions on the 2012 Budget with the social partners, assessed the recent performance of the Maltese economy.

Budget estimates for 2012

14 November: The Minister of Finance, the Economy and Investment presented the Budget for 2012 in Parliament and announced a number of fiscal measures. These included increases in customs and excise duties, tax credits to companies, the extension for a further year of the tax credit to women returning to the job market, a reduction in income tax rates for working parents and lower income tax rates for certain categories of part-time workers. The Minister also announced additional incentives to companies and the launching of a number of projects aimed at enhancing industrial infrastructure. Regarding social welfare assistance, a number of measures assisting pensioners and the elderly were announced.

The Minister also announced that the wage increase to be awarded to whole-time employees in terms of the cost-of-living adjustment was to be EUR4.66 per week.

Excessive Deficit Procedure – Malta

18 January: The ECOFIN Council decided that the Maltese Government's fiscal consolidation measures to address the excessive deficit position represented adequate progress within the established time limit set by the Council. These measures were expected to correct the excessive deficit in 2011. However, the Council called for rigorous execution of the budget and for close monitoring of budgetary developments to ensure that the deficit target of 2.8% of GDP was achieved in 2011.

National Reform Programme and updated Stability Programme of Malta

7 June: The European Commission published a recommendation on the National Reform Programme 2011 of Malta and on the updated Stability Programme of Malta 2011-2014. On this basis, on 12 July the ECOFIN Council delivered a recommendation on the National Reform Programme and an opinion on the updated Stability Programme.

Privatisation Programme

18 March: The Government privatised the Malta Super Yacht Yard facility through a concession agreement with the Italian-owned shipyard company, Palumbo Malta Superyacht Limited. Under the agreement, which runs for a period of 30 years, the company would pay a global amount of EUR29.4 million. It was also committed to invest a minimum of EUR3.6 million in the yard during the first five years.

Issue of Malta Government Stocks

28 January: The Government, through Legal Notice 29 of 2011, announced the issue of EUR120 million worth of Malta Government Stocks (MGS). The issue was divided into 4.25% MGS 2017(III), 5.25% MGS 2030(I) Fungibility Issue, or any combination of the two stocks.

29 April: The Government, through Legal Notice 161 of 2011, announced the issue of EUR52.0 million worth of Floating Rate MGS 2013(VII) linked to the six-month EURIBOR.

29 April: The Government, through Legal Notice 162 of 2011, announced the issue of EUR100.0 million worth of MGS, subject to an over-allotment option of EUR50.0 million, consisting of 4.25% MGS 2017(III) Fungibility Issue and 5.25% MGS 2030(I) Fungibility Issue.

27 May: The Government, through Legal Notice 201 of 2011, announced the issue of EUR466,000 worth of 7% MGS 2021(II), under the Local Loans (Registered Stock and Securities) Ordinance (Cap. 161) and in accordance with the agreement made between the Holy See and Malta on 28 November 1991.

27 May: The Government, through Legal Notice 202 of 2011, announced the issue of EUR2,858,800 worth of 7% MGS 2021(III) under the Local Loans (Registered Stock and Securities) Ordinance (Cap. 161) and in accordance with the agreement made between the Holy See and Malta on 28 November 1991.

4 November: The Government, through Legal Notice 430 of 2011, announced the issue of EUR100 million worth of MGS, subject to an over-allotment option of a maximum of EUR44 million, consisting of 4.25% MGS 2017(III) Fungibility Issue and 5.2% MGS 2031(I).

4 November: The Government, through Legal Notice 431 of 2011, announced the issue of EUR24 million MGS as Floating Rate MGS 2014(V) linked to the six-month EURIBOR.

Conversion of Stock

29 November: The Government, through Legal Notice 466 of 2011, announced the conversion of EUR200 million out of the 5.70% MGS 2012(III) into a new issue of EUR200 million 4.30% MGS 2016(IV). This is the first of an MGS Switch Auctions Programme on a voluntary basis over a three-year period for MGS maturing from 2012 to 2014.

Double taxation relief agreements

18 January: Legal Notice 14 of 2011 amended the relevant double taxation relief agreement between the Republic of Malta and the Republic of Italy.

20 September: Legal Notice 383 of 2011 amended the Double Taxation Relief on Taxes on Income with the Federal Republic of Germany Order S.L.123.06, regarding the exchange of information. The Protocol specified in the Schedule of this Order entered into force on 19 May 2011.

4 November: Legal Notice 423 of 2011 was issued to afford relief from double taxation on individual income tax and enterprise income tax as imposed by the laws of the People's Republic of China and by the Maltese Income Tax Act. This agreement entered into force on 25 August 2011.

Financial sector

EU-wide banking sector stress test results

15 July: The results of the 2011 EU-wide stress-testing exercise, prepared and conducted by the EBA in close cooperation with the ECB and the national supervisory authorities in EU Member States, were announced. The Bank of Valletta plc, which was one of the banks stress tested, achieved positive results and exceeded the capital benchmark set by the authorities conducting the stress tests.

Electronic money institution

24 October: The Malta Financial Services Authority (MFSA) granted a licence to Syspay Limited to issue electronic money under the provisions regulating electronic money institutions of the Financial Institutions Act (Cap. 376).

Legislation related to banking and finance

Acts

8 March: Act No. II of 2011 was enacted to amend the Banking Act (Cap. 371). The amendments included provisions affecting the competent authority's supervisory tools, practices and functions as well as other

provisions covering, among others, the opening of bank branches and banks' remuneration policies and practices.

5 August: Act No. XVI of 2011, the Retirement Pensions Act, was enacted to regulate retirement schemes, retirement funds and related service providers. The MFSA is the competent authority responsible for the administration of the Act.

18 October: Act No. XVIII of 2011 was enacted to amend the Participation and Guarantees under the European Financial Stability Facility Act (Cap. 505) and to amend the Government Borrowing and the Granting of Loans to the Hellenic Republic Act (Cap. 502). Among other provisions, the Act increased Malta's guarantee commitment to EUR704.3 million.

29 November: Act No. XIX of 2011 was enacted to amend the Malta Membership of the International Monetary Fund Act (Cap. 209). This Act amended the definition of "Fund Agreement" to ensure that changes in the Articles of Agreement of the IMF are automatically incorporated in the same Act.

Legal Notices

22 February: Legal Notice 62 of 2011 amended the Investor Compensation Scheme Regulations regarding payment of contributions by certain categories of firms licenced to provide investment services. These regulations came into force on 1 January 2011.

22 February: Legal Notice 63 of 2011 partly implemented several articles of Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) as amended by the Second Capital Requirements Directive.

29 March: Legal Notice 117 of 2011 amended the Protection and Compensation Fund Regulations S.L.403.13, related to the conduct of insurance business.

29 March: Legal Notice 118 of 2011 published the Financial Collateral Arrangements (Amendment) Regulations, 2011, to implement, in part, provisions of Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009, amending Directive 98/26/EC on the settlement finality in payment and securities settlement systems, and Directive 2002/47/EC on financial collateral arrangements in linked systems and credit claims.

13 May: Legal Notice 191 of 2011 applied to financial institutions providing payment services with regard to rights and obligations of payment service users, electronic money holders and the financial institutions themselves.

28 June: Legal Notice 243 of 2011 included regulations on the establishment and freedom to provide services both by Maltese and European companies that manage Undertakings for Collective Investment in Transferable Securities (UCITS) as well as for cooperation with regulatory authorities in other EU Member States or European Economic Area (EEA) states. These regulations came into force on 1 July 2011.

30 September: Legal Notice 400 of 2011 regulated the tax treatment of high net worth individuals from the EU, EEA and Switzerland wishing to reside in Malta. Such individuals could benefit from a flat rate of tax, set at 15%, on income remitted to Malta from abroad provided certain conditions, particularly related to income and ownership of property, were met. This Legal Notice came into force on 1 January 2011.

7 October: Legal Notice 403 of 2011 regulated the tax treatment of high net worth individuals from countries not in the EU, EEA and Switzerland wishing to reside in Malta. Such individuals could benefit from a flat rate of tax, set at 15%, on income remitted to Malta from abroad provided certain conditions were met. The rules came into force on 1 January 2011.

14 November: Legal Notice 456 of 2011 provided for a one-time remittance by the Commissioner of Value Added Tax (VAT) for the interest and/or administrative penalty incurred or that accrued to a person under VAT legislation and under the Customs and Excise Tax Act.

25 November: Legal Notice 458 of 2011 regarded the exercise of passport rights by European financial institutions wishing to operate in Malta and Maltese financial institutions wishing to operate in another EU Member State or EEA State.

International ratings

6 September: Moody's Investors Service downgraded Malta's foreign-currency and local-currency government bond ratings to A2 from A1 and revised the outlook to negative.

25 October: Fitch Ratings left Malta's sovereign rating unchanged and affirmed Malta's long-term foreign and local currency Issuer Default Rating (IDR) at "A+" with stable outlook. The short-term IDR was also affirmed at "F1" and the country ceiling at "AAA".

28 October: Standard & Poor's Ratings Services affirmed its "A/A-1"sovereign credit ratings on Malta with a stable outlook.

5 December: Standard & Poor's announced that it was placing its "A" long-term and "A-1" short-term sovereign credit ratings on Malta on CreditWatch with negative implications.

PART III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2011

Directors' report

The Directors present their report and the audited financial statements of the Central Bank of Malta (the Bank) for the year ended 31 December 2011.

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 2011, and of its profit for the year then ended. The financial statements have been prepared in accordance with the provisions established by the Governing Council of the European Central Bank under Article 26.4 of the Statute of the European System of Central Banks and of the European Central Bank and in accordance with the requirements of the Central Bank of Malta Act (Cap. 204). The provisions established by the Governing Council are outlined in the Guideline ECB/2010/20 of 11 November 2010 on the legal framework for accounting and financial reporting in the European System of Central Banks (recast), as amended.

Financial results

The Bank's financial statements for the year ended 31 December 2011 are set out on pages A-6 to A-41 and disclose an operating profit of €52.5 million (2010: €57.6 million). The amount payable to the Government of Malta is €42.0 million (2010: €48.0 million).

Board of Directors

The members of the Board of Directors during the year ended 31 December 2011 and up to the date of authorisation for issue of the financial statements were:

Professor Josef Bonnici – Governor (from 1 July 2011; Director from 10 January 2011 to 30 June 2011)
Mr Michael C. Bonello – Governor (up to 30 June 2011)
Mr Alfred DeMarco – Deputy Governor
Mr Victor Busuttil
Ms Antoinette Caruana
Ms Philomena Meli (appointed on 23 January 2012)

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

Auditors

KPMG have been appointed as the Bank's auditors with effect from the financial year ending 31 December 2009 and have signified their willingness to continue in office.

By order of the Board

Professor Josef Bonnici
Governor

Mr Alfred DeMarco
Deputy Governor

Pjazza Kastilja
Valletta VLT 1060
Malta

26 March 2012

Statement of Directors' responsibilities in respect of the financial statements

The Board of Directors is responsible for ensuring that the financial statements are drawn up in accordance with the requirements of the Central Bank of Malta Act (Cap. 204). The Bank is required to prepare financial statements in accordance with the requirements of the Guideline ECB/2010/20 of 11 November 2010 on the legal framework for accounting and financial reporting in the European System of Central Banks (recast), as amended.

The Board of Directors is responsible for ensuring that these financial statements give a true and fair view of the state of affairs of the Bank as at 31 December 2011 and of the profit for the year then ended.

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

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

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 (the "Bank") as set out on pages A-6 to A-41, which comprise the balance sheet as at 31 December 2011, the profit and loss account for the year then ended, and a summary of significant accounting policies and other explanatory notes.

The responsibility of the Central Bank of Malta's Board of Directors for the financial statements

As explained more fully in the Directors' Responsibilities Statement set out on page A-3, the Directors are responsible for the preparation of financial statements that give a true and fair view in accordance with the provisions established by the Governing Council of the European Central Bank, which are set out in Guideline ECB/2010/20 (recast) issued on 11 November 2010, as amended by Guideline ECB/2011/27 of 21 December 2011 ("Guideline ECB/2010/20, as amended"), and the requirements of the Central Bank of Malta Act (Chapter 204, Laws of Malta) and for such internal control as the Directors determine are necessary to enable the preparation of financial statements that are free from material misstatement whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. This report, including the opinion, has been prepared for and only for the Bank's Directors in accordance with article 20 of the Central Bank of Malta Act (Chapter 204, Laws of Malta), and in terms of Article 27.1 of the Statute of the European System of Central Banks (ESCB) and of the European Central Bank, and may not be appropriate for any other purpose.

In addition, we read the Directors' Report and consider the implications for our report if we become aware of any apparent material misstatements of fact.

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our 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, we consider internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Directors, as well as evaluating the overall presentation of the financial statements.

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

Opinion on Financial Statements

In our opinion, the financial statements:

- give a true and fair view of the financial position of the Bank as at 31 December 2011 and of its financial performance for the year then ended in accordance with the provisions established by the Governing Council, which are set out in Guideline ECB/2010/20, as amended; and
- have been properly prepared in accordance with the Central Bank of Malta Act (Chapter 204, Laws of Malta).

Mr Noel Mizzi (Partner) for and on behalf of

KPMG
Registered Auditors
Portico Building
Marina Street
Pietà PTA 9044
Malta

26 March 2012

Balance sheet as at 31 December 2011

	Assets	2011 €'000	2010 €'000
A 1	**Gold and gold receivables**	**10,347**	**3,713**
A 2	**Claims on non-euro area residents denominated in foreign currency**	**386,988**	**399,036**
A 2.1	Receivables from the IMF	161,973	146,723
A 2.2	Balances with banks and security investments, external loans and other external assets	225,015	252,313
A 3	**Claims on euro area residents denominated in foreign currency**	**276,681**	**250,804**
A 4	**Claims on non-euro area residents denominated in euro**	**182,251**	**104,620**
A 4.1	Balances with banks, security investments and loans	182,251	104,620
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**	**498,210**	**1,074,500**
A 5.1	Main refinancing operations	141,000	384,000
A 5.2	Longer-term refinancing operations	357,210	686,000
A 5.3	Fine-tuning reverse operations	-	4,500
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**	**15,207**	**554**
A 7	**Securities of euro area residents denominated in euro**	**1,367,673**	**1,056,271**
A 7.1	Securities held for monetary policy purposes	164,891	119,453
A 7.2	Other securities	1,202,782	936,818
A 8	**General government debt denominated in euro**	**-**	**-**
A 9	**Intra-Eurosystem claims**	**50,404**	**49,351**
A 9.1	Participating interest in ECB	13,997	12,944
A 9.2	Claims equivalent to the transfer of foreign reserves	36,407	36,407
A 9.3	Claims related to the issuance of ECB debt certificates *	-	-
A 9.4	Net claims related to the allocation of euro banknotes within the Eurosystem	-	-
A 9.5	Other claims within the Eurosystem (net)	-	-
A 10	**Items in course of settlement**	**14,314**	**6,632**
A 11	**Other assets**	**755,538**	**698,261**
A 11.1	Coins of euro area	99	189
A 11.2	Tangible and intangible fixed assets	19,919	19,924
A 11.3	Other financial assets	596,591	527,823
A 11.4	Off-balance sheet instruments revaluation differences	167	6,311
A 11.5	Accruals and prepaid expenses	45,873	38,429
A 11.6	Sundry	92,889	105,585
Total Assets		**3,557,613**	**3,643,742**

* Only an ECB balance sheet item

		2011	2010
	Liabilities	**€'000**	**€'000**
L 1	**Banknotes in circulation**	**737,561**	**701,151**
L 2	**Liabilities to euro area credit institutions related to monetary policy operations denominated in euro**	**1,101,141**	**501,197**
L 2.1	Current accounts (covering the minimum reserve system)	431,571	470,397
L 2.2	Deposit facility	668,644	30,800
L 2.3	Fixed-term deposits	-	-
L 2.4	Fine-tuning reverse operations	-	-
L 2.5	Deposits related to margin calls	926	-
L 3	**Other liabilities to euro area credit institutions denominated in euro**	**-**	**-**
L 4	**Debt certificates issued***	**-**	**-**
L 5	**Liabilities to other euro area residents denominated in euro**	**438,553**	**410,881**
L 5.1	General government	420,756	389,659
L 5.2	Other liabilities	17,797	21,222
L 6	**Liabilities to non-euro area residents denominated in euro**	**86,530**	**96,962**
L 7	**Liabilities to euro area residents denominated in foreign currency**	**122,511**	**96,523**
L 8	**Liabilities to non-euro area residents denominated in foreign currency**	**-**	**27**
L 8.1	Deposits, balances and other liabilities	-	27
L 8.2	Liabilities arising from the credit facility under ERM II	-	-
L 9	**Counterpart of special drawing rights allocated by the IMF**	**113,213**	**110,399**
L 10	**Intra-Eurosystem liabilities**	**557,872**	**1,329,739**
L 10.1	Liabilities equivalent to the transfer of foreign reserves*	-	-
L 10.2	Liabilities related to the issuance of ECB debt certificates	-	-
L 10.3	Net liabilities related to the allocation of euro banknotes within the Eurosystem	130,049	104,533
L 10.4	Other liabilities within the Eurosystem (net)	427,823	1,225,206
L 11	**Items in course of settlement**	**-**	**-**
L 12	**Other liabilities**	**61,148**	**68,164**
L 12.1	Off-balance sheet instruments revaluation differences	-	-
L 12.2	Accruals and income collected in advance	45,559	52,035
L 12.3	Sundry	15,589	16,129
L 13	**Provisions**	**847**	**1,970**
L 14	**Revaluation accounts**	**14,430**	**12,265**
L 15	**Capital and reserves**	**281,807**	**266,464**
L 15.1	Capital	20,000	20,000
L 15.2	Reserves	261,807	246,464
L 16	**Profit for the year**	**42,000**	**48,000**
Total Liabilities		**3,557,613**	**3,643,742**

* Only an ECB balance sheet item

Profit and Loss account for the year ended 31 December 2011

		2011	2010
		€'000	€'000
1.1	Interest income	92,203	71,573
1.2	Interest expense	(23,524)	(16,005)
1	**Net interest income**	**68,679**	**55,568**
2.1	Realised gains / (losses) arising from financial operations	7,474	11,688
2.2	Write-downs on financial assets and positions	(8,386)	(5,459)
2.3	Transfer (to) / from provisions for foreign exchange rate, interest rate, credit and gold price risks	-	-
2	**Net result of financial operations, write-downs and risk provisions**	**(912)**	**6,229**
3.1	Fees and commissions income	95	96
3.2	Fees and commissions expense	(588)	(559)
3	**Net income / (expense) from fees and commissions**	**(493)**	**(463)**
4	**Income from equity shares and participating interests**	**744**	**1,328**
5	**Net result of pooling of monetary income**	**(4,826)**	**(1,013)**
6	**Other income**	**3,982**	**12,158**
	Total net income	**67,174**	**73,807**
7	**Staff costs**	**(9,423)**	**(10,934)**
8	**Administrative expenses**	**(4,449)**	**(3,879)**
9	**Depreciation of tangible and intangible fixed assets**	**(639)**	**(1,067)**
10	**Banknote production services**	**(196)**	**(306)**
11	**Other expenses**	**(3)**	**(3)**
	Profit for the year	**52,464**	**57,618**
	Transfer to reserves for risks and contingencies	**(10,464)**	**(9,618)**
	Payable to the Government of Malta in terms of article 22(2) of the Central Bank of Malta Act (Cap. 204)	**42,000**	**48,000**

The financial statements on pages A-6 to A-41 were approved for issue by the Board of Directors on 26 March 2012 and were signed on its behalf by:

Professor Josef Bonnici Governor	Mr Alfred DeMarco Deputy Governor	Mr Raymond A. Bonnici Director Corporate Services	Mr Robert Caruana Financial Controller

Notes to the financial statements for the year ended 31 December 2011

General notes to the financial statements

1 The Eurosystem

As from 1 January 2008, the Central Bank of Malta (the Bank) became part of the Eurosystem and took over joint responsibility for monetary policy and for exercising the common strategic goals of the European System of Central Banks (ESCB).[1]

2 Basis of preparation

The Central Bank of Malta is required under article 21(5) of the Central Bank of Malta Act (Cap. 204) (the Act) to prepare its financial statements in accordance with the provisions established by the Governing Council of the European Central Bank (ECB) under Article 26.4 of the Statute of the European System of Central Banks and of the European Central Bank (the Statute). These provisions are outlined in the Guideline ECB/2010/20 of 11 November 2010 on the legal framework for accounting and financial reporting in the European System of Central Banks (recast), as amended[2] (Guideline ECB/2010/20 as amended). In the absence of requirements and guidance provided by Guideline ECB/2010/20 as amended, that specifically apply to transactions, other events or conditions, the requirements of International Financial Reporting Standards as adopted by the EU are applied.

These financial statements have been drawn up so as to give a true and fair view of the state of affairs of the Bank as at 31 December 2011 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.

3 Accounting policies

(a) Basic accounting principles

The accounting principles applied by the Eurosystem and the Bank in the preparation of these financial statements are:

- economic reality and transparency
- prudence
- post-balance sheet events
- materiality
- going concern
- accruals
- 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.

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[1] The ECB, together with NCBs, shall constitute the ESCB. The ECB together with the NCBs of the Member States whose currency is the euro, which constitute the Eurosystem, shall conduct the monetary policy of the Union, Article 282.1 of the Treaty of the Functioning of the European Union (TFEU). The Eurosystem and the ESCB will co-exist as long as there are EU Member States outside the euro area.

[2] Amended by Guideline ECB/2011/27 of 21 December 2011 OJ L19, 24.1.2012, p. 37.

(c) Recording of transactions

Foreign exchange transactions, comprising spot and forward deals in gold and foreign currencies, are recorded off-balance sheet on trade date at the prevailing spot exchange rate for ascertaining the average acquisition costs and the realised gains and losses. Accordingly, purchases and sales of foreign currency affect the net foreign currency position on the trade date and realised gains and losses arising from the net reduction in foreign currency positions are calculated on trade date. On-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. For the purpose of this accounting policy, holdings of SDR currency, including designated individual foreign exchange holdings underlying the SDR basket, shall be treated as one holding.

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.

(f) Income recognition

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

(i) Interest income and expense

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

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

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

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

In the case of foreign currency or gold positions, inflows and outflows are compared against each other to determine any realised gains or losses. The resulting net inflow or outflow, apart from changing the position in that currency, will give rise to 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, except as explained in accounting policy (h) (ii), are taken to the profit and loss account when they exceed previous unrealised gains registered in the corresponding revaluation account. Unrealised losses recorded in the profit and loss account in previous years are not reversed against new unrealised gains in subsequent years. Unrealised losses in any one security or in any foreign currency (including gold holdings) are not netted against unrealised gains in other securities or foreign currency.

(g) Off-balance sheet instruments

Spot and forward foreign exchange contracts 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

(i) Securities held for monetary policy purposes

Following the decisions of the Governing Council, the securities held for monetary policy purposes comprise euro-denominated covered bonds issued in the euro area and public and/or private debt under the Securities Markets Programme (SMP). These securities are valued at amortised cost subject to a Eurosystem impairment framework.

(ii) Securities held for other than monetary policy purposes

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

Marketable securities (other than those held-to-maturity) and similar assets are valued either at the mid-market prices or on the basis of the relevant yield curve prevailing at the balance sheet date, on a security by security basis. For the year ending 31 December 2011, mid-market prices at 30 December 2011 were used.

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 and Treasury bills 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' while 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 (SDR) 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 30 December 2011. 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 at the conversion rate of the Maltese lira for the euro of 0.4293 as established by Council Regulation (EC) No 1134/2007 of 10 July 2007 and without charge.

In accordance with article 62 of the Central Bank of Malta Act (Cap. 204), after the expiration of one year following the end of the period established in the notice, any unpresented demonetised Maltese lira currency notes cease to be included in the Bank's currency liabilities. The value of such notes, after deducting therefrom the value of any notes which are subsequently redeemed, shall be apportioned to the profits of the Bank over the remaining period until the expiration of the ten-year period which ended on 1 February 2010.

(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 of 0.4293 as established by Council Regulation (EC) No 1134/2007 of 10 July 2007 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, shall be apportioned to the profits of the Bank over the remaining period until the expiration of the two-year period which ended on 1 February 2010.

(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. The carrying amount of an asset is written down immediately to its recoverable amount if that carrying amount is greater than its estimated recoverable amount.

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

(o) Post-balance sheet events

The values of assets and liabilities are, in principle, adjusted for events that occur between the annual balance sheet date and the date of authorisation for issue of the financial statements, if such events materially affect the condition of assets and liabilities at the balance sheet date.

Post-balance sheet events that do not affect the condition of assets and liabilities at the balance sheet date are disclosed in the notes.

4 Capital key

The capital key determines the allocation of the ECB share capital to the national central banks (NCBs) on the basis of population and gross domestic product in equal share. It is adjusted every five years and 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 2011 was 0.0632% (2010: 0.0632%).

A second key, derived from the above capital key, is used as the basis for allocation of monetary income, banknotes in circulation and the ECB's financial results among the seventeen Eurosystem NCBs. In 2011, the Bank's share decreased to 0.0903% (2010: 0.0906%) following the accession of Eesti Pank into the Eurosystem.

5 Change to the capital key

On 1 January 2009, the ESCB experienced a quinquennial capital key change in accordance with Article 29.3 of the Statute with the Bank's share in the fully paid-up capital of the ECB increasing from 0.0622% to 0.0632% on that date. Also, as at the same date, the Eurosystem expanded due to the accession of Národná banka Slovenska. In 2010 there were no changes to the capital key. In 2011, the Eurosystem again expanded due to the accession of Eesti Pank, which did not have any effect on the capital key.

6 Banknotes in circulation

The ECB and the seventeen participating NCBs, which together comprise the Eurosystem, issue euro banknotes.[3,4] 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.[5]

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation, whereas the remaining 92% has been allocated to the NCBs according to their weightings in the capital key of the ECB. In the year under review, the Bank had a 0.0830% share (2010: 0.0835%) 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'.

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[6] at the main refinancing operations (MRO) 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[7] 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,[8] and the average value of banknotes which would have been allocated to it during that period in accordance with its capital key. The adjustments are reduced in annual stages until the first day of the sixth year after the cash changeover year, when income on banknotes will be allocated fully in proportion to the NCB's paid-up shares in the ECB's capital. The 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 under item 1 'Net interest income'.

7 Interim profit distribution

The Governing Council of the ECB has decided that the seigniorage income of the ECB, which arises from the 8% share of euro banknotes allocated to the ECB, and the ECB's (net) income arising from the SMP shall be due to the NCBs in the same financial year it accrues. The ECB distributes this income in January of the following year in the form of an interim distribution of profit.[9] The amount of the ECB's income on euro banknotes in circulation may be reduced in accordance with any decision by the Governing Council in respect of expenses incurred by the ECB in connection with the issue and handling of euro banknotes. Before the end of the year, the Governing Council decides whether all or part of the ECB's income arising

[3] ECB Decision of 13 December 2010 on the issue of euro banknotes (recast) (ECB/2010/29), OJ L35, 9.2.2011, p. 26.

[4] Eesti Pank has only participated in the Eurosystem since 2011.

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

[6] ECB Decision of 25 November 2010 on the allocation of monetary income of the NCBs of Member States whose currency is the euro (ECB/2010/23) (recast) OJ L35, 9.2.2011, p.17.

[7] Cash changeover year refers to the year in which the euro banknotes are introduced as legal tender in the respective Member State. For Malta, this was 1 January 2008.

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

[9] ECB Decision of 25 November 2010 on the interim distribution of the income of the ECB on euro banknotes in circulation and arising from securities purchased under the SMP (ECB/2010/24) OJ L6, 11.1.2011, p.35.

from SMP securities and, if necessary, all or part of the ECB's income on euro banknotes in circulation should be retained to the extent necessary to ensure that the amount of the distributed income does not exceed the ECB's net profit for that year. The Governing Council may also decide to transfer all or part of the ECB's income arising from SMP securities and if necessary, all or part of the ECB's seigniorage income to a provision for foreign exchange rate, interest rate, credit and gold price risks. 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 TARGET2 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 TARGET2. The resulting balance is included as an asset or liability, as appropriate, under the sub-items A9.5 'Other claims within the Eurosystem (net)' or L10.4 'Other liabilities within the Eurosystem (net)'.

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. On 31 December 2011, gold was revalued at €1,216.864 (2010: €1,055.418) per fine ounce. The resultant unrealised valuation gains of €993,288 (2010: €983,418) are disclosed under liability item L14 'Revaluation accounts'.

	€'000	Fine troy ounces
Balance as at 31 December 2010	3,713	3,518
Net transactions during the year	6,624	4,985
Increase in revaluation on 31 December 2011	10	
Balance as at 31 December 2011	**10,347**	**8,503**

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

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

	2011	2010	Change
	€'000	€'000	€'000
USD	**205,134**	218,214	(13,080)
JPY	**6**	34	(28)
GBP	**1,266**	31,027	(29,761)
XDR	**161,973**	146,723	15,250
Other	**18,609**	3,038	15,571
Total	**386,988**	399,036	(12,048)

A 2.1 Receivables from the IMF

	2011	2010	Change
	€'000	€'000	€'000
Reserve Tranche Position	**37,612**	24,113	13,499
SDR holdings	**107,629**	110,922	(3,293)
IMF Borrowing Agreement	**16,732**	11,688	5,044
Total	**161,973**	146,723	15,250

(a) IMF quota

Malta's membership subscription to the IMF amounts to SDR102 million (2010: SDR102 million). The Bank's financial position relating to this subscription at 31 December 2011 is reflected in the balance sheet as follows:

(i) Reserve Tranche Position included in the above table is equivalent to SDR31,694,400 (2010: SDR20,837,120). 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. During the period under review, Malta's reserve tranche increased by SDR10,857,280 due to net lending under IMF lending arrangements.

(ii) Currency Subscription included within asset sub-item A11.6 'Sundry assets' is stated at €83,420,465 (2010: €94,121,796) and represents the balance of the quota 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 €83,420,465 or SDR70,305,600 (2010: €94,121,796 or SDR81,162,880).

On 15 December 2010, the Board of Governors of the IMF adopted Resolution No. 66-2 on the 14th General Review of Quotas which proposes increases in the quotas of all 187 IMF members. Each member shall pay the IMF the increase in its quota within 30 days of the later of its consent or the date on which the requirements for the effectiveness of the increase in quota are met. Malta consented to this quota increase on 29 December 2011. However, as at the date of authorisation of the financial statements, no notification from the IMF has been received of the effectiveness of the increase in quota.

Malta's quota will increase by SDR66.3 million to SDR168.3 million. Twenty-five per cent of the quota increase amounting to SDR16.6 million will be paid in reserve assets, either in SDRs or in the currencies specified by the IMF. The remaining seventy-five per cent will be credited to the IMF No. 1 account, held with Bank, with a corresponding entry in the Currency Subscription account (see (ii) above).

(b) Malta's SDR position in the IMF

In November 2009, the Bank entered into a two-way voluntary trading arrangement with the IMF. Under this arrangement the Bank stands ready to buy and sell SDRs against euro, subject to certain limits, in transactions that the Fund arranges between prospective buyers and sellers of SDRs. There were three transactions in 2011 under this arrangement whereby the Bank sold a total of SDR5.3 million (2010: Nil). Malta's SDR holdings, including interest thereon, stood at SDR90,695,608 (2010: SDR95,853,968).

The total SDR allocated to Malta remained unchanged from 2010 at SDR95,401,757 to which a corresponding liability exists in the form of a restricted demand deposit of the Government of Malta included under liability item L9 'Counterpart of special drawing rights allocated by the IMF' together with other SDRs acquired in accordance with IMF requirements and procedures. SDRs allocated to Malta cannot be withdrawn unless such advice is received from the Fund.

(c) IMF interest on the SDR position

The Reserve Tranche Position, SDR holdings and the SDR allocation are subject to SDR interest rates quoted by the Fund on a weekly basis. The Currency Subscription and IMF current accounts are not subject to interest.

(d) Bilateral Borrowing Agreement

In February 2010, the IMF and the Bank signed an agreement to provide the Fund with an SDR denominated amount up to the equivalent of €120 million, as part of a commitment made by the EU in 2009 to support the IMF's lending capacity. The total term of this interest-bearing agreement shall not exceed four years. As at 31 December 2011, the amount utilised under this facility stood at €16.7 million (SDR14.1 million), an increase of €5 million (SDR4 million) over the previous year.

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.

	2011	2010	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**177,578**	177,084	494
Balances with banks			
Fixed-term deposits	**38,624**	70,155	(31,531)
Current accounts and overnight deposits	**8,094**	4,637	3,457
Other external assets	**719**	437	282
Total	**225,015**	252,313	(27,298)

A 3 Claims on euro area residents denominated in foreign currency

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

	2011	2010	Change
	€'000	€'000	€'000
USD	**234,265**	244,005	(9,740)
GBP	**42,416**	23	42,393
Other	**-**	6,776	(6,776)
Total	**276,681**	250,804	25,877

The short-term US dollar liquidity-providing programme (Term Auction Facility) was not availed of in 2011 (2010: nil). Under this programme, US dollars are provided by the Federal Reserve to the ECB by means of a temporary swap line with the aim of offering short-term US dollar funding to Eurosystem counterparties. The ECB simultaneously enters into back-to-back swap transactions with NCBs that have adopted the euro, which use 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 result in intra-Eurosystem balances reported under liability sub-item L10.4 'Other liabilities within the Eurosystem (net)'.

	2011	2010	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**100,224**	109,176	(8,952)
Balances with banks			
Fixed-term deposits	**176,393**	141,560	34,833
Current accounts and overnight deposits	**64**	68	(4)
Total	**276,681**	250,804	25,877

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.

	2011	2010	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**106,443**	83,198	23,245
Held-to-maturity debt securities	**75,535**	21,144	54,391
Current accounts and overnight deposits	**273**	278	(5)
Total	**182,251**	104,620	77,631

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

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

The total Eurosystem holding of monetary policy assets amounts to €863,568 million (2010: €546,747 million) of which the Bank holds €498 million (2010: €1,075 million). In accordance with Article 32.4 of the Statute, any risks from monetary policy operations, if they were to materialise, should eventually be shared in full by the Eurosystem NCBs, in proportion to the prevailing ECB capital key shares.

A 5.1 Main refinancing operations

Main refinancing operations (MROs) 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.[10] All counterparties that fulfil the general eligibility criteria may submit bids within a specified timeframe. Participation in MROs requires the availability of eligible collateral.

During 2011, all MROs were conducted at a fixed rate tender procedure with full allotment. The aggregate MROs carried out with the Bank during the year amounted to €16,519.8 million (2010: €18,252.3 million). The outstanding operations at the end of the year amounted to €141 million (2010: €384 million).

The following table highlights the changes in the MRO rate during 2011 as decided by the Governing Council (2010: 1% throughout):

With effect from:	Changes in basis points (bps)	Effective rate (%)
1 January		1.00
13 April	+25 bps	1.25
13 July	+25 bps	1.50
9 November	-25 bps	1.25
14 December	-25 bps	1.00

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

A 5.2 Longer-term refinancing operations

Longer-term refinancing operations (LTROs) are regular liquidity-providing reverse transactions carried out in the form of variable or fixed rate tender procedure, with a monthly frequency and a maturity of three months. These operations aim to provide counterparties with additional longer-term refinancing. Participation in LTROs requires the availability of eligible collateral.

During the year, the 3-month LTROs were conducted at fixed rate tender procedures with full allotment, with the rate fixed at the average rate of the MROs over the life of the respective operation. Moreover, the maintenance period operations that are conducted on the last day of the reserve maintenance period remained in operation.

Furthermore, during the year, the ECB conducted a 6-month and a 12-month LTRO, both at fixed rate tender procedure with full allotment, with the rate fixed at the average rate of the MROs over the life of the respective operation.

The ECB also announced a 36-month LTRO with the option of early repayment after one year. The operation was conducted at fixed rate procedure with full allotment, with the rate fixed at the average rate of the MROs over the life of the respective operation. Moreover, counterparties had the possibility to shift all of the outstanding amounts received in the 12-month LTRO into the 36-month LTRO.

The aggregate LTROs carried out during 2011 amounted to €2,252.8 million[11] (2010: €1,145.7 million), while outstanding LTROs at the end of the year amounted to €357.2 million (2010: €686 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 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. Participation in liquidity-providing reverse operations would only be allowed against eligible collateral.

During 2011, the ECB conducted one liquidity-providing fine-tuning reverse operation. The aggregate fine-tuning reverse operations with the Bank carried out during the year amounted to €1 million (2010: €384.5 million). There were no outstanding liquidity-providing reverse operations at end of the year (2010: €4.5 million).

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 2011 (2010: nil).

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 2011, the aggregate volume of such transactions with the Bank amounted to €662 million (2010: €686.1 million). There were no outstanding balances as at 31 December 2011 (2010: nil).

[11] This amount includes the shift from the 12-month to the 36-month LTRO.

The following table highlights the changes in the marginal lending facility rate during 2011 as decided by the Governing Council (2010: 1.75% throughout):

With effect from:	Changes in basis points (bps)	Effective rate (%)
1 January		1.75
13 April	+25 bps	2.00
13 July	+25 bps	2.25
9 November	-25 bps	2.00
14 December	-25 bps	1.75

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.

	2011	2010	Change
	€'000	€'000	€'000
Fixed-term deposits	**15,000**	-	15,000
Current accounts and overnight deposits	**207**	205	2
Other claims	**-**	349	(349)
Total	**15,207**	554	14,653

A 7 Securities of euro area residents denominated in euro

A 7.1 Securities held for monetary policy purposes

This item contains securities acquired by the NCBs within the scope of the covered bond purchase programmes (CBPP)[12] and the SMP.[13] These securities are classified as held-to-maturity and reported on an amortised cost basis subject to impairment. (See note 3 (h) (i) 'Securities held for monetary policy purposes' in the general notes to the financial statements). Annual impairment tests are conducted on the basis of the information available and recoverable amounts estimated as at the reporting date. The Bank decided to participate in the SMP only.

Under the SMP, established in May 2010, the ECB and the NCBs may purchase euro area public and private debt securities in order to address the malfunctioning of certain segments of the euro area debt securities markets and to restore the proper functioning of the monetary policy transmission mechanism.

[12] ECB Decision of 2 July 2009 on the implementation of the CBPP (ECB/2009/16), OJ L 175, 4.7.2009, p. 18 and ECB Decision of 3 November 2011 on the implementation of the second CBPP (ECB/2011/17) 16.11.2011, p. 70.
[13] ECB Decision of 14 May 2010 establishing a SMP (ECB/2010/5), OJ L 124, 20.5.2010, p. 8.

The total Eurosystem NCBs' holding of SMP securities amounts to €194,199 million, of which the Bank holds €165 million. In accordance with Article 32.4 of the Statute, any risks from holdings of SMP securities, if they were to materialise, should eventually be shared in full by the Eurosystem NCBs, in proportion to the prevailing ECB capital key shares. The net increase of €46 million in 2011 was due to further purchases that more than offset the redemptions in 2011.

In the context of an impairment test conducted as at 31 December 2011, the Governing Council of the ECB considered the launch in 2011 of the so called Private Sector Involvement (PSI) initiative, proposing a restructuring of part of the debt issued by the Hellenic Republic, to secure debt sustainability in the long term. Part of the Bank's holdings under the SMP has been issued by the Hellenic Republic. However, given that the PSI was designed as to voluntarily restructure debt held by the private sector no changes were expected to all future contractual cash flows associated with the Bank's holdings on these securities. As at 31 December 2011, the Governing Council of the ECB considered that there was no evidence to assume that the PSI initiative was not going to be successfully implemented and therefore no impairment losses were recorded at year end.

In relation to the other securities purchased under the SMP no impairment was recorded.

The Governing Council of the ECB assesses on a regular basis the financial risks associated with the securities held under the SMP and CBPP portfolios.

Post-balance sheet events
In February 2012 the Eurosystem NCBs exchanged their holdings of Greek government bonds purchased under the SMP for new securities issued by the Hellenic Republic. The newly acquired securities have the same characteristics as those purchased under the SMP in terms of their nominal values, coupon rates, interest payment dates and redemption dates. The new securities were not included in the list of eligible securities that were subject to restructuring in the context of the PSI initiative.

A 7.2 Other securities

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

	2011	2010	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**403,869**	365,423	38,446
Held-to-maturity debt securities	**798,913**	571,395	227,518
Total	**1,202,782**	936,818	265,964

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

In accordance with the legal acts adopted by the Governing Council on the increase of the subscribed capital of the ECB on 29 December 2010 and the pay-up of the increase via three instalments[14], the Bank has paid up an additional €1,053,333 representing the second instalment of its contribution to the increase in the capital of the ECB. As a result, the subscribed and paid-up capital of the NCBs is as follows:

	Subscribed capital since 29 December 2010	Paid-up capital on 31 December 2010	Paid-up capital as at 1 January 2011	Paid-up capital since 28 December 2011
Nationale Bank van België / Banque Nationale de Belgique	261,010,385	180,157,051	180,157,051	220,583,718
Deutsche Bundesbank	2,037,777,027	1,406,533,694	1,406,533,694	1,722,155,361
Eesti Pank	19,261,568	722,309	13,294,901	16,278,234
Central Bank of Ireland	119,518,566	82,495,233	82,495,233	101,006,900
Bank of Greece	211,436,059	145,939,392	145,939,392	178,687,726
Banco de España	893,564,576	616,764,576	616,764,576	755,164,576
Banque de France	1,530,293,900	1,056,253,900	1,056,253,900	1,293,273,900
Banca d'Italia	1,344,715,688	928,162,355	928,162,355	1,136,439,021
Central Bank of Cyprus	14,731,333	10,168,000	10,168,000	12,449,666
Banque centrale du Luxembourg	18,798,860	12,975,526	12,975,526	15,887,193
Central Bank of Malta / Bank Ċentrali ta' Malta	6,800,732	4,694,066	4,694,066	5,747,399
De Nederlandsche Bank	429,156,339	296,216,339	296,216,339	362,686,339
Oesterreichische Nationalbank	208,939,588	144,216,254	144,216,254	176,577,921
Banco de Portugal	188,354,459	130,007,793	130,007,793	159,181,126
Banka Slovenije	35,381,025	24,421,025	24,421,025	29,901,025
Národná banka Slovenska	74,614,364	51,501,030	51,501,030	63,057,697
Suomen Pankki-Finlands Bank	134,927,820	93,131,154	93,131,154	114,029,487
Subtotal for euro area NCBs	**7,529,282,289**	**5,184,359,697**	**5,196,932,289**	**6,363,107,289**
Bulgarian National Bank	93,467,027	3,505,013	3,505,013	3,505,013
Česká národní banka	155,728,161	5,839,806	5,839,806	5,839,806
Danmarks Nationalbank	159,634,278	5,986,285	5,986,285	5,986,285
Latvijas Banka	30,527,971	1,144,800	1,144,800	1,144,800
Lietuvos bankas	45,797,337	1,717,400	1,717,400	1,717,400
Magyar Nemzeti Bank	149,099,600	5,591,235	5,591,235	5,591,235
Narodowy Bank Polski	526,776,978	19,754,137	19,754,137	19,754,137
Banca Naţională a României	265,196,278	9,944,860	9,944,860	9,944,860
Sveriges Riksbank	242,997,052	9,112,389	9,112,389	9,112,389
Bank of England	1,562,145,431	58,580,454	58,580,454	58,580,454
Subtotal for non-euro area NCBs	**3,231,370,113**	**121,176,379**	**121,176,379**	**121,176,379**
Total	**10,760,652,402**	**5,305,536,076**	**5,318,108,668**	**6,484,283,668**

In 2011, there were no contributions to the ECB reserves and provisions and as at the year end the balances stood at €5,772,319 and €2,477,252 respectively.

[14] Decision ECB/2010/26 of 13 December 2010 on the increase of the ECB's capital, OJ L 11, 15.1.2011, p. 53; Decision ECB/2010/27 of 13 December 2010 on the paying-up of the increase of the ECB's capital by the national central banks of Member States whose currency is the euro, OJ L 11, 15.1.2011, p. 54, Decision ECB/2010/34 of 31 December 2010 on the paying-up of capital, transfer of foreign reserve assets and contributions by Eesti Pank to the ECB's reserves and provisions, OJ L 11, 15.1.2011, p. 58; Agreement of 31 December 2010 between Eesti Pank and the ECB regarding the claim credited to Eesti Pank by the ECB under Article 30.3 of the Statute of the ESCB and of the ECB, OJ C 12, 15.1.2011, p. 6.

A 9.2 Claims equivalent to the transfer of foreign reserves

This asset which represents 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 remained unchanged at €36,407,323. The claims are denominated in euro fixed at the time they were transferred and are remunerated at the latest available marginal rate for the Eurosystem main refinancing operations, adjusted to reflect a zero return on the gold component.

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

This sub-item reflects claims which would arise from application of the banknote allocation key (see note 6 'Banknotes in circulation' in the general notes to the financial statements). As at 31 December 2011, 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' (2010: nil).

A 9.5 Other claims within the Eurosystem (net)

As at 31 December 2011, the Bank's claims were netted off from liability sub-item L10.4 'Other liabilities within the Eurosystem (net)' (2010: nil).

A 10 Items in course of settlement

These assets comprise transactions 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	Computer equipment and other assets	Total
	€'000	€'000	€'000
Cost			
As at 31 December 2010	22,885	4,029	26,914
Additions	167	467	634
As at 31 December 2011	**23,052**	**4,496**	**27,548**
Accumulated depreciation			
As at 31 December 2010	3,643	3,347	6,990
Charge for the year	196	443	639
As at 31 December 2011	**3,839**	**3,790**	**7,629**
Net book value			
As at 31 December 2010	19,242	682	19,924
As at 31 December 2011	**19,213**	**706**	**19,919**

The table above includes an amount of €248,173 (2010: nil) related to assets not yet available for use.

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 2011, 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 Malta Government securities and Treasury bills purchased on the secondary market by the Bank in its role as market maker.

	2011	2010	Change
	€'000	€'000	€'000
Malta Government stocks	**341,432**	272,562	68,870
Malta Government Treasury bills	**2,472**	2,100	372
Held-to-maturity debt securities	**252,687**	253,161	(474)
Total	**596,591**	527,823	68,768

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. Malta Government Treasury bills, which are also 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 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 2011. At year end, these unrealised gains amounted to €167,016 (2010: €6,310,771).

A 11.5 Accruals and prepaid expenses

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

	2011	2010	Change
	€'000	€'000	€'000
Accrued interest income	**45,839**	38,387	7,452
Prepaid expenditure	**34**	42	(8)
Total	**45,873**	38,429	7,444

Accrued interest income at 31 December 2011, includes an amount of €1,458,078 (2010: €1,381,868) attributable to interest on intra-Eurosystem claims.

A 11.6 Sundry

Sundry assets consist of IMF Currency Subscription and other assets.

	2011	2010	Change
	€'000	€'000	€'000
IMF Currency Subscription (see note A2.1)	**83,420**	94,122	(10,702)
Other	**9,469**	11,463	(1,994)
Total	**92,889**	105,585	(12,696)

Liabilities

L 1 Banknotes in circulation

In accordance with the banknote allocation key applicable on 31 December 2011, the Bank has a 0.0830% share (2010: 0.0835%) of the value of all euro banknotes in circulation (see note 6 'Banknotes in circulation' in the general notes to the financial statements). During the year ended 31 December 2011, the total value of banknotes in circulation within the Eurosystem increased from €839,702 million to €888,628 million. In accordance with the banknote allocation key, the Bank disclosed holdings of euro banknotes amounting to €737,561,240 at the end of the year (2010: €701,151,170). The value of the euro banknotes actually issued by the Bank as at that date was €867,610,170 (2010: €805,684,425). As this amount exceeded the allocated amount, the difference of €130,048,930 (2010: €104,533,255) is presented in liability sub-item L10.3 'Net liabilities related to the allocation of euro banknotes within the Eurosystem'.

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

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

	2011	2010	Change
	€'000	€'000	€'000
Current accounts			
(covering the minimum reserve system)	**431,571**	470,397	(38,826)
Deposit facility	**668,644**	30,800	637,844
Credit related to margin calls	**926**	-	926
Total	**1,101,141**	501,197	599,944

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. The 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.

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 2011, the aggregate volume of such transactions with the Bank amounted to €81,806.3 million (2010: €49,344.3 million). The outstanding balance as at year end amounted to €668.6 million (2010: €30.8 million).

The following table highlights the changes in the interest rate on the overnight deposit facility during 2011 as decided by the Governing Council of the ECB:

With effect from:	Changes in basis points (bps)	Effective rate (%)
1 January		0.25
13 April	+25 bps	0.50
13 July	+25 bps	0.75
9 November	-25 bps	0.50
14 December	-25 bps	0.25

L 2.3 Fixed-term deposits

These liabilities relate to liquidity-absorbing fine-tuning operations for a fixed-term at variable rate tender. During 2011, the aggregate volume of such transactions with the Bank amounted to €1,578 million (2010: €1,010 million). There were no outstanding fixed-term deposits at the balance sheet date (2010: nil).

In line with the SMP, weekly 7-day liquidity-absorbing operations were conducted with an intended volume covering the amount of securities purchased in the previous week. The aggregate volume of such transactions with the Bank amounted to €138.2 million. There were no outstanding operations as at the year end (2010: nil).

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 2011 (2010: nil).

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. Deposits related to margin calls were used by counterparties during 2011, on those instances where their respective pool of collateral fell below the mentioned trigger level. The balance as at end of 2011 amounted to €0.9 million (2010: nil).

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.

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 MRO rate.

	2011	2010	Change
	€'000	€'000	€'000
Current accounts	**271,704**	232,886	38,818
Sinking fund accounts	**149,052**	156,773	(7,721)
Total	**420,756**	389,659	31,097

L 5.2 Other liabilities

Current accounts and fixed-term deposits denominated in euro by Maltese public sector corporations are included within this item. Current accounts are repayable on demand and subject to variable interest rates linked to the ECB's MRO rate. Fixed-term deposits are subject to fixed interest rates.

L 6 Liabilities to non-euro area residents denominated in euro

This item includes balances denominated in euro held by international and supranational organisations and by non-Eurosystem central banks, including the IMF current accounts. These liabilities are principally non-interest bearing.

	2011	2010	Change
	€'000	€'000	€'000
IMF current accounts (see note A2.1)	**83,420**	94,122	(10,702)
Others	**3,110**	2,840	270
Total	**86,530**	96,962	(10,432)

L 7 Liabilities to euro area residents denominated in foreign currency

Balances held by the Government of Malta which are repayable on demand and other customer deposits are included in this item. These balances are principally subject to floating interest rates based on weekly average rates applied to call funds.

	2011	2010	Change
	€'000	€'000	€'000
Government of Malta			
Current accounts	**105,657**	74,847	30,810
Sinking fund accounts	**3,745**	3,810	(65)
Other customers			
Current accounts and fixed-term deposits	**13,109**	17,866	(4,757)
Total	**122,511**	96,523	25,988

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 item represents the Bank's liabilities to the ECB and to the other Eurosystem NCBs.

L 10.3 Net liabilities related to the allocation of euro banknotes within the Eurosystem

This 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 MRO rate, taking cognisance of the adjustments referred to in note 6 'Banknotes in circulation' in the general notes to the financial statements in the cash changeover year and in the subsequent five years.

	2011	2010	Change
	€'000	€'000	€'000
Issued banknotes	**867,610**	805,684	61,926
Banknotes allocated as per banknote allocation key	**(737,561)**	(701,151)	(36,410)
Excess of issued banknotes over allocation	**130,049**	104,533	25,516

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. 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.

	2011	2010	Change
	€'000	€'000	€'000
TARGET2 balance	**422,463**	1,222,583	(800,120)
Net result from pooling of monetary income	**5,949**	2,623	3,326
Seigniorage income receivable	**(589)**	-	(589)
Total	**427,823**	1,225,206	(797,383)

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 2011. At year end, there were no unrealised losses (2010: nil).

L 12.2 Accruals and income collected in advance

These liabilities include accrued interest expense on interest-bearing liabilities and other accrued expenses. Also included is the balance of demonetised Maltese lira currency notes which have not yet been presented or recognised in the profit and loss account. This amount is recognised as deferred income until the final date when such currency notes cease to be exchangeable at the Bank.

	2011	2010	Change
	€'000	€'000	€'000
Accrued interest payable	**1,109**	1,299	(190)
Deferred income in respect of demonetised Maltese Lira currency notes	**43,676**	49,894	(6,218)
Other	**774**	842	(68)
Total	**45,559**	52,035	(6,476)

Accrued interest expense at 31 December 2011 includes an amount of €730,129 (2010: €981,217) attributable to interest on intra-Eurosystem liabilities.

L 12.3 Sundry

Sundry liabilities include unrealised revaluation gains attributable to Malta Government stocks held as part of an earmarked portfolio amounting to €5,166,436 (2010: €5,947,335). These liabilities also comprise realised losses attributable to off-balance sheet positions, principally forward foreign exchange contracts outstanding at year end, which are offset by realised profits arising from on-balance sheet positions. The net result is disclosed within note 2.1 'Realised gains / losses arising from financial operations' to the profit and loss account. This item also includes the provision in respect of the *ad hoc* voluntary severance scheme created in 2010. The outstanding balance of €304,606 (2010: €1,310,841) was fully utilised by the date of authorisation of the financial statements.

L 13 Provisions

In accordance with Article 32.4 of the Statute, the provision against counterparty risks in monetary policy operations is allocated among the NCBs of participating Member States in proportion to their subscribed capital key, prevailing in the year when the defaults have occurred. In accordance with the general accounting principle of prudence, the Governing Council has reviewed the appropriateness of the volume of this provision and decided to reduce the provision from a total amount of €2,207 million as at 31 December 2010 to an amount of €949 million as at 31 December 2011. The Bank's share in this provision amounts to €846,888 (2010: €1,969,527).

The respective adjustments are reflected in the NCBs' profit and loss accounts. In the case of the Bank, the resulting income amounted to €1,122,639 (2010: €1,609,890) (see note 5 'Net result of pooling of monetary income' to the profit and loss account).

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.

	2011	2010	Change
	€'000	€'000	€'000
Gold	**993**	983	10
Securities	**13,108**	11,166	1,942
Foreign currency positions	**329**	116	213
Total	**14,430**	12,265	2,165

L 15 Capital and reserves

The following table analyses the movement in capital and reserves of the Bank:

	Capital €'000	General reserve fund €'000	Reserves for risks and contingencies €'000	Capital contribution €'000
Balance as at 31 December 2010	20,000	75,505	130,002	40,957
Net issuance of euro coins	-	-	-	4,879
Transfer from profits for the year			10,464	
Balance as at 31 December 2011	**20,000**	**75,505**	**140,466**	**45,836**

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(1) of the Central Bank of Malta Act (Cap. 204) to cover the broad range of risks to which the Bank is exposed. The major risks in this regard arise from potential movements in market values of the Bank's holdings of domestic and foreign securities and other investments, losses which could arise from support of the financial system in the Bank's role as a lender of last resort, and other non-insured losses.

(c) Capital contribution

This reserve represents the capital contribution made by the Government of Malta to the Bank in respect of the agency agreement between the Bank and the Government relating to the issuance of euro coins. The Bank shall act as agent of the Government and shall retain full responsibility for procurement, storage and issuance of euro coins. This reserve represents seigniorage revenue arising from the issue of euro coins. In terms of the agency agreement, the Government has agreed not to withdraw such revenue and retain these amounts in a reserve account held at the Bank. Allocation of revenue to the reserve account shall be deemed as a capital contribution to the Bank by the Government.

Notes to the profit and loss account

1 Net interest income

This item represents the net result of interest income and interest expense.

1.1 Interest income

Interest income includes income on foreign reserve assets and euro-denominated portfolios, as well as interest income on intra-Eurosystem claims and monetary policy instruments.

	2011	2010	Change
	€'000	€'000	€'000
Marketable debt securities			
- In euro	**58,258**	43,314	14,944
- In foreign currency	**4,124**	5,978	(1,854)
Fixed-term deposits			
- In euro	**285**	-	285
- In foreign currency	**1,682**	1,108	574
Current accounts and overnight deposits			
- In euro	**3**	-	3
- In foreign currency	**5**	31	(26)
IMF	**160**	81	79
Monetary policy operations			
- Main refinancing operations	**4,037**	3,551	486
- Longer-term refinancing operations	**7,655**	9,028	(1,373)
- Fine-tuning reverse operations	**1**	65	(64)
- Marginal lending facility	**46**	39	7
- Securities Markets Programme	**10,630**	4,294	6,336
Intra-Eurosystem claims			
- Claims arising from the transfer of foreign reserves	**392**	314	78
- Net claims related to the allocation of banknotes within the Eurosystem	**2,454**	3,118	(664)
- TARGET2 balances	**-**	-	-
Forward foreign exchange contracts	**2,353**	545	1,808
Other interest income	**118**	107	11
Total	**92,203**	71,573	20,630

Income from 'Net claims related to the allocation of banknotes within the Eurosystem' principally comprises 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). The adjustments are reduced in annual stages until the first day of the sixth year after the cash changeover year. The Bank's adjustment period started on 1 January 2008 and will end on 31 December 2013. This item also includes net interest payment 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, intra-Eurosystem liabilities as well as liabilities to euro area credit institutions related to monetary policy operations.

	2011	2010	Change
	€'000	€'000	€'000
Government accounts			
- In euro	**2,976**	2,044	932
- In foreign currency	**322**	132	190
Other customer accounts			
- In euro	**169**	13	156
- In foreign currency	**27**	22	5
Monetary policy operations			
- Minimum reserves	**5,711**	4,816	895
- Overnight deposits	**2,008**	492	1,516
- Fixed-term deposits	**80**	42	38
- Deposits related to margin calls	**21**	8	13
Intra-Eurosystem liabilities			
- TARGET2 balances	**12,113**	8,332	3,781
Other interest expense	**97**	104	(7)
Total	**23,524**	16,005	7,519

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 debt securities.

	2011	2010	Change
	€'000	€'000	€'000
Net gains / (losses) on disposal of financial instruments	**5,895**	7,183	(1,288)
Net gains / (losses) on foreign currency positions	**1,579**	4,505	(2,926)
Total	**7,474**	11,688	(4,214)

2.2 Write-downs on financial assets and positions

This item comprises unrealised revaluation losses arising from the price revaluation of debt securities and the exchange rate revaluation of foreign currency assets and liabilities, including off-balance sheet positions, by comparing the market value at balance sheet date with the average book value.

	2011	2010	Change
	€'000	€'000	€'000
Write-downs on debt securities	**8,381**	5,442	2,939
Write-downs on foreign currency positions	**5**	17	(12)
Total	**8,386**	5,459	2,927

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

During 2011, the Bank received seigniorage income of €588,911 (2010: nil) and €154,697 (2010: €1,327,569) representing its relative share of the ECB's distributable profits for 2010 in proportion to the Bank's subscribed capital key (see note 4 'Capital key' in the general notes to the financial statements).

In 2011 the ECB's entire income on SMP securities amounting to €1,003 million and part of the seigniorage income was retained by the ECB in accordance with a decision of the Governing Council dated 12 January 2012 in order to fund the increase in the ECB provision for foreign exchange rate, interest rate, credit and gold price risks to its maximum allowable level. In 2010, the ECB's seigniorage income and income on SMP securities amounting to €1,091 million was fully retained by the ECB in accordance with a decision of the Governing Council dated 16 December 2010 in order to fund the increase of the above mentioned provision to its maximum allowable level.

5 Net result of pooling of monetary income

This item contains the net result of pooling of monetary income for 2011 amounting to an expense of €5,948,645 (2010: €2,622,592); and the Bank's share of the net result from the decrease in the provision against counterparty risks in monetary policy operations of the Eurosystem of €1,122,639 (2010: €1,609,890) (see note L13 'Provisions' in the notes to the balance sheet). The net expenditure shown in this item amounted to €4,826,006 (2010: €1,012,702) .

The amount of each Eurosystem NCB's monetary income is determined by measuring the actual annual income that is derived from the earmarkable assets held against the liability base. The liability base consists 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; securities held for monetary policy purposes; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET2 transactions; net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem; and a limited amount of each NCB's gold holdings in proportion to each NCB's capital key. Gold is considered to generate no income.

Where the value of an NCB's earmarkable assets exceeds or falls short of the value of the liability base, the difference shall be offset by applying to the value of the difference the latest applicable marginal rate for the Eurosystem main refinancing operations.

The monetary income pooled by the Eurosystem is allocated among NCBs in relation to the subscribed capital key. The net result arising from the calculation of monetary income is a payment by the Bank which is the difference between the monetary income pooled amounting to €20,153,207 (2010: €12,025,705) and the amount redistributed of €14,168,090 (2010: €9,472,568). An income of €36,472, being an adjustment for previous years' payments, was received as against a payment of €69,455 in 2010.

6 Other income

Other income includes an amount of €3 million, relating to the balance of unredeemed Maltese lira 5th series currency notes, which as at 31 December 2011 amounted to €46,675,865 (2010: €49,894,300). These currency notes will still be exchangeable at the Bank until 31 January 2018. The value of unredeemed currency notes, after deducting therefrom the amount of currency notes which are expected to be redeemed until that date, is apportioned as income in the profit and loss account over the remaining period until 31 January 2018. This accounting treatment is in accordance with the provisions of article 62(3) of the Central Bank of Malta Act (Cap. 204) (see note 3(l) 'Demonetised Maltese lira currency notes' in the general notes to the financial statements). In 2010 this item included an amount of €6.9 million and €2.3 million relating to the balance of unredeemed Maltese coins and demonetised Lm10 4th series currency notes which ceased to be exchangeable at the Bank subsequent to 1 February 2010 and 13th September 2010 respectively. This item also includes income from numismatic issues of coins.

7 Staff costs

Staff costs include salaries and other ancillary costs.

	2011	2010	Change
	€'000	€'000	€'000
Staff salaries	**7,773**	7,857	(84)
Other staff costs	**852**	2,324	(1,472)
Training, welfare and other related expenditure	**798**	753	45
Total	**9,423**	10,934	(1,511)

In 2011, there was no further recognition (2010: €1,310,841) of termination benefits under the *ad hoc* voluntary severance scheme launched during 2010 as part of the Bank's restructuring programme.

The full-time equivalent average number of staff employed by the bank during the year was as follows:

	2011	2010	Change
	Number	Number	Number
Governors	**2**	2	-
Divisional Directors	**5**	4	1
Heads and executives	**85**	89	(4)
Supervisory and clerical staff	**174**	180	(6)
Non-clerical staff	**34**	34	-
Total	**300**	309	(9)

8 Administrative expenses

This item consists of operating expenditure incurred by the Bank.

	2011	2010	Change
	€'000	€'000	€'000
Market information and communication expenses	**582**	527	55
Other administrative expenditure	**3,867**	3,352	515
Total	**4,449**	3,879	570

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, inclusive of VAT, for the current financial year amounted to €74,000 (2010: €71,500).

Compensation to the members of the Board of Directors for the financial year under review amounted to €179,966 (2010: €221,648). The Governor is entitled to such benefits as the use of a leased motor vehicle, health insurance cover and refund of certain other expenses. The Deputy Governor and other members of the Board of Directors are entitled to health insurance cover and the refund of certain other expenses.

9 Depreciation of tangible and intangible fixed assets

Depreciation of buildings, equipment, computer hardware and software was charged to the Bank's profit and loss account according to the depreciation rates disclosed in note 3(m) 'Tangible and intangible fixed assets' in the general notes to the financial statements.

10 Banknote production services

This item includes expenditure relating to the procurement and transportation of euro banknotes and other ancillary costs. Accrued expenditure also reflects the expected costs attributable to the consumption of banknotes issued.

Other notes

(a) Off-balance sheet instruments

At the balance sheet date, the principal outstanding off-balance sheet instruments consisted of forward foreign exchange contracts with a notional amount of €376,250,000 (2010: €408,065,000) involving the forward deals of euro against the forward purchase or sale of other currencies.

(b) Contingent liabilities and commitments

	2011	2010	Change
	€'000	€'000	€'000
Contingent liabilities			
Guarantees and letters of credit	**2,063**	2,563	(500)
Financial commitments			
Repayment of foreign loans on behalf of the Government	**1,447**	3,434	(1,987)
Total	**3,510**	5,997	(2,487)

The Bank's customers with respect to guarantees and letters of credit are mainly public sector corporations, government departments and other entities owned by the Government.

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

The Bank also has commitments in respect of tangible / intangible fixed assets and recurrent expenditure which extend beyond the balance sheet date. Capital commitments, which are spread over a number of years, amount to €9.2 million.

(c) Transactions with Government

In the course of its operations, the Bank conducts banking transactions with, and provides several banking services to, the Government of Malta, government departments, public sector corporations and other entities owned by the Government. The Bank holds the principal accounts of the Government and maintains accounts for the other entities. Balances held with the Bank by the Government and the other entities as at the balance sheet dates, together with the terms of such instruments, are disclosed in notes L5 'Liabilities to other euro residents denominated in euro' and L7 'Liabilities to euro area residents denominated in foreign currency' to the balance sheet. The principal impact of banking transactions entered into with the Government and the entities referred to above on the Bank's profit and loss account is 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 note A11.3 'Other financial assets' to the balance sheet). Income earned by the Bank from these assets amounting to €11,641,456 (2010: €8,751,403) is included in note 1.1 'Interest income' to the profit and loss account.

(d) Demonetised Maltese lira currency notes

Maltese lira currency notes were replaced by euro banknotes when Malta became part of the Eurosystem on 1 January 2008. Consequently, Maltese lira currency notes remained legal tender until 31 January 2008 but will continue to be redeemed at the conversion rate of the Maltese lira for the euro of 0.4293 and without charge until 31 January 2018.

During 2011, demonetised Maltese lira currency notes presented for redemption amounted to €3,218,435 (2010: €6,022,243). At 31 December 2011, the value of unpresented demonetised currency notes amounted to €46,675,865 (2010: €49,894,300).

(e) Investment securities pledged as collateral

As at 31 December 2011, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of US$45 million or approximately €35 million (2010: USD45 million or approximately €34 million). No amounts were borrowed under these facilities at the balance sheet dates.

(f) Assets held in custody

As at 31 December 2011, assets held in custody by the Bank in terms of the Insurance Business Act (Cap. 403) amounted to €33,056,173 (2010: €45,006,571).

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

In 2003, the Bank was appointed investment manager in respect of funds belonging to the Investor and Depositor Compensation Schemes. The Bank manages these funds on a discretionary basis in accordance with the investment parameters set by the Management Committees of the respective Schemes. As at 31 December 2011, the Investor and Depositor Compensation Schemes had deposits of €175,007 (2010: €211,084) and €477,532 (2010: €148,564) respectively, with the Bank.

(h) 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	Other €'000	Total €'000
Cash, current accounts and overnight deposits with banks					**9,456**
Gold balances					**10,347**
Placements with banks by exposure country:					
Belgium	-	-	29,369	-	**29,369**
Canada	-	-	-	14,148	**14,148**
Denmark	-	-	23,186	-	**23,186**
France	-	18,436	62,911	-	**81,347**
Italy	-	-	3,864	-	**3,864**
Malta	-	23,943	-	-	**23,943**
Spain	15,000	-	13,525	-	**28,525**
The Netherlands	-	-	24,345	-	**24,345**
Other countries	-	-	-	1,290	**1,290**
	15,000	**42,379**	**157,200**	**15,438**	**230,017**
Securities by issuer category:					
Government	1,404,167	-	108,439	-	**1,512,606**
Insurance	10,150	-	-	-	**10,150**
Monetary financial institutions	559,202	-	122,843	-	**682,045**
Other financial institutions	123,326	-	42,170	-	**165,496**
Non-financial institutions	39,119	-	-	-	**39,119**
Supranational	10,279	-	4,349	-	**14,628**
	2,146,243	**-**	**277,801**	**-**	**2,424,044**
Claims on the International Monetary Fund					**161,973**
Participating interest in the ECB					**13,997**
Transfer of foreign reserves to the ECB					**36,407**
Other foreign currency assets					**179**
Total investments					**2,886,420**