BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

FORTY-FIFTH ANNUAL REPORT
AND
STATEMENT OF ACCOUNTS
2012

Address
Pjazza Kastilja
Valletta VLT 1060
Malta

Telephone
(+356) 2550 0000

Fax
(+356) 2550 2500

Website
http://www.centralbankmalta.org

E-mail
info@centralbankmalta.org

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MISSION STATEMENT

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

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

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

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

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

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

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

vi. **Collect, compile and publish economic and financial statistics** in line with international standards;

vii. **Act as banker to the Government and the banking system;**

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

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

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

BOARD OF DIRECTORS*

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Monetary Operations & Government Securities

Mr Jesmond Gatt
Strategy, Planning & Risk

Mr Jesmond Pulé
Statistics

Mr Peter Paul Tabone
Currency Services & Security

**as at 31 December 2012*

THE BOARD OF DIRECTORS*

(left to right)
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Seated: Mr Alfred DeMarco (Deputy Governor), Professor Josef Bonnici (Governor & Chairman), Dr Bernadette Muscat (Secretary).

*as at 31 December 2012

ORGANISATION CHART*

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  Professor Josef Bonnici
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- 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 and Assessment
        - 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
    - Statistics Department
      - Monetary, Financial and External Statistics
      - General Economic Statistics, Securities and Data Management
    - Strategy, Planning and Risk Department
  - Corporate Services Directorate
    Mr Raymond A. Bonnici
    - Financial Control Department
      - 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 31 December 2012*

Bank Ċentrali ta' Malta
Eurosistema
Il-Gvernatur

Central Bank of Malta
Eurosystem
The Governor

28 March 2013

The Hon Prof. Edward Scicluna B.A.(Hons)Econ, M.A.(Toronto),
Ph.D. (Toronto), D.S.S.(Oxon) MP
Minister of Finance
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 2012.

Yours sincerely

Prof. Josef Bonnici

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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
EUR	euro
EURIBOR	Euro Interbank Offered Rate
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
LFS	Labour Force Survey
LTRO	long-term refinancing operation
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
OECD	Organisation for Economic Co-operation and Development
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

As the global economy experiences the fifth year of the financial crisis, the outlook for the euro area remains fraught with uncertainty even though financial tensions eased during the second half of 2012. Impairment in the transmission of monetary policy has been reflected in financial fragmentation and divergent economic performances across the monetary union, while credit growth is generally weighed down by continuing risk aversion and ongoing deleveraging. Following an expansion of 1.4% in 2011, real gross domestic product (GDP) in the euro area contracted by 0.6% in 2012, with the growth rate (measured on a year-on-year basis) decelerating as the year progressed.

Against such an unfavourable external environment, Malta's economy continues to endure adverse conditions in important export markets. It registered a GDP growth rate of 0.8% in 2012, down from 1.7% in 2011. The Central Bank of Malta's projections for GDP growth in 2013 have been revised to 1.4%, following the publication of the GDP outcome for the fourth quarter of 2012.

Although the GDP growth rate was the third highest in the euro area in 2012, it has not been strong enough to support improvements in labour market conditions or to generate a reduction in the unemployment rate. In fact, even though Malta's jobless rate remains markedly low by international standards, the fourth quarter's unemployment rate, as estimated by Eurostat, stood at 6.9%, up from 6.5% a year earlier. Recent statistics on the number of persons registering for unemployment benefits have edged up, so that the number of registrants increased from 6,714 in January 2012 to 7,237 one year later.

Meanwhile, on the basis of the Retail Price Index, the rate of inflation is projected to decline from 2.4% in 2012 to 2.0% in 2013.

Developments during 2012 have to be seen in the context of longer-term concerns related to the underlying competitiveness of the economy. Macroeconomic difficulties have compelled many countries to address their economic imbalances and to introduce structural reforms and fiscal consolidation measures. Internal devaluation has involved cuts in wages and other costs that duplicate the effect of a devaluation in the exchange rate. Such major structural changes will leave these countries in a stronger competitive position in the eventual recovery, and this is set to pose a serious challenge to Malta's competitiveness.

In this context, it should be repeated that only higher productivity can provide sustainably higher wages and living standards. Towards that end, the quality of human capital has to adapt to the changing needs of both the domestic and export markets, and for that purpose the educational system must provide the required skills and qualification profiles. In addition, prudence and caution are required on the issue of minimum wage increases as recent examples abroad have attributed the loss of competitiveness and of employment prospects to earlier minimum wage increases.

The slow pace of economic growth also weighs down on the government's budgetary outcome. Slow economic growth puts upward pressure on the deficit-to-GDP ratio both directly and through income-dependent revenues and expenditure.

On the fiscal side, the Bank's forecast (based on current budgetary proposals) indicates a deficit ratio falling from 2.7% in 2012 to 2.6% in 2013, while the debt ratio would rise slightly from 72.1% to 72.5%. Bringing the debt ratios down to the 60% benchmark in a deliberate manner is essential since at current levels the debt ratio severely constrains the room for fiscal manoeuvre. It hampers the ability of the fiscal authorities to engage in counter-cyclical expansionary policy.

In addition, fiscal prudence will promote the sustainability of public sector financing and ensure compliance with the new European Union-level (EU) fiscal rules that call for reductions in the structural balance and for a contraction of the debt ratio, programmed on a number of years. Prudence and cost awareness in the management of public sector resources are important for putting public finances on a solid and sustainable footing, and thereby promoting low borrowing costs and long-term economic growth.

On the funding side, government securities have retained their positive track record, continuing to benefit from favourable investor sentiment. Funding difficulties that are evident in the international financial markets have been absent from Maltese financial markets, where all primary and secondary-market trade in domestic government securities takes place. Indeed, the average bid-to-cover ratio for government bonds has averaged around 2.2 between 2010 and 2012 and peaked at 2.4 in 2011. In recent years, funding volumes have averaged around €880 million per annum, and going forward current indications are that the funding requirement for 2013 is likely to be lower than that level, and thus it is anticipated that the issues will again be taken up in full. Indeed, the first bond issue of 2013 was oversubscribed by nearly €93 million with a robust bid-to-cover ratio of 1.47.

Domestic government bond yields generally decreased during 2012, extending the decline observed since the start of 2011. Still, the spread over the German bund continued to widen slightly, against the background of heightened sensitivity across many government debt markets. A wider spread during the first half of the year was in line with tensions affecting the euro area in general. Subsequently, a number of European Central Bank (ECB) measures led to narrower spreads in the second half of the year.

Fiscal consolidation should be complemented with improvements in the regulatory infrastructure. The current economic situation calls for the enhancement of a business friendly approach, as indicated in the World Bank's *Doing Business Report 2013*. The report has highlighted the room for improvement in the business environment, facilitating start-ups and also putting in place efficient insolvency proceedings.

The banking sector

Although credit growth in Malta has slowed down marginally, it remained positive even during the crisis. In 2012 credit growth in Malta, excluding government, amounted to 1.8%, compared with a contraction of 1.1% for the euro area. And between December 2007 and December 2012, a period that spans the current financial crisis, credit growth in Malta amounted to around 35.9%, whereas in the euro area it was limited to 8.8%.

On the liabilities side, recourse by Maltese resident banks to Eurosystem funding has remained modest, reflecting the absence of funding distress. In fact, the ratio of main refinancing operations and long-term refinancing operations to total assets was lower for Maltese banks when compared with the euro area as a whole.

While financial conditions in Malta have averted the tensions evident in many other countries, credit exposure remains a source of risk for the core domestic banks. To strengthen resilience, provisioning levels must be increased in the short run. In the longer term, a greater degree of diversification in the lending portfolio of banks is warranted. Ahead of the introduction of more stringent regulatory requirements under the Capital Requirements Directive IV, banks should strengthen their capital buffers and further lengthen the maturity profile of their liabilities to more closely match that of their assets.

While banks' return on equity continues to be adequate, increased competition and stricter regulatory requirements in the coming years may exert downward pressures on profits in the medium term. Consequently, prudent dividend policies, which also reflect the economic and financial climate, are called for, especially for those banks whose capital ratios or profitability levels are on the relatively low side.

Joint Financial Stability Board

On the subject of financial stability, an important institutional development involved the formation of the Joint Financial Stability Board (JFSB). This was set up in January 2013 jointly by the Central Bank of Malta and the Malta Financial Services Authority (MFSA) and has as its objective the establishment of mechanisms of cooperation between the Bank and the Authority. The setting up of the JFSB is in line with the recommendation adopted by the European Systemic Risk Board (ESRB) in December 2011 regarding the macro-prudential mandate of national authorities.

The mandate of the Board includes (i) the identification, monitoring and assessment of any risks to financial stability; (ii) the selection of relevant macro-prudential tools to mitigate these risks and the formulation of policy recommendations; (iii) the assessment of whether relevant macro-prudential tools could have cross-border implications and finally (iv) the drafting of press statements in respect to macro-prudential policy decisions.

The Board shall look into any issues of a macro or micro-prudential nature that may impact on domestic financial stability. Recommendations of a macro-prudential nature will be sent for the consideration of the Board of Directors of the Central Bank of Malta, while micro-prudential recommendations shall be referred to the Board of Governors of the MFSA.

The Board shall also ensure adherence to the advice of and recommendations issued by the ESRB and will follow up on any other matters of a macro-prudential nature that the domestic authorities may need to communicate to the ESRB or to other international and local authorities.

Single Supervisory Mechanism

Looking ahead, the Single Supervisory Mechanism (SSM), which will commence operations in 2014, is a financial stability supervisory mechanism covering all commercial banks in the euro area. The underlying rationale for SSM is the recognition that a central authority is better placed to spot systemic risks at euro area level.

The SSM will be composed of the national competent authorities and the ECB, with the MFSA serving as the Maltese authority. The SSM will endow the ECB with the ultimate responsibility for specific supervisory tasks related to the financial stability of banks across the euro area.

Proposal for a development bank

In the financial system, there is a financing gap that would be filled by the establishment of a development or promotional bank. The financial system can thereby be improved to meet medium and long-term financing needs, particularly for infrastructural, social and environmental projects. Existing sources of funding – including commercial bank loans and government budgetary resources – are not sufficient in the light of the challenges facing the financial system and the already high level of public debt. In fact, a development bank could be instrumental in contributing to a more effective mobilisation of the excess liquidity characterising the financial system and to an efficient deployment of certain government assets, especially underutilised real estate. The bank may be able to channel EU funds and may also draw on other international funding sources, including Islamic or other sovereign sources.

As it has done on previous occasions, the Central Bank of Malta supports the view that an exploration by the government of the establishment of a development bank is appropriate, with a view to the commencement of negotiations with the European Commission on this subject.

A promotional or development bank would be on similar lines as in many EU countries, particularly Germany, where such banks undertake at a regional level a role in promoting the economy and assisting the government in social and environmental projects. Such banks have the backing of a government guarantee and can thus borrow on the basis of the sovereign rating of the government either locally or from supranational institutions. The funding model is based on the repayment of loans and is thus on a sustainable path that is separate from that of the national debt. In this way such an institution can serve to unlock further the financial potential available to spur competitiveness and economic growth with a limited added burden on government finance.

A development bank can also enable the government to obtain the benefits of the financial leverage that a bank can create. Such a public sector institution would complement, rather than compete with, the commercial banking system.

Bank policies and operations

As a member of the Eurosystem, the Bank contributes to the formulation of monetary policy in the euro area through its 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.

During the year the Bank conducted open market operations with eligible banks worth an aggregate of €11.2 billion, compared with €20.5 billion registered last year.

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. In this respect, the Bank maintained close contacts with the MFSA and with the Ministry of Finance, the Economy and Investment. The Bank also participated actively in the work of the ESRB. In liaison with the MFSA, the Bank played a key role in the European Banking Authority's recapitalisation exercise, which replaced the stress test in 2012. The Maltese bank which participated in this exercise met the necessary requirements of the test and comfortably exceeded the capital threshold.

Efficient payment and settlement systems are important components of the 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. At the operational level, the Bank participates in TARGET2, which is the automated payment system through which the Eurosystem's central banking operations and large-value interbank transfers are settled. The total payment flows through TARGET2 in Malta rose by €153.1 billion from 2011 to stand at €263.8 billion in 2012. This significant increase was primarily due to a rise in overnight deposits placed by credit institutions with the Bank, and the participation during all of 2012 by two credit institutions that joined the system during the course of 2011.

The Bank also continued to participate in the Eurosystem's TARGET2-Securities (T2S) project. T2S is a single IT platform for securities settlement that is aimed at maximising safety and efficiency in the settlement of euro-denominated securities transactions. Both the Bank and the Malta Stock Exchange will join the T2S in the first migration wave in 2015.

The Bank's overall profit for the year, including this year's provisions, increased by 49% and amounted to €78.2 million, as against €52.5 million in 2011. Enhancements in the management of investments contributed significantly to this performance. In accordance with ECB guidelines designed to cover interest rate and credit risk, an additional provision of €10.9 million was approved by the Board of Directors. Funds passed on to Government increased by 24% in 2012 to €52 million, while €14.2 million were transferred to reserves, as compared with the transfer of €10.5 million in 2011.

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

Prof. Josef Bonnici

PART I

FINANCIAL AND ECONOMIC DEVELOPMENTS

1. INTERNATIONAL ECONOMIC DEVELOPMENTS AND THE EURO AREA ECONOMY

Developments in the world's major economies were mixed during 2012. Output growth was solid in the United States as the domestic economy continued to improve. China showed signs of positive momentum towards the end of the year, following relatively slow growth at the start of the year. Meanwhile, the Japanese economy continued to show signs of weakness, as did the United Kingdom. During the year the weak global economic environment contributed to an easing of inflationary pressures. Financial market tensions were high during the first half of the year on account of overall weak growth and uncertainty in the euro area, before they abated in the second half as concerns about the euro area diminished and stimulus measures were undertaken in major economies.

After having expanded in the previous year, the euro area economy contracted in 2012, driven by developments in domestic demand. Growth decelerated as the year progressed. Labour market conditions deteriorated further, with the unemployment rate reaching a new record high, approaching the 12% mark. Meanwhile, the annual inflation rate decreased as the contribution of all major Harmonised Index of Consumer Price (HICP) components, except unprocessed food, fell. Energy and unprocessed food were the two categories which registered the highest price increases during the year.

The Governing Council of the European Central Bank (ECB) reduced key interest rates by 25 basis points in July, bringing the rate on the main refinancing operations (MRO) to 0.75%. Official interest rates were otherwise left unchanged during the year under review. In addition, the Eurosystem continued to implement a range of non-standard measures in order to provide liquidity to the banking system and, hence, support economic activity.

The international economy

United States

Real gross domestic product (GDP) in the United States expanded by 2.2% in 2012, an improvement on the 1.8% recorded in the previous year (see Table 1.1). Economic expansion was driven wholly by domestic demand, reflecting positive contributions from private consumption, investment, and, to a lesser extent, inventories, whereas government consumption contributed negatively for the second year running.

Economic growth was solid during the first three quarters of the year when measured on an annual basis, before decelerating in the fourth quarter. However, this was mainly due to one-off factors, such as a large amount of inventory destocking by businesses and Superstorm Sandy, which is estimated to have reduced GDP by around half a percentage point.

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

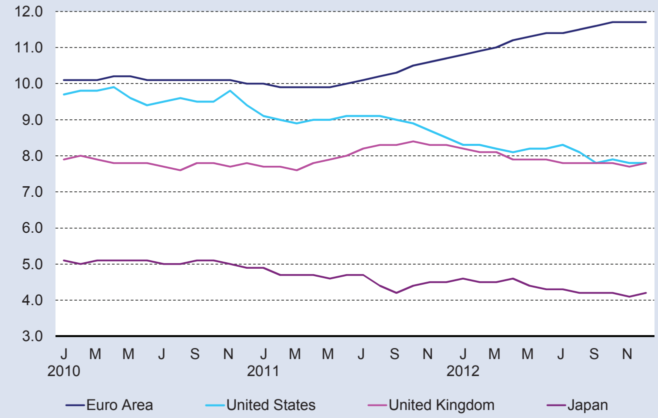
	2010	2011	2012	2012			
				Q1	Q2	Q3	Q4
United States	2.4	1.8	2.2	2.4	2.1	2.6	1.5
Euro area	2.0	1.4	-0.6	-0.1	-0.5	-0.6	-0.9
United Kingdom	1.8	0.9	0.0	0.2	-0.3	0.0	0.0
Japan	4.7	-0.6	1.9	3.3	4.0	0.4	0.3
China	10.4	9.2	7.8	8.1	7.6	7.4	7.9

Sources: Eurostat; IMF WEO Database; OECD.

Private consumption grew by 1.9% during 2012, faster than the 1.5% increase in personal disposable income, but down from 2.5% in 2011. Meanwhile, growth in gross fixed capital formation accelerated to 6.1% from 3.7% in the previous year. Prior to 2011, investment had declined for four years in succession, mainly reflecting a prolonged contraction in private residential investment. Residential fixed investment recovered in 2012, growing by 11.9% following a 1.4% decline in the previous year. Meanwhile, private non-residential fixed investment grew by 7.7% in 2012. Government investment declined, as did government consumption expenditure. The latter dropped by 1.3%, the second successive annual contraction, which was largely a result of lower defence spending.

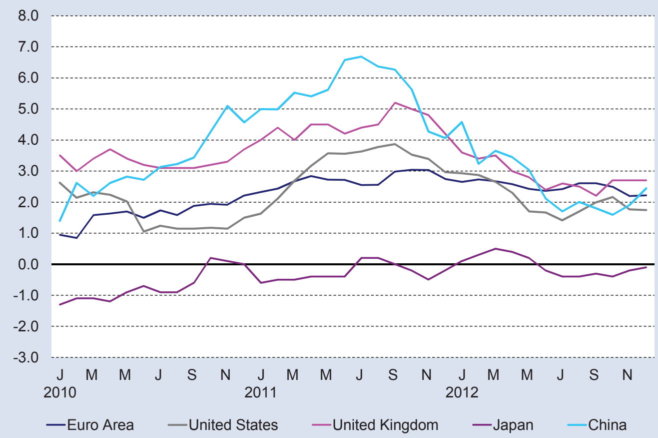
The contribution of external demand to real GDP growth was negligible during 2012. Export growth slowed to 3.2% from 6.7% in 2011. This deceleration was broad-based between goods and services, and mainly occurred during the second half of the year. The same developments were seen on the import side, with import growth decelerating to 2.5% in 2012 from 4.8% in the previous year. As a result, the United States ended 2012 with a slightly smaller trade deficit than in 2011.

Chart 1.1
UNEMPLOYMENT RATE
(monthly data; seasonally adjusted)



Source: Eurostat.

Chart 1.2
CONSUMER PRICE INFLATION
(annual percentage changes)



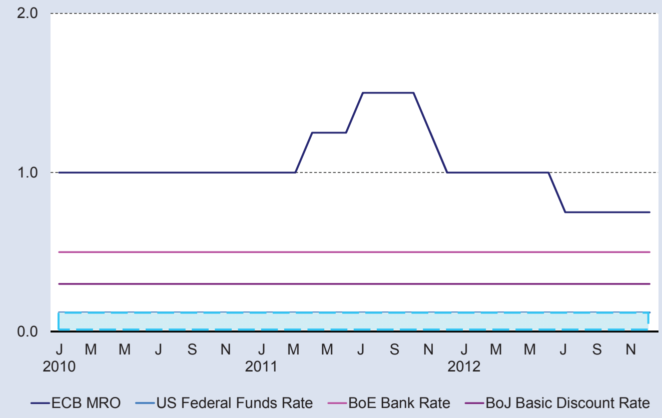
Sources: Eurostat; US Bureau of Labor Statistics; Japan Statistics Bureau; OECD.

Total non-farm employment rose in 2012. As the pace of hiring was more than enough to keep up with the natural growth in the labour force, the unemployment rate declined steadily to 7.8% in December from 8.5% at the end of 2011 (see Chart 1.1). The jobless rate has been slowly declining since its peak in 2009.

The Consumer Price Index in the United States increased by 2.1% during 2012, down from 3.2% in 2011 (see Chart 1.2). Annual inflation stood above 2% during the first four months of the year, mainly owing to high food and energy inflation. The inflation rate then decelerated for most of the year on the back of a gradual easing of commodities' inflation, though higher prices for motor fuel temporarily caused the rate to accelerate at the end of summer. Meanwhile, the underlying inflation measure, excluding food and energy, declined slowly throughout the year from 2.2% at end-2011 to 1.9% in December 2012.

During 2012 the Federal Reserve kept the federal funds rate target unchanged in a range between zero and 0.25% (see Chart 1.3). Throughout the first half of the year, the Federal Reserve continued with its programme to extend the average maturity of its holdings in Treasury securities, referred to as "operation twist", as announced in the previous year. In June the Federal Open Market Committee (FOMC) decided to extend this programme until the end of the year, resulting in additional purchases of long-term Treasury securities and in the sale or redemption of an equal amount of shorter-term securities. During the year the FOMC maintained its existing policy of reinvesting the principal repayments derived from the redemption of mortgage-backed securities and government agency bonds in mortgage-backed securities, rather than in government securities. Furthermore, in September it announced the third round of quantitative easing. This involved the purchase of additional agency mortgage-backed securities at a pace of USD40 billion per month. These measures were intended to put downward pressure on long-term interest rates, support mortgage markets, and make financial conditions more accommodative. Moreover, in December the Federal Reserve announced that, as from the beginning of 2013, it would purchase USD45 billion per month in long-term Treasury securities and resume rolling over maturing Treasury securities. In December it also specified that the federal funds target rate would be maintained at current levels as long as the unemployment rate remained above 6.5% and inflation was projected to be below 2.5% in the medium term, in line with its dual mandate of maximum employment and price stability.

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

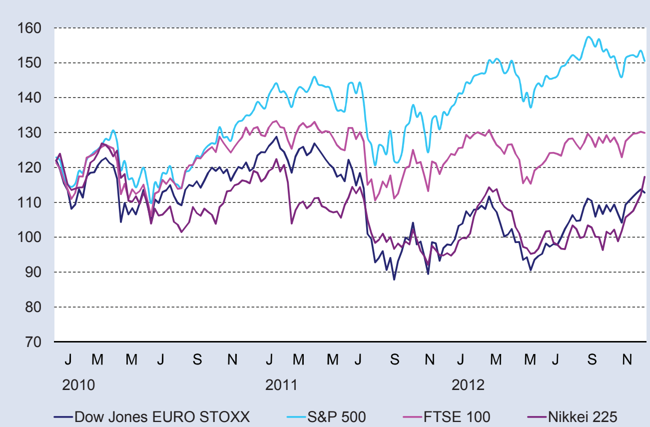


Sources: ECB; Federal Reserve; Bank of England; Bank of Japan.

The US fiscal deficit was estimated at 8.5% of GDP in 2012, down from 10.2% in 2011. Meanwhile, the gross government debt-to-GDP ratio rose to 109.8% from 102.2% in 2011. The fiscal scene during the year was dominated by the Presidential election in November and by uncertainty regarding the so-called "fiscal cliff", a series of tax increases and spending cuts that were scheduled to come into force at the end of the year. The latter issue was partly resolved when Congress passed legislation raising tax rates on the highest income groups, while extending middle-class tax cuts and higher unemployment benefits, apart from other measures.

Stock market conditions improved significantly during the year under review. Equity prices, as measured by the S&P500 Index, rose by 13.4% in 2012, following zero growth during the previous year (see Chart 1.4). Markets rallied at the start of the year on positive earnings announcements, as well as by macroeconomic news indicating increased growth momentum. These gains were reversed in the second quarter as mixed economic data led to a reassessment of growth prospects. During the summer, however, equity prices began an upward trend, reflecting better than expected company earnings, signs of an improving property mar-

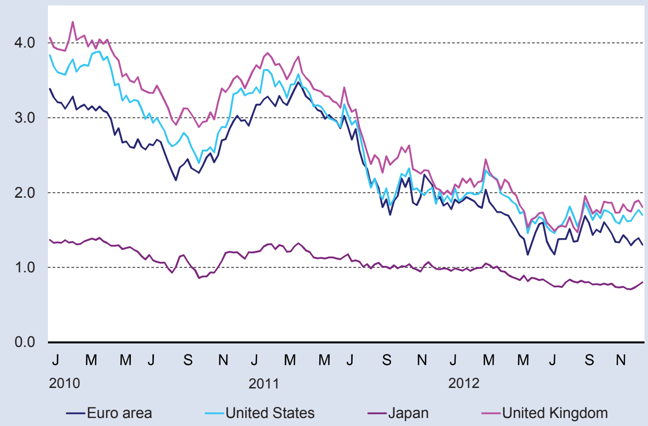
Chart 1.4
STOCK PRICE INDICES
(end of week index; 1 Jan. 2009=100)



Source: Reuters.

ket, and moves by central banks in major economies to stimulate growth and reduce financial tensions. At the start of the fourth quarter, equity prices were dampened by increased risk aversion relating to the fiscal cliff, though these downward pressures were offset at the end of the year by improvements in employment conditions, production and the housing sector.

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



Source: Reuters.

The ten-year US government bond yields stood at 1.8% at the end of 2012, down by 12 basis points when compared with their value at end-2011 (see Chart 1.5). Demand for US government bonds at the start of the year was affected by contrasting impacts of positive macroeconomic news and reservations by the Federal Reserve on the short-term growth outlook. Yields rose in March as the ECB's second long-term refinancing operation (LTRO) and a deal on Greek debt restructuring reduced financial market tensions. Subsequently, yields declined, reaching their lowest level ever at 1.4% in July. This reflected mixed economic releases leading to a reassessment of growth prospects, increased demand for safe-haven assets on account of euro area tensions, and the Federal Reserve's extension of "operation twist". Demand for US government bonds dropped in September, pushing up their yields, as monetary policy decisions taken by major central banks reduced risk aversion. Towards the end of the year, bond yields were affected on the downside by the uncertainty about the fiscal cliff and by downward revisions to global growth prospects, and on the upside by positive macroeconomic news.

United Kingdom

Output in the United Kingdom stagnated during 2012, following real GDP growth of 0.9% in the previous year (refer to Table 1.1). During the year under review, the UK economy was impacted by negative developments in net exports and inventories. However, private and government consumption, as well as investment, contributed positively. These developments resulted in growth in domestic demand, which had contracted in 2011. Still, domestic demand was tepid during 2012, constrained by tight credit conditions, a squeeze in real income and fiscal tightening. Meanwhile, demand for UK exports was hit by weak growth in the UK's trading partners, notably the euro area.

When measured on a quarterly basis, economic growth declined in three of the four quarters of the year, rising only during the summer on the back of one-off events, such as the London Olympics and the unwinding of the negative impact of the Jubilee bank holiday in June. During the year, output growth was held back by negative developments in the construction, manufacturing, and mining industries, the latter due to maintenance works in the United Kingdom's largest North Sea oil field.

Nevertheless, the unemployment rate in the United Kingdom declined gradually throughout the year, going from 8.2% in January to 7.8% in December. During 2012 the number of employed persons rose to its highest level ever.

In 2012 the rate of consumer price inflation averaged 2.8% (refer to Chart 1.2). As the year progressed, annual price growth continued to decelerate from its peak in September 2011, going from 4.2% at end-2011 to 2.7% in December 2012. The drop in inflation was brought about by the unwinding of the VAT and energy price increases during 2011, as well as by weak demand. In September the inflation rate reached its lowest level in over two years, before accelerating once again on the back of a surge in tuition fees and increases in the price of gas and electricity in the final quarter of the year.

Against this backdrop, the Bank of England maintained its official bank rate at 0.50% throughout 2012 (refer to Chart 1.3). In February, and subsequently in July, the Bank extended its asset purchase programme by GBP50 million on each occasion, to a total of GBP375 billion. Furthermore, the Bank announced in February that it would be purchasing shorter-term assets under the programme to reduce the risk of undesirable frictions in the market arising from concentration of the Bank's holdings in certain maturity sectors. Asset purchases as announced under the programme were completed by the end of October. In July, together with the Treasury, the Bank launched the Funding for Lending Scheme, designed to boost lending to the real economy by providing increased funds to financial institutions at favourable rates.

Meanwhile, the general government deficit in the United Kingdom for 2012 was estimated at 6.6% of GDP, down from 8.3% in 2011. At the same time, gross government debt rose to 105.3% of GDP, from 99.9% in the previous year.

Equity prices in the United Kingdom, as measured by the FTSE 100 Index, rose by 5.8% during 2012, reversing the 5.6% decline observed in 2011 (refer to Chart 1.4). At the start of the year, financial market sentiment was boosted by developments in the euro area, including the ECB's three-year LTROs. The Index subsequently declined in the second quarter, reflecting an intensification of tensions in the euro area and reduced investor demand for risky assets. Equity prices recovered during the summer, possibly reflecting actual and anticipated policy stimulus. The stock market then fluctuated in a narrow range in September and October, before equity prices rose again towards the end of the year.

UK ten-year government bond yields remained at historically low levels during the year under review, shedding 16 basis points to end December at 1.8% (refer to Chart 1.5). The demand for UK government bonds broadly declined during the second and third quarters, following a period of sideways oscillation at the start of the year. The decline reflected a continuation of the Bank of England's accommodative monetary policy and was in line with expectations of weak output growth in the long term. Concerns about euro area periphery countries could also have contributed to strong demand for UK sovereign bonds. Yields increased at the end of the third quarter and subsequently fluctuated within a narrow range till the end of year, as reduced financial tensions in the euro area might have diverted capital flows away from UK government bonds.

Japan

The Japanese economy expanded by 1.9% during 2012, after declining by 0.6% in 2011 when output was hit hard by natural disasters. However, this upturn occurred mainly during the first half of the year, with the economy slowing down significantly during the third and fourth quarters.

During the year output growth resulted from a positive contribution from domestic demand, partly offset by a negative contribution from net exports. Apart from inventories, all components of domestic demand grew at solid rates during the year under review, with investment in particular going up by 4.1%. This was mainly due to a surge in government investment. On the external side, exports declined for the second consecutive year in 2012 as a result of weak global demand. Imports, on the other hand, posted strong growth, mainly reflecting the rise in energy needs resulting from the closure of the Fukushima nuclear plant in 2011. As a result, the Japanese trade surplus narrowed to a record low during the year.

Labour market conditions in Japan gradually improved during the year under review. The unemployment rate went from 4.5% in December 2011 to 4.2% in December 2012 (refer to Chart 1.1).

Consumer price inflation averaged 0% during 2012, going from -0.2% at the end of 2011 to -0.1% in December 2012 (refer to Chart 1.2). The annual inflation rate was slightly positive during the first five months of the year, mainly owing to rising energy prices. From June onwards, however, the inflation rate turned negative on account of a broad-based decline in prices. Throughout the year, the core inflation rate excluding food and energy stood in a range of between -0.3% and -0.9%, thereby extending a deflationary trend that began in January 2009.

Given this backdrop, the Bank of Japan held its basic discount rate at 0.3% during 2012, while encouraging the uncollateralized overnight call rate to remain in a range of between zero to 0.1% (refer to Chart 1.3). The Bank increased the size of its asset purchase programme on five occasions during the year, bringing its total value up to 101 trillion yen from 55 trillion yen in 2011. The Bank intends to complete the purchases by end-2013. In April the Bank announced that it would extend the remaining maturity of Japanese government bonds and corporate bonds to be purchased under the programme, in an attempt to bring down long-term interest rates.

With regard to other monetary policy measures, in February the Bank quantified its medium to long-term price stability goal at 1.0% in terms of the annual change in the Consumer Price Index. In March the Bank of Japan increased the total amount of loans available under its Growth Supporting Funding Facility, launched in 2010, by 2 trillion yen, to 5.5 trillion yen, while introducing new rules governing loans denominated in US dollars. The facility supplies long-term funds at a low interest rate to encourage lending by financial institutions aimed at strengthening the foundations of economic growth. In December the Bank established the operational details of its Stimulating Bank Lending Facility, which aims to provide long-term funds at a low interest rate to financial institutions until March 2014.

In 2012 the Japanese Government approved two fiscal stimulus packages aimed at reviving flagging growth. During the year, the Japanese general government deficit was estimated at 9.9% of GDP, up from 9.3% in 2011. Meanwhile, the gross government debt-to-GDP ratio rose to 214.3%.

During 2012 equity prices in Japan, as measured by the Nikkei 225 Index, rose by 22.9%, completely reversing the 17.3% decline in 2011 (refer to Chart 1.4). The Index registered its strongest quarterly performance in many years during the first quarter, reflecting positive news from Japan's key trading partners and expansionary policy moves by the Bank of Japan, which aided exports through a depreciation of the yen. The rally also reflected a recovery after the previous year's earthquake and tsunami. Equity prices partially reversed their gains in the following quarter, reflecting a deepening euro area crisis and the resulting appreciation of the yen against the euro, along with concerns about slowing Chinese economic activity. Subsequently, the Index entered a phase of sideways movement lasting till November, as concerns about the euro area and a territorial dispute with China that negatively affected Japanese exports contrasted with the announcement of additional accommodative monetary policy measures in Japan and elsewhere. Equity prices rebounded at the end of the year, following a commitment by the newly-elected government to major fiscal and monetary stimulus.

During 2012 ten-year Japanese government bond yields continued to fall, shedding 18 basis points to end December at 0.8% (refer to Chart 1.5). Movements in the yields mirrored those of the corresponding US government bond yields during the first seven months of the year, moving sideways during the first quarter, before declining in the second and most of the third quarter on account of higher demand for safe-haven assets. Yields rose in late August and September as an increased monetary stimulus on the part of major central banks reduced risk aversion, before gradually declining over the following months. Yields recovered at the end of the year on the expectation of a further economic stimulus following the December general elections.

China

In 2012 real GDP in China expanded by 7.8%, down from 9.2% in 2011, thus registering its slowest rate of growth since 1999 (refer to Table 1.1). This slowdown was the result of weak global growth, which reduced demand for Chinese exports; the moderation was also due to policy tightening by the authorities to tame inflation and the property price boom following major stimulus measures taken in earlier years. The annual rate of economic growth in China had decelerated for four successive quarters, before picking up again in the final quarter of the year.

Inflation eased during 2012, with the rate of change of consumer prices slowing down to 2.4% in December from 4.1% a year earlier, well below the 4% rate targeted by authorities (see Chart 1.2). Inflation decelerated during the first three quarters of the year as a result of a sharp slowdown in food price growth, before accelerating slightly in the fourth quarter as a result of higher prices for food and services.

Against this background of slowing growth and falling inflation, the People's Bank of China in 2012 cut the deposit reserve requirement ratio twice, in February and in May, to 20% for large banks and 18% for smaller institutions. In addition, the Bank reduced its benchmark deposit and loan interest rates in June and again in July. In total, the deposit rate was cut by 0.5 percentage point to 3%, while the loan rate was reduced by 0.6 percentage point to 6%. The Chinese Government also attempted to revive flagging growth during the year by fast-tracking infrastructure projects, among other measures.

India[1]

Economic growth in India slowed down in 2012, averaging 4.0% from 7.8% in 2011. Activity decelerated during the first three quarters of the year, before recovering somewhat during the final quarter on account of higher private consumption and investment. Meanwhile, the annual inflation rate, as measured by the wholesale price index, declined marginally to 7.2% in December 2012, from 7.5% 12 months previously. Following a slight deceleration at the start of the year, inflation accelerated during the second and third quarters, before easing once again towards the end of 2012.

Commodities

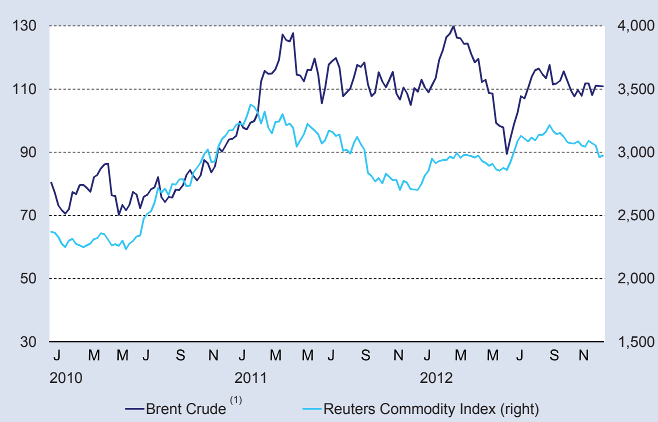
Oil

The price of Brent crude oil at the end of 2012 stood at USD111.6 per barrel, 2.2% above its level 12 months earlier (see Chart 1.6). The onset of winter weather, coupled by concern about supply disruptions and tensions surrounding Iran, pushed up Brent prices during the first quarter. The price reversed its upward course during the second quarter, amid increased oil production and growth concerns in Europe and China, reaching a low of USD88.95 in June. The price of Brent crude rose once again in summer, as US sanctions and a European Union (EU) embargo affected Iranian oil sales, while maintenance works in the United States and in North Sea oil fields reduced global oil supply. Subsequently, the oil price fluctuated in a narrow range till the end of the year, as the effect of geopolitical tensions in the Middle East was blunted by lower demand expectations that were fed by concerns about the world economy and the looming US fiscal cliff.

Other commodities

The prices of non-energy commodities, as measured by the RT Commodity Index, rose by 10.3% during 2012, partly reversing the 14.8% decline observed in 2011 (see Chart 1.6). The Index picked up during the first three months of the year, as strong demand from emerging market economies supported metal prices, while adverse supply conditions sustained the price of grains and soybeans. Prices gradually declined in the second quarter of the year, before rising sharply in July as dry weather in the United States and Asia led to an increase in food prices. Prices rose again in Septem-

Chart 1.6
COMMODITY PRICES
(end of week)



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

1 GDP data for India were updated on 28 February 2013.

ber on the back of higher prices for base metals, before declining in the fourth quarter on account of improved supply conditions for agricultural commodities and lower demand for base metals.

Chart 1.7
GOLD
(US dollars per ounce; end of week)

Source: Reuters.

Gold

The price of gold stood at USD1,674.3 per ounce at end-2012, 7.1% above its level 12 months earlier, following a 10.2% gain in the previous year (see Chart 1.7). During the first quarter, the demand for gold was mainly driven by safe-haven concerns, before abating in March following positive developments in the euro area. Subsequently, the gold price declined, reflecting an increased preference on the part of investors for other safe-haven assets and weaker physical demand from emerging Asian economies, partly owing to the doubling of gold import tariffs in India. In September monetary policy announcements raised the gold price as inflation expectations increased, though this upward momentum was short-lived as better economic news from the United States and China reduced the demand for safe-haven assets. However, throughout the year central bank gold demand remained strong as authorities attempted to diversify their asset holdings out of fiat money.

The euro area

Gross domestic product[2]

Having expanded by 1.4% in 2011, real GDP in the euro area contracted by 0.6% during the year under review (see Table 1.2). The fall in real GDP was driven by domestic demand. The quarterly profile shows that annual GDP growth decelerated as the year progressed. A similar pattern can be seen when looking at quarter-on-quarter changes, with a relatively large decline in GDP taking place in the final three months of the year.

Domestic demand contracted by 2.2% in 2012, after it had expanded by 0.5% in the previous year. It thus acted as a drag on overall economic expansion, reducing real GDP growth by 2.2 percentage points. An uncertain economic environment, rising unemployment, tight credit conditions, and fiscal consolidation contributed to the drop in domestic demand. Looking at individual components, investment declined on a year earlier, falling by 4.1% and more than reversing the 1.5% increase of 2011. Private consumption dropped by 1.3%, as opposed to the 0.1% increase reported in the previous year, whereas government consumption remained unchanged following a 0.1% drop in 2011. Changes in inventories contributed negatively to growth.

On the external front, exports grew by 2.6%, a slower rate than the 6.3% registered in 2011. On the other hand, in line with the decline in aggregate demand, imports contracted by 1.0%, compared with a 4.2% rise in the previous year. As a result, the contribution of net exports to growth was positive at 1.6 percentage points, up from 0.9 percentage point in 2011.

[2] The cut-off date for euro area GDP statistics is 6 March 2013.

Table 1.2
REAL GDP GROWTH IN THE EURO AREA

	2011	2012	2012 Q1	2012 Q2	2012 Q3	2012 Q4
			Annual percentage changes			
Private consumption	0.1	-1.3	-1.1	-1.1	-1.5	-1.2
Government consumption	-0.1	0.0	0.1	-0.1	-0.1	-0.2
Gross fixed capital formation	1.5	-4.1	-2.5	-3.9	-4.4	-4.9
Domestic demand	**0.5**	**-2.2**	**-1.7**	**-2.3**	**-2.5**	**-2.2**
Exports	6.3	2.6	2.5	3.6	3.2	2.2
Imports	4.2	-1.0	-1.1	-0.7	-1.0	-0.6
GDP	**1.4**	**-0.6**	**-0.1**	**-0.5**	**-0.6**	**-0.9**
			Percentage point contributions			
Private consumption	0.1	-0.7	-0.6	-0.6	-0.9	-0.7
Government consumption	0.0	0.0	0.0	0.0	0.0	0.0
Gross fixed capital formation	0.3	-0.8	-0.5	-0.8	-0.8	-0.9
Changes in inventories	0.2	-0.6	-0.5	-0.9	-0.8	-0.5
Domestic demand	**0.5**	**-2.2**	**-1.6**	**-2.3**	**-2.5**	**-2.1**
Net exports	**0.9**	**1.6**	**1.6**	**1.8**	**1.8**	**1.3**
GDP	**1.4**	**-0.6**	**-0.1**	**-0.5**	**-0.6**	**-0.9**

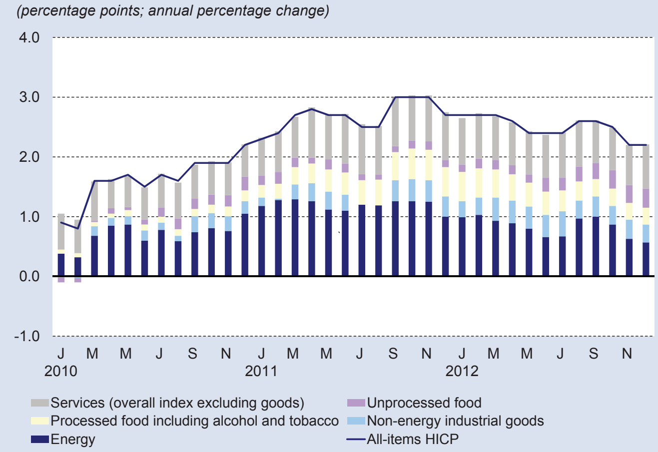
Source: Eurostat.

Inflation

The annual rate of inflation in the euro area, as measured using the HICP, fell during 2012 to 2.2% in December from 2.7% a year earlier (see Chart 1.8). Thus, the annual inflation rate went back to the level registered at the end of 2010. The general downward trend in HICP inflation during 2012 was only interrupted once, in August. On average, over the year, area-wide inflation went down to 2.5% from 2.7% in 2011.

The drop in the annual inflation rate mainly reflected developments in prices of energy and of processed food. During 2012 the energy prices component, which increased by 5.2% year-on-year, registered the fastest growth among the five major HICP components. Nevertheless, this increase was considerably less than the 9.7% registered in 2011, so that its contribution to overall inflation diminished. Similarly, processed food price inflation dropped to 2.4%, from 4.1% a year earlier. In contrast, unprocessed food prices rose at a faster annual rate, going up by 4.4% on a year earlier and pushing up overall inflation. Services and non-energy industrial goods registered the lowest rise in prices, at 1.8% and 1.0%, respectively. Their contribution to overall inflation decreased marginally.

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



Source: Eurostat.

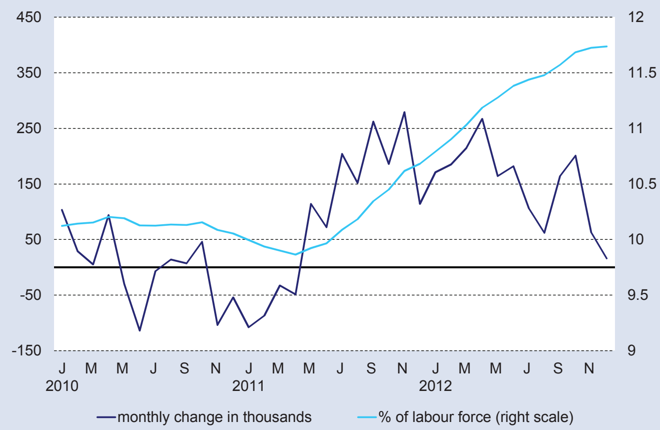
At the same time, excluding energy and unprocessed food prices from the HICP, inflation also edged down, falling by 0.4 percentage point to 1.6% in December 2012. This decline mainly reflected developments in processed food prices.

Labour market

Labour market conditions in the euro area continued to deteriorate during 2012, against the backdrop of weakening economic growth.

Data available up until the third quarter show that employment continued to contract. The fall in employment became more pronounced as the year progressed, with an annual contraction going from 0.5% in the first quarter to 0.7% in the second and third quarters.

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



Source: Eurostat.

The area-wide unemployment rate rose consistently throughout the year (see Chart 1.9). The jobless rate ended the year at a new high of 11.7%, or 1 percentage point higher than the rate at the end of 2011. The number of unemployed in the euro area rose by 1.8 million during 2012 to 18.7 million persons in December 2012.

Monetary policy

The Governing Council of the ECB changed key interest rates once during 2012, reducing them by 25 basis points in July. This brought the MRO rate to a historical low of 0.75%. In parallel, the rates on the marginal lending facility and the deposit facility were cut to 1.50% and zero, respectively, leaving the symmetry and width of the policy rates corridor unchanged. This decision was taken against the background of weaker inflationary pressures over the medium term. At the same time, the underlying pace of monetary expansion continued to be subdued while inflation expectations remained firmly anchored.

Policy rates were left unchanged during the rest of the year as the inflation rate in the euro area was expected to remain in line with price stability over the policy relevant horizon, while the underlying pace of monetary expansion continued to be subdued. In addition, inflation expectations for the euro area remained firmly anchored and consistent with the aim of maintaining inflation rates below, but close to, 2% over the medium term.

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. In particular, in September the Council decided on the modalities to be used for Outright Monetary Transactions (OMT) in secondary markets for sovereign bonds issued by the euro area. Such transactions, which are subject to conditionality, seek to address distortions in government bond markets that hinder the transmission of interest rate decisions to the euro area economy.[3]

Money and credit

Broad money M3 in the euro area accelerated during the year under review. The overall annual growth rate more than doubled over the year, going from 1.5% in December 2011 to 3.3% a year later (see Table 1.3).

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

Table 1.3
EURO AREA MONETARY AGGREGATES
Annual percentage changes

	2011	2012	2012 Mar.	2012 June	2012 Sep.	2012 Dec.
M1	**1.8**	**6.2**	**2.9**	**3.7**	**5.0**	**6.2**
Currency in circulation	6.2	2.5	5.5	5.5	4.2	2.5
Overnight deposits	0.9	7.0	2.4	3.3	5.1	7.0
M2-M1 (Other short-term deposits)	1.9	2.1	3.0	2.2	0.6	2.1
Deposits with an agreed maturity of up to two years	1.9	-1.9	3.5	1.0	-3.0	-1.9
Deposits redeemable at notice of up to three months	1.9	5.9	2.4	3.3	4.1	5.9
M2	**1.8**	**4.4**	**3.0**	**3.0**	**3.1**	**4.4**
M3	**1.5**	**3.3**	**2.9**	**3.0**	**2.6**	**3.3**

Source: ECB.

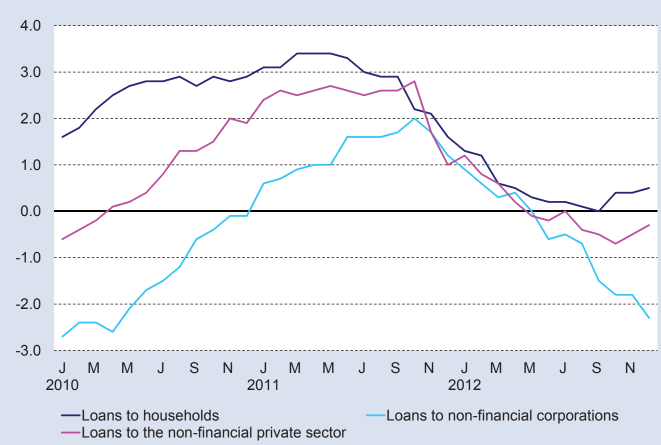
M3 rose strongly in the first quarter of the year, as an indirect result of the substantial injection of liquidity by the Eurosystem into the banking system, particularly through two three-year LTROs, which stimulated increased bank purchases of government debt. After having remained broadly unchanged in the second quarter, growth in M3 decelerated in the third quarter, only to rise again in the final quarter of the year, the latter reflecting a further acceleration in overnight deposits.

The pick-up in M3 growth during the year was broad-based, though the narrow money component (M1) rose especially strongly. In fact, the annual growth rate of M1 increased to 6.2% in December 2012 from 1.8% a year earlier. This, however, masks different developments in its two components. While the annual growth rate of the smaller of the two components, currency in circulation, decreased, that of overnight deposits surged to 7.0%. The latter was a result of the prevalent low interest rates, which gave rise to a strong preference for very liquid deposits in an environment of high uncertainty.

The annual growth rate of other short-term deposits (i.e. M2 minus M1) rose only slightly during 2012, gaining just 0.2 of a percentage point to 2.1% at the end of the year. This, once again, masks different developments in its two components. While the annual growth rate of deposits with an agreed maturity of up to two years (short-term time deposits) fell and turned negative, that of deposits redeemable at notice of up to three months (short-term savings deposits) picked up. These developments were mainly attributable to households, which shifted funds toward more liquid deposits.

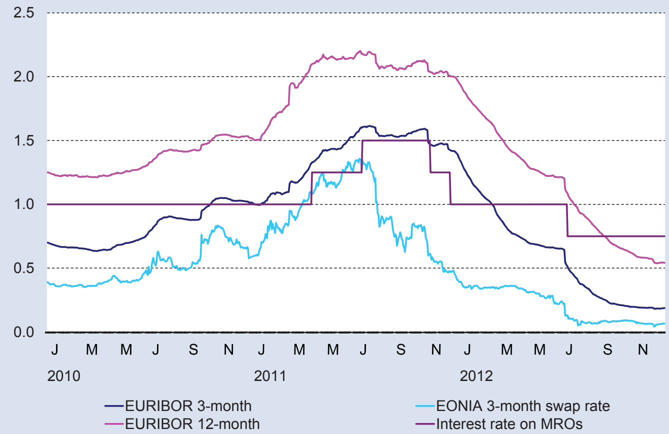
On the counterparts' side, credit to euro area residents decelerated further in 2012, with the annual growth rate dropping to 0.4% in December from 0.9% a year earlier. Growth in loans granted by monetary financial institutions to the non-financial private sector was weak by historical standards. Indeed, the annual growth rate of lending to the sector extended the downward trend that began towards the end of 2011 and turned negative, going from 1.0% in December 2011 to -0.3% a year later (see Chart 1.10).

Chart 1.10
MFI LOANS TO THE NON-FINANCIAL PRIVATE SECTOR IN THE EURO AREA
(annual percentage changes)



Source: ECB.

Chart 1.11
KEY INTEREST RATES
(percentages per annum; daily data)



Sources: ECB; Euribor FBE.

The annual growth rate of loans to non-financial corporations dropped to -2.3% by December 2012 from 1.2% a year earlier. At the same time, the corresponding growth rate of lending to households slowed down to 0.5% from 1.6% over the same period. This weakening mainly reflected the deterioration of the economic outlook and weak housing market prospects, together with the continuing pressure to reduce leverage in a number of euro area countries.

The money market

Money market interest rates in the euro area followed a downward trend during the year under review. This was a result of the injection of substantial amounts of liquidity into the financial system through the two three-year LTROs mentioned earlier and the Governing Council's decisions to reduce official interest rates by 25 basis points in December 2011, and again in July 2012.

Unsecured money market interest rates in the euro area, as measured by EURIBOR, generally decreased throughout 2012, in contrast with a rise in the previous year.[4] Over the year as a whole, at the three-month and 12-month maturities, EURIBOR dropped by 117 basis points and 141 basis points, to end 2012 at 0.19% and 0.54%, respectively (see Chart 1.11).

Secured rates, such as those implicit in the three-month EONIA swap index, also declined uninterruptedly during the year under review, responding to the reduction in key ECB interest rates, and approached the zero mark.[5] The index reached a new low of 0.04% in mid-December. Over the year, it shed 33 basis points to end 2012 at 0.07%.

As a result, the spread between unsecured EURIBOR and secured EONIA swap rates at the three-month maturity generally narrowed over the course of the year. This spread is often used as a measure of market confidence in the soundness of the banking system. By the end of 2012, the spread fell to 12 basis points from 96 points a year earlier, signalling improved confidence in the interbank market.

Bond yields

Ten-year German government bond yields, which often serve as a benchmark for the euro area, declined during the year under review (refer to Chart 1.4). After remaining relatively stable in the first quarter, these yields fell steadily until end-July. This was mainly due to new information pointing to weakening short-term economic prospects, the diverse conditions across the euro area economy, and the renewed political and financial market tensions in the euro area.

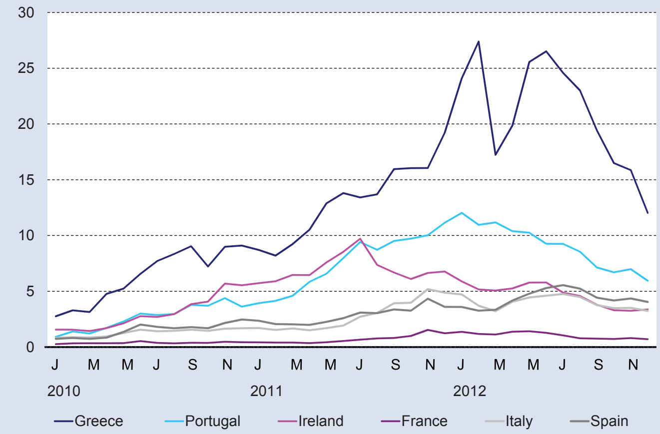
German government bond yields were more volatile over the rest of year, as financial market participants continued to assess the implications of a sequence of official discussions on financial stability issues in the EU, the recapitalisation package agreement for the Spanish banking system and the ECB's announcement that it would undertake OMTs. Over 2012 as a whole, ten-year German bond yields dropped by 52 basis

[4] The Euro Interbank Offered Rate (EURIBOR) refers to the rates at which prime banks are willing to lend funds to other prime banks in euro on an unsecured basis.

[5] 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.

points, to end the year at 1.31%. This fall was, however, lower that the 114 basis point drop recorded in 2011.

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



Source: ECB.

During 2012 spreads between sovereign bond yields in a number of euro area countries, which are shown in Chart 1.12, decreased vis-à-vis their German counterparts, with the exception of Spain. After narrowing slightly during the first quarter of the year, they widened again during the second quarter. In particular, the difference between yields on Greek sovereign bonds and their German counterparts rose significantly, reflecting increased political uncertainty, going from 17 to almost 27 percentage points between March and June. Spreads, however, generally diminished in the second half of the year, as flight-to-safety flows weakened from mid-July onwards, while the announcement of OMTs and the definition of the modalities for their implementation eased market concerns.

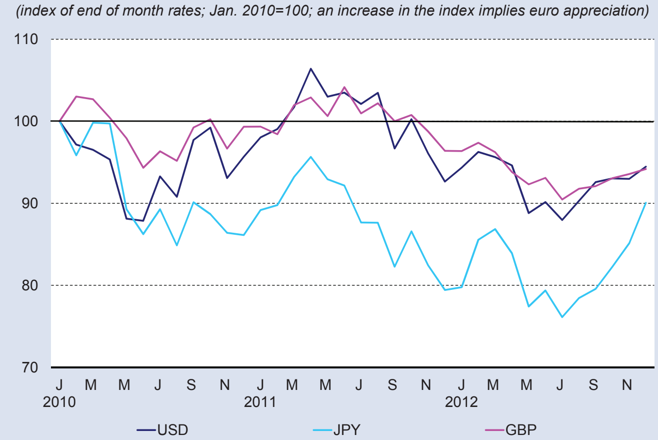
Equity prices

Euro area equity prices, as measured by the Dow Jones EURO STOXX index, rose during 2012, with the index gaining 15.5% overall, almost recuperating the 17.7% loss recorded during the previous year (refer to Chart 1.5).

In particular, the index rose in the first five months of the year amid renewed hope of a durable solution to the sovereign debt crisis. This was also supported by an easing in funding pressures following the three-year refinancing operations conducted by the Eurosystem in December 2011 and February 2012.

This rally, however, came to a halt in May, as data releases pointed towards a weaker economic outlook in most of the euro area and market tensions re-emerged. The index then followed a general upward trend for the rest of the year, as positive sentiment was supported by initiatives to strengthen financial stability in the euro area.

Chart 1.13
EXCHANGE RATE MOVEMENTS OF THE EURO AGAINST OTHER MAJOR CURRENCIES
(index of end of month rates; Jan. 2010=100; an increase in the index implies euro appreciation)



Source: Eurostat.

Exchange rates

During 2012 the euro depreciated against all major currencies up to July, as market tensions related to the sovereign debt crisis in the euro area intensified. Moreover, perceptions related to economic prospects in the euro area relative to other economies worsened, while developments in expected yield differentials between the euro and other currencies also weighed on the euro. However, the euro strengthened during the remainder of the year, following a series of policy decisions that eased concerns about the sovereign debt crisis. In addition, sentiment regarding fiscal and economic prospects for some euro area countries improved.

On a bilateral basis, the euro weakened by 2.3% against the pound sterling but gained 2.0% against the US dollar over the year as a whole (see Chart 1.13). The euro rose particularly strongly against the Japanese yen, putting on 13.4% during 2012, as the yen weakened following a series of announcements regarding expansionary monetary and fiscal policy measures in Japan.

Chart 1.14
EURO NOMINAL EFFECTIVE EXCHANGE RATE
(index of daily effective exchange rate; Q1 1999=100)

Source: ECB.

Similarly, the nominal effective exchange rate of the euro, as measured against the currencies of 20 of the euro area's main trading partners, depreciated up to July and appreciated thereafter. Overall, in 2012 the euro lost just 0.4% in nominal effective terms, whereas in 2011 the index had fallen by 2.1% (see Chart 1.14).

2. MONETARY AND FINANCIAL DEVELOPMENTS

During 2012 the contribution of Maltese monetary financial institutions (MFI) to the euro area's broad money stock, M3, expanded at a faster pace than in the previous year.[1] Deposits held by Maltese residents grew more rapidly than in 2011, whereas credit extended to them decelerated substantially.[2]

Domestic money market rates generally rose for most of 2012 before declining in the final quarter. In the capital market, government bond yields largely increased during the first half of the year, but then eased towards the end. Equity prices fell sharply during the first quarter, but recovered strongly thereafter.

Contribution to euro area monetary aggregates

The contribution of Maltese MFIs to the euro area's M3 increased by 8.7% in 2012, up from 3.3% in the previous year (see Table 2.1).

The increase was led by strong growth in M1, the narrow money component. An expansion of 10.7% in this aggregate during 2012 reflected a continuing shift into liquid monetary assets that was observed throughout the year.

At the same time, the intermediate money component (M2) grew at 9.0%, up from 3.8% in the previous year, mostly because of deposits belonging to private non-financial corporations (NFC) and households. The increase occurred primarily in the second half of the year.

Residents' deposits

Residents' preferences continued to shift in part toward overnight deposits, as strong inflows of balances held by both households and private NFCs led to an acceleration in their annual growth rate to 11.3% from 8.7% in 2011 (see Table 2.2). The share of these deposits in the resident M3 deposits' total rose to just above 57% at end-December 2012.

At the same time, deposits redeemable at up to three months' notice recorded double-digit growth, rising by 23.8% in 2012 as against the slight drop reported a year earlier. However, such deposits accounted for only 2% of total resident M3 deposits at the end of December, with their movements tending to be volatile.

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

	2010	2011	2012	2012	
	Dec.	Dec.	Dec.	Amount outstanding	Absolute change
Narrow money (M1)	14.7	8.5	10.7	6,005.7	580.0
Intermediate money (M2)	5.3	3.8	9.0	10,328.9	856.9
Broad money (M3)[(2)]	**5.5**	**3.3**	**8.7**	**10,520.4**	**844.1**

(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) Broad money comprises M2 plus certain marketable instruments, namely, repurchase agreements, money market fund shares and units, and debt securities with a maturity of up to and including two years issued by MFIs.

Source: Central Bank of Malta.

1 The contribution of Maltese MFIs to euro area monetary aggregates comprises the notional issue of euro currency attributed to the Central Bank of Malta, deposits held by Maltese and other euro area residents (except those belonging to central governments and interbank deposits) with resident MFIs, and other monetary liabilities of Maltese MFIs towards euro area residents.

2 Unless otherwise specified, the term "residents" in this Chapter refers to residents of Malta only. "Other euro area residents" consist of residents of all euro area countries except Malta.

Table 2.2
DEPOSITS OF MALTESE RESIDENTS IN M3
Annual percentage changes; EUR millions

	2010 Dec.	2011 Dec.	2012 Dec.	2012 Amount outstanding	2012 Absolute change
Total residents' deposits	**5.1**	**2.6**	**6.5**	**8,951.5**	**545.0**
Overnight deposits	16.3	8.7	11.3	5,110.0	519.1
Deposits redeemable at notice up to 3 months	10.7	-0.8	23.8	151.7	29.2
Deposits with agreed maturity up to 2 years	-5.2	-4.0	-0.1	3,689.8	-3.3

Source: Central Bank of Malta.

The steady decline in deposits with an agreed maturity of up to two years seen since 2009 was followed by a slight drop in 2012. Within this deposit category, a sizeable drop in holdings belonging to private NFCs and insurance companies during the first half of the year outweighed a rise in household balances observed during the second half.

To some extent, portfolio flows into monetary assets outside M3, largely on the part of households, coupled with the acquisition of government bonds, may have dampened growth in deposits with an agreed maturity of up to two years, as investors sought higher yields.

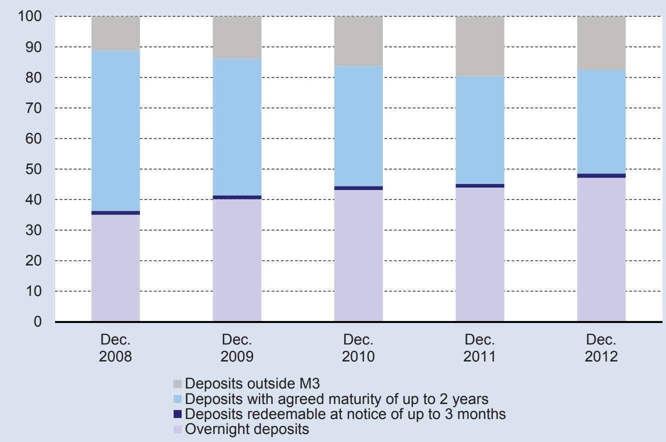
Overall, total residents' deposits in M3, which had expanded by 2.6% during 2011, grew at a faster pace, adding 6.5% in 2012 (see Table 2.2).

The last five years have seen portfolio shifts both toward overnight deposits forming part of M1, as well as toward long-term monetary assets classified outside M3 (see Chart 2.1).

Excluding deposits belonging to government, residents' deposits outside M3 expanded by €68.5 million during the year, or 5.2%, following an increase of 42.9% in 2011 (see Chart 2.2). The slowdown during 2012 follows the considerable increase in such deposits that had been driven by a large number of new savings products launched by some banks.

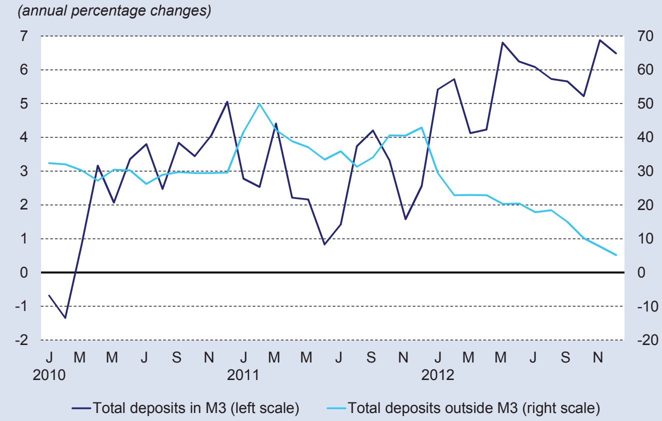
Changes in the weighted average interest rate paid by MFIs on all

Chart 2.1
DISTRIBUTION OF TOTAL RESIDENT DEPOSITS
(percentage points)



Source: Central Bank of Malta.

Chart 2.2
DEPOSITS OF MALTESE RESIDENTS[(1)]
(annual percentage changes)



(1) Excluding deposits belonging to central government.
Source: Central Bank of Malta.

Table 2.3
MFI INTEREST RATES ON OUTSTANDING DEPOSITS BELONGING TO RESIDENTS OF MALTA
Percentages per annum; weighted average rates as at end of period

	2010 Dec.	2011 Dec.	2012 Dec.
Total deposits belonging to households and non-financial corporations(1)	**1.38**	**1.41**	**1.42**
Overnight deposits			
Households	0.28	0.31	0.32
Non-financial corporations	0.24	0.30	0.28
Time deposits with agreed maturity up to 2 years			
Households	2.08	2.05	2.07
Non-financial corporations	1.97	2.00	1.99
Time deposits with agreed maturity over 2 years			
Households	3.16	3.21	3.42
Non-financial corporations	3.24	3.13	3.06

(1) Annualised agreed rates (AAR) on euro-denominated deposits.
Source: Central Bank of Malta.

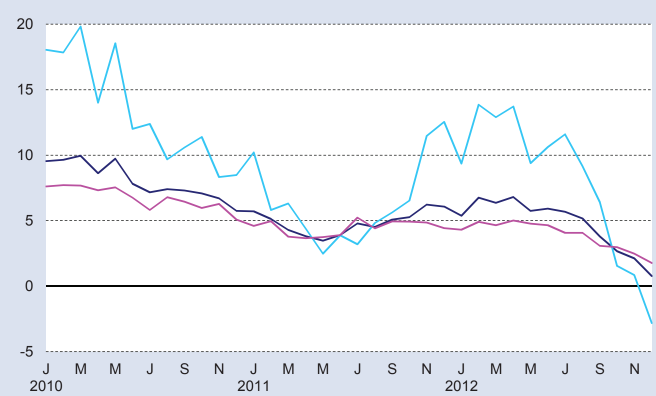
deposits belonging to households and NFCs resident in Malta were minimal, with the average rate edging up by just 1 basis point. Rates offered on overnight deposits and time deposits with agreed maturities of up to two years changed marginally. More significant changes involved rates on time deposits with an agreed maturity of over two years. While rates offered to households increased by 21 basis points to 3.42%, those offered to NFCs fell by 7 points to 3.06% (see Table 2.3).[3]

Credit

During 2012 credit to residents expanded modestly, with the growth rate falling to 0.8% from 6.1% in 2011 (see Chart 2.3). Subdued credit dynamics were in line with the level of economic activity during 2012. While credit to general government contracted during the year, the growth rate of credit to other residents slowed down substantially (see Table 2.4).[4]

Credit to general government contracted by 2.8% during 2012, whereas it had expanded by 12.6% in the preceding year. A drop in Treasury bills held by credit institutions outpaced a rise in their holdings of Malta Government Stocks (MGS). The latter increased at a much slower pace than in 2011. The decline in credit to general government towards the end of the year coincided with a reduction in government deposits held with the banking system.

Chart 2.3
CREDIT TO RESIDENTS OF MALTA
(annual percentage changes)



Source: Central Bank of Malta.

[3] Data on interest rates on outstanding amounts shown in Table 2.3 cover MFI euro-denominated deposits belonging to households and non-financial corporations resident in Malta. The household sector also includes non-profit institutions serving households (NPISH). NFCs include all enterprises except banks, insurance companies and other financial institutions. Hence, these statistics do not cover all economic sectors.
[4] The term "other residents" represents all economic sectors that are resident in Malta but do not form part of general government. It includes households, private NFCs and public NFCs.

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

	2010 Dec.	2011 Dec.	2012 Dec.	2012 Amount outstanding	2012 Absolute change
Total credit	**5.8**	**6.1**	**0.8**	**10,988.6**	**84.8**
Credit to general government	8.5	12.6	-2.8	2,287.1	-66.2
Credit to other residents(1)	5.1	4.4	1.8	8,701.5	151.0
Credit to non-bank private sector	5.4	4.0	2.1	7,971.5	166.3
Credit to public non-financial corporations	1.4	8.9	-2.1	730.0	-15.3
Total loans to other residents	**5.2**	**4.2**	**1.8**	**8,441.7**	**147.2**

(1) Credit to other residents consists mainly of loans and holdings of securities, including equities, issued by non-bank private corporations and public non-financial companies, and financial derivatives. Interbank claims are excluded.

Source: Central Bank of Malta.

Credit to other residents expanded by 1.8% in 2012, a slower pace than in 2011. Credit to the non-bank private sector, which is composed mainly of households and NFCs, grew by 2.1%, offsetting a decline in credit to public NFCs.[5]

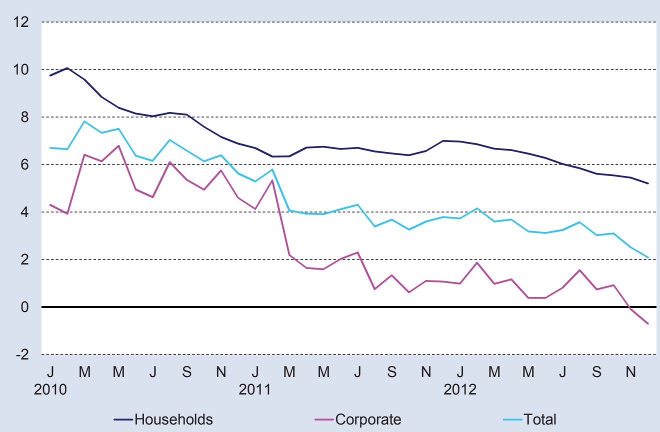
Loans

Loans, which accounted for 97% of total credit to other residents, expanded by €147.2 million, or 1.8%, during the year (see Table 2.5). Demand stemmed predominantly from loans to households – to finance house purchases – and to the manufacturing sector. While growth in the former continued to slow down during 2012, the latter recovered substantially, turning positive as activity within the sector picked up. In contrast, lending to various sectors, including construction and wholesale & retail trade, declined during the period reviewed. The decrease in lending to the electricity, gas, steam & air conditioning supply sector reflected developments regarding public NFCs.

Loans to the private sector continued to decline consistently throughout 2012, with the year-on-year growth rate falling from 3.8% in December 2011 to 2.1% in December 2012.

Despite remaining strong, borrowing by the household sector decelerated throughout 2012, with its growth rate ending the year at 5.2% (see Chart 2.4). Loans to households remained the largest single category of bank lending, however, contributing to more than 48% of total private sector lending. Mortgage lending, which makes up more than four-fifths of loans to households, grew at a slower pace in 2012, with its growth rate decelerating to 6.7% from 8.5% in 2011. At the same time, growth in consumer credit and other lending to households turned negative towards the end of the year, resulting in a drop of 1.2% during the year as a whole.

Chart 2.4
LOANS TO THE PRIVATE SECTOR
(annual percentage changes)



Source: Central Bank of Malta.

[5] Public NFCs are government-owned entities that do not form part of the general government sector.

Table 2.5
LOANS TO RESIDENTS OF MALTA OTHER THAN GENERAL GOVERNMENT
Annual percentage changes; EUR millions

	2011 Dec.	2012 Dec.	2012 Amount outstanding	2012 Absolute change
Total loans	**4.2**	**1.8**	**8,441.7**	**147.2**
Agriculture	0.0	-0.3	26.2	-0.1
Fishing	-0.3	2.9	10.2	0.3
Manufacturing	-0.9	18.9	333.8	53.0
Electricity, gas, steam and air conditioning supply	8.3	-4.1	457.0	-19.4
Water supply; sewerage waste management & remediation activities	2.2	5.0	66.6	3.2
Construction	-1.9	-6.3	1,023.5	-68.7
Wholesale & retail trade; repair of motor vehicles & motor cycles	2.7	-2.1	829.9	-18.1
Transportation and storage	4.2	-6.2	386.2	-25.5
Accommodation and food service activities	3.0	1.8	468.2	8.5
Information and communication	-1.5	-0.3	114.5	-0.4
Real estate activities(1)	1.1	0.5	398.4	1.8
Professional, scientific and technical activities	-11.9	-5.1	57.5	-3.1
Administrative and support service activities	6.6	-2.8	101.7	-2.9
Households and individuals(2)	7.0	5.2	3,783.2	187.2
Other(3)	9.0	8.9	384.8	31.4

(1) Includes imputed rents of owner-occupied dwellings.

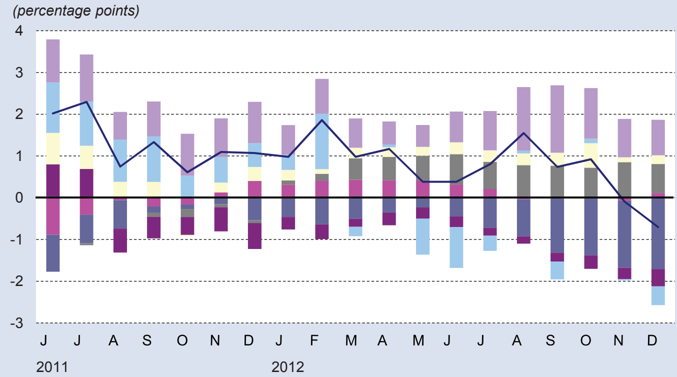
(2) Excludes sole proprietors.

(3) Includes mining & quarrying, public administration, education, human health & social work activities, arts, entertainment & recreation, other services activities, extra-territorial organisations & bodies, and non-bank financial institutions.

Source: Central Bank of Malta.

Developments in corporate loans were less positive, with growth in lending turning negative towards the end of 2012, reaching -0.7%. Lending to construction contracted significantly during the second half of the year and accounted for most of the decline in lending to private firms (see Chart 2.5). In contrast, a pick-up in manufacturing as well as in the arts, entertainment and recreation (which drove developments in the "other" category) restrained the decline in corporate loans.

Chart 2.5
CONTRIBUTIONS TO GROWTH IN LOANS TO PRIVATE CORPORATIONS
(percentage points)



Source: Central Bank of Malta.

The weighted average interest rate charged by MFIs on outstanding loans to resident households and NFCs fell by 11 basis points, reaching 4.33% at end-December (see Table 2.6).[6] The largest decline, by 13 basis points to 4.72%, was observed in rates charged on lending to NFCs. Rates on lending to households also fell, though to a lesser extent.

[6] Data on interest rates on outstanding amounts shown in Table 2.6 cover MFI euro-denominated loans granted to households and NFCs resident in Malta.

Table 2.6
MFI INTEREST RATES ON OUTSTANDING LOANS TO MALTESE RESIDENTS
Percentages per annum; weighted average rates as at end of period

	2010 Dec.	2011 Dec.	2012 Dec.
Total loans to households and non-financial corporations[(1)]	**4.38**	**4.44**	**4.33**
Households and NPISH			
Lending for house purchases	3.46	3.43	3.39
Consumer credit and other lending[(2)]	5.58	5.66	5.59
Non-financial corporations[(2)]	4.67	4.85	4.72

[(1)] Annualised agreed rates (AAR) on euro-denominated loans.
[(2)] Includes bank overdrafts.
Source: Central Bank of Malta.

Credit market conditions continued to be monitored through the quarterly Bank Lending Survey (BLS).[7] Credit standards applied on loans to enterprises were unchanged for most of 2012, with the exception of a slight tightening carried out by one bank during the first quarter of the year. Meanwhile, credit standards applied on loans to households remained unchanged throughout the year. Declines in demand for loans by enterprises and households during the first half of the year were followed by a slight increase in demand in the third quarter from firms and a small rise in demand during the fourth quarter for mortgages.

Credit to other residents of the euro area

Credit granted by resident MFIs to other residents of the euro area contracted substantially during 2012, falling by €559.7 million, or 10.8%, as opposed to an expansion of 23.5% in the previous year. This sizeable decline stemmed from a sharp drop in MFI holdings of euro area sovereign bonds. In contrast, credit institutions further increased their holdings of private debt securities and also extended more loans to the private sector. Thus, at end-December, credit extended by resident MFIs to residents of other euro area countries stood at €4.6 billion.

Net claims on non-residents of the euro area

The above-mentioned drop in credit to euro area residents was partly offset by higher credit to residents outside the euro area. In fact, during 2012 the external counterpart of M3, which consists of resident MFIs' net claims on non-residents of the euro area, expanded by €2.3 billion, or 29.6% (see Table 2.7). MFI claims on non-residents of the euro area rose by 11.1% during the year, owing to an increase in holdings of

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

	2011 Dec.	2012 Dec.	Change Amount	Change %
External counterparts	**7,840.0**	**10,159.8**	**2,319.8**	**29.6**
Claims on non-residents of the euro area	29,300.0	32,561.1	3,261.1	11.1
Liabilities to non-residents of the euro area	21,460.0	22,401.2	941.3	4.4
Other counterparts (net)[(2)]	**14,238.0**	**15,238.7**	**1,000.7**	**7.0**

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

[7] The BLS gauges credit demand and supply conditions. It is carried out as part of a quarterly exercise conducted by the Eurosystem across the entire euro area.

securities issued by non-euro area governments. At the same time, resident MFIs' liabilities to non-residents of the euro area grew by 4.4%, driven by time deposits belonging to non-euro area banks. An increase in repurchase agreements also contributed. In contrast, foreign loans taken up by resident banks dropped. Transactions carried out by one internationally-oriented bank greatly influenced these developments.

Other counterparts (net), which were heavily influenced by interbank transactions within the euro area, expanded by €1.0 billion, or 7.0%, during 2012. Further growth stemmed from a strong rise in longer-term financial liabilities, mostly in the form of reserves.

The money market

During 2012 the European Central Bank (ECB) cut the interest rate on its main refinancing operations (MRO) by a further 25 basis points, lowering it to 0.75% in July. At the same time, the three-month EURIBOR declined significantly, reflecting substantial injections of liquidity by the Eurosystem.[8]

Money market activity in Malta was dominated by trading in Treasury bills. During 2012 €845.2 million worth of Treasury bills were issued by the Maltese Government, €39.7 million less than in the previous year. More than half of the new issues (54%) were due to mature in three months, while the remainder mainly consisted of one-month bills.

Resident banks continued to participate actively in the primary market and bought more than three-fourths of the total, approximately the same proportion as in the previous two years, with money market funds buying most of the remainder.

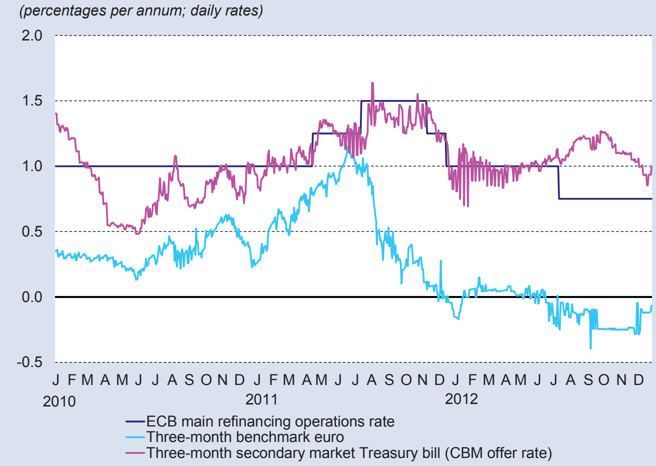
The primary market yield on Maltese three-month Treasury bills rose throughout most of the year, peaking at 1.27% in September. It declined thereafter, reaching 0.85% at year's end, 3 basis points higher than a year earlier (see Chart 2.6).

Despite the decline in the primary market activity during the year, turnover in the secondary market for Treasury bills amounted to €38.5 million, slightly higher than €36.2 million in the previous year, though still significantly lower than the amount registered in 2010. All transactions involved the Central Bank of Malta in its capacity as market-maker.

In the secondary market, domestic three-month bills traded within a narrow range in the first half of the year. Following some fluctuation in the second half, the yield ended December at 1.00%, 3 basis points higher than at end-2011.

Similarly, the three-month benchmark euro area yield rose by 3 basis points when compared with the previous year.[9] Consequently, the spread remained unchanged at 90 basis points by the end of 2012 (see Chart 2.6).

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



Sources: Central Bank of Malta; ECB; Reuters.

8 The Euro Interbank Offered Rate (EURIBOR) refers to rates at which a prime bank is willing to place deposits with another prime bank within the euro area in euro on an unsecured basis.

9 The benchmark euro area yield is the secondary market yield on three-month securities issued by the German Government.

The capital market

Net issues of long-term debt securities on the domestic primary market during 2012 amounted to €348.5 million, down from €495.6 million in the previous year (see Table 2.8).

Outstanding long-term government debt increased by €296.6 million in 2012, compared with a rise of €439.6 million in 2011, reflecting a significant rise in redemptions that was partly offset by an increase in gross issues.

Total gross issues of long-term government debt amounted to €792.4 million, €64.7 million higher than in the previous year. Issues during 2012 included the conversion of bonds maturing in 2013 into longer-dated securities. Together with the reduced issuance of Treasury bills mentioned earlier, this implies a shift towards long-term debt, as was also observed in 2011, in an environment of comparatively low yields.

Government bond issues took place in February, June, September, November and December, with maturities ranging from five to 19 years, and were all oversubscribed. Overall, just more than half was auctioned for institutional investors, while the remainder was bought at a fixed price by retail investors, particularly resident households. The prolonged period of low bank interest rates rendered sovereign fixed-income securities relatively attractive.

In December the Treasury operated the second stage of the three-year MGS switch auction programme that was launched in 2011, aimed at lengthening and smoothing the interest payments and redemptions of existing MGSs. Around one-third of the MGSs maturing in 2013 were converted into a €20.1 million MGS issue maturing in 2017, and a further €121.4 million MGS issue maturing in 2018. Once more, the programme attracted strong demand from investors, mainly financial institutions.

Following increased activity in the primary market, turnover in the secondary government bond market grew by almost 50%, reaching €598.4 million in 2012 (see Table 2.9). The Central Bank of Malta, acting as market-maker, accounted for more than three-fourths of the value traded, with the remainder being carried out by other brokers.

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

	2010	2011	2012
Government			
Total issues[2]	578.0	727.7	792.4
Redemptions[3]	189.8	288.1	495.8
Net issues	388.2	439.6	296.6
Corporate sector			
Total issues	303.7	60.4	80.0
Redemptions[3]	119.7	4.4	28.1
Net issues	184.0	56.0	51.9
Total net issues	**572.2**	**495.6**	**348.5**

[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 €0.4 million in 2010, €3.3 million in 2011 and €1.3 million in 2012. Data include the creation of MGSs as part of the MGS Switch Auction Programme. These include the creation of €158.1 million 4.3% MGS 2016 (IV) in 2011 and the creation of €20.2 million 3.75% MGS 2017 (IV) and €121.4 million 3.85% MGS 2018 (V) in 2012.

[3] Redemptions include debt securities bought back by the issuer but exclude the redemption of MGSs that were issued directly to the Foundation for Church Schools. Data for 2011 and 2012 include the cancellation of €159.9 million 5.7% MGS 2012 (III) issue and €146.5 million 3.6% MGS 2013 (IV) as part of the MGS Switch Auction Programme.

Sources: Central Bank of Malta; MSE; Treasury.

Table 2.9
SECONDARY MARKET TRADING IN GOVERNMENT STOCKS
EUR millions

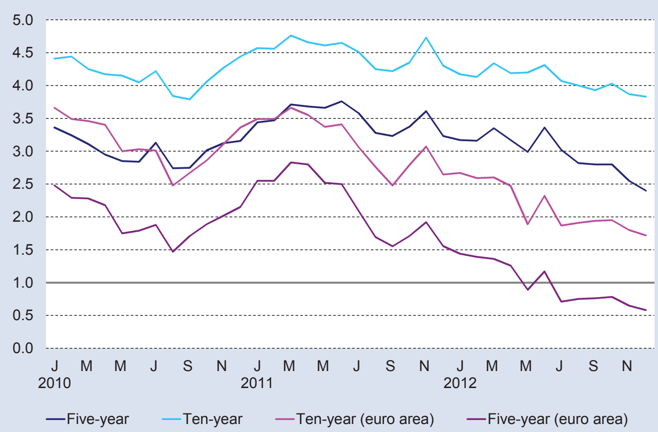
	2010	2011	2012
Central Bank of Malta purchases	144.5	163.3	266.1
Central Bank of Malta sales	82.8	91.2	200.6
Other deals[(1)]	51.4	150.7	131.7
Total	**278.7**	**405.2**	**598.4**

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

Source: Central Bank of Malta.

Domestic government bond yields mirrored benchmark euro area rates and generally decreased during 2012, extending the decline observed since the start of 2011 (see Chart 2.7). Still, the spread continued to widen moderately, in an environment of heightened market sensitivity.

Chart 2.7
GOVERNMENT BOND YIELDS
(percentages per annum; end of month)



Sources: Central Bank of Malta; ECB.

Movements in the spreads between yields on domestic sovereign debt and the corresponding euro area benchmarks broadly mirrored developments in the euro area as a whole. A wider spread during the first half of the year could have reflected financial market tensions affecting the euro area in general, including the rating downgrades of a number of euro area sovereigns, including Malta. Subsequently, a number of policy initiatives, including measures taken by the ECB, led to narrower spreads during the second half of the year.

The yield on five-year government securities fell by 83 basis points to a record new low of 2.40%. The corresponding benchmark euro area government bond yield dropped by 98 basis points and also closed the year at a record low of 0.58%. This stemmed from the growing demand for German bonds, which were increasingly seen as a safe haven.[10] As a result, the five-year sovereign spread widened by 15 basis points to 182 basis points from end-2011 to end-2012.

The yield on ten-year domestic government bonds reached a peak of 4.34% in March 2012. Overall, however, yields on ten-year sovereign debt fell by 47 basis points from end-2011, reaching 3.83% in December 2012. The benchmark ten-year yield in the euro area declined, although at a faster rate, falling by 93 basis points and ending the year at 1.72%. Consequently, the spread on ten-year debt also widened, adding 46 basis points to 211 basis points.

Turning to the corporate sector, the value of corporate debt securities issued on the primary market amounted to €80.0 million, €19.6 million more than in 2011, although considerably below the surge experienced during 2010. The five corporate debt security issues were well received by the public and were oversubscribed.

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

Activity in the secondary market for corporate bonds rose significantly during the period as turnover grew by €12.8 million, or almost 38%, reaching €47.0 million. This reflected an increase in the volume of trading, as well as a rise in prices. In fact, the continuous strong demand for fixed interest instruments, coupled with a relatively low level of new bond issuance generally pushed up corporate bond prices and lowered their yields. More than three-fourths of total trading was concentrated around 15 bonds, mostly issued by the banking sector.

Chart 2.8
MALTA STOCK EXCHANGE SHARE INDEX
(end of month)

Source: MSE.

Turning to the equity market, Malita Investments plc was listed on the Malta Stock Exchange (MSE), following the €15 million initial public offering in August 2012.

Turnover in the equity market decreased to €33.5 million in 2012, from €37.6 million in 2011. This development mirrored a decline in most share prices, particularly during the first few months of 2012. The MSE Index also fell at the beginning of the year, before recovering thereafter, reflecting an improvement in investor sentiment. Equity price movements were mixed across companies and sectors. The MSE Index closed the year at 3,211.9, 3.8% higher than at end-2011 (see Chart 2.8).

3. OUTPUT, EMPLOYMENT AND PRICES[1]

The Maltese economy continued to grow in 2012, although at a slower pace compared with the previous year. Net exports remained resilient, driving economic growth whereas domestic demand continued to decline owing to lower private consumption and investment, and to downward movements in inventories.

Output increased across most sectors, though services continued to provide the major contribution to growth in gross value added (GVA). In absolute terms, public administration & defence, and wholesale & retail, transportation & accommodation recorded the largest increases over 2011.

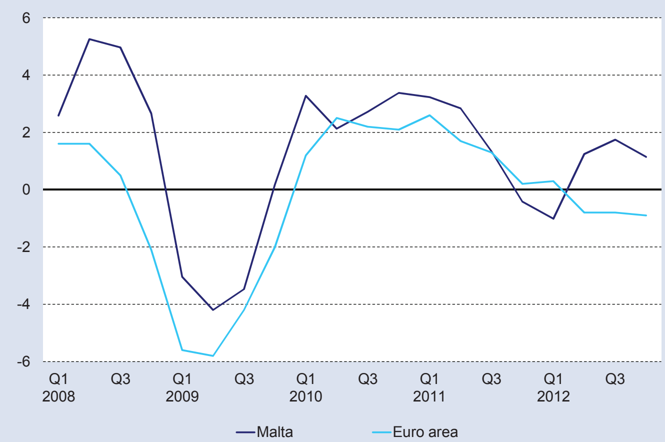
Gross domestic product

Real gross domestic product (GDP) growth decelerated to 0.8% during 2012 from 1.7% in the previous year and 2.9% in 2010. After having declined on a year-on-year basis during the first quarter of the year, output recovered, with real GDP expanding in each of the subsequent quarters. Growth eased in the final quarter of the year.

Developments in the Maltese economy generally followed a similar path to that in the euro area up to 2011; however, GDP growth rates diverged during 2012.[2] Euro area real GDP contracted throughout 2012, implying an annual drop of 0.6% for the whole year, which contrasts with the economic expansion in Malta (see Chart 3.1).

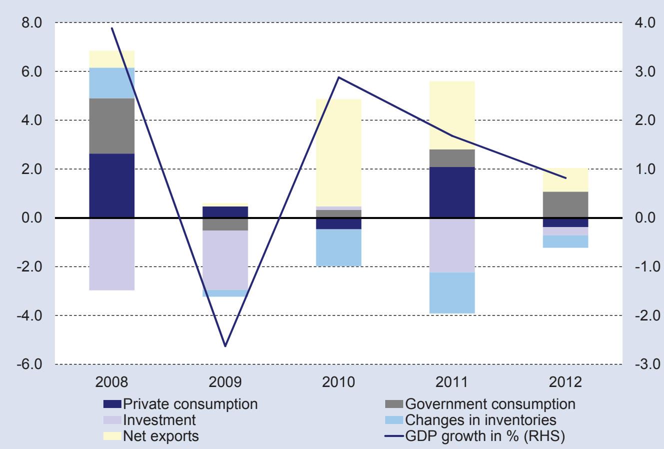
Net exports remained positive for the third consecutive year in 2012 and increased their share of GDP, boosting real GDP growth by 1 percentage point. In contrast, domestic demand continued to contract, dampening growth. This was due to a fall in private consumption and investment, as well as to a larger decline in inventories compared with the previous year. These developments outweighed higher government consumption expenditure (see Chart 3.2 and Table 3.1).[3]

Chart 3.1
REAL GDP GROWTH
(annual percentage change)



Source: NSO.

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



Source: NSO.

[1] The cut-off date for data on GDP related variables included in this Chapter is 11 March 2013.

[2] Annual real GDP growth rates for the euro area reported in this Chapter are not seasonally adjusted in order to maintain comparability with data for Malta. Therefore, figures for the euro area given in this Chapter may differ from those provided elsewhere in this *Report*.

[3] The figure for inventories also includes acquisitions less disposals 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	2012
			Annual percentage changes		
Private final consumption expenditure	4.1	0.7	-0.7	3.3	-0.6
Government final consumption expenditure	12.7	-2.7	1.7	3.8	5.5
Gross fixed capital formation	-13.6	-13.4	0.9	-14.1	-2.5
Changes in inventories (% of GDP)	1.7	1.4	-0.1	-1.7	-2.2
Domestic demand	**3.1**	**-2.7**	**-1.5**	**-1.1**	**-0.2**
Exports of goods & services	2.1	-8.4	18.1	0.8	5.2
Imports of goods & services	1.3	-8.2	12.7	-2.0	4.4
Gross domestic product	**3.9**	**-2.6**	**2.9**	**1.7**	**0.8**
			Percentage point contributions		
Private final consumption expenditure	2.6	0.5	-0.5	2.1	-0.4
Government final consumption expenditure	2.3	-0.5	0.3	0.7	1.1
Gross fixed capital formation	-3.0	-2.4	0.1	-2.2	-0.3
Changes in inventories	1.3	-0.3	-1.5	-1.7	-0.5
Domestic demand	**3.2**	**-2.8**	**-1.5**	**-1.1**	**-0.2**
Exports of goods & services	2.0	-7.8	15.9	0.8	5.2
Imports of goods & services	-1.3	7.9	-11.6	2.0	-4.2
Net exports	**0.7**	**0.1**	**4.4**	**2.8**	**1.0**
Gross domestic product	**3.9**	**-2.6**	**2.9**	**1.7**	**0.8**

Source: NSO.

Domestic demand

Private consumption was 0.6% lower in 2012 following a strong recovery in 2011. Positive growth in the last quarter was not enough to overturn annual declines in the first three quarters of the year. Consequently, over the entire year, private consumption pulled down real GDP growth by 0.4 percentage point.

The drop in private consumption occurred despite a moderate estimated increase in real wages and, hence, in real disposable income. This suggests that households boosted their savings, postponing consumption in an environment of increased uncertainty. Available data indicate that the decline in consumption in real terms mainly reflected lower spending on transport and food & beverages. With regard to the former, the number of licences issued for new and used passenger vehicles was lower in 2012 compared with 2011.

Government consumption accelerated for the third consecutive year, expanding by 5.5% following an increase of 3.8% in 2011. It contributed 1.1 percentage points to real GDP growth. In nominal terms, both compensation of employees and intermediate consumption contributed towards higher government consumption. On a sectoral level, this increase was widely distributed, with education and health absorbing the largest amounts.

In contrast, gross fixed capital formation (GFCF) decreased again in 2012, although at a slower pace of 2.5% compared with a decline of 14.1% in 2011. The drop in GFCF lowered real GDP growth by 0.3 percentage point. The annual fall was driven by a large year-on-year drop in the final quarter of the year. This partly resulted from a base effect concerning spending on the Valletta City Gate project, which had pushed up investment during the fourth quarter of 2011. In fact, on average, annual investment growth was positive in the first three quarters of the year.

All categories of investment spending decreased in real terms in 2012, except for the sector comprising IT-related products. Indeed, investment spending on construction declined, with a renewed fall in dwelling investment and a smaller drop in investment on other buildings and structures. Spending on transport equipment and machinery also fell.

In nominal terms, available information indicates that government investment increased, driven by spending on machinery and on non-residential construction. On the other hand, private investment was lower compared with 2011, as higher nominal investment in IT-related products and machinery was outweighed by lower investment in the construction sector and in transport equipment.

Changes in inventories, which are influenced by the statistical discrepancy, became more negative during 2012. They were equivalent to -2.2% of GDP, as against -1.7% in 2011. As a result, the negative impact on real GDP growth amounted to 0.5 percentage point.

Net exports

Exports of goods and services increased by 5.2% in 2012, up from 0.8% in 2011, driven by a very strong performance during the first three quarters of the year. Goods exports, which went up by 6.0%, were the largest contributor towards export growth in absolute terms, expanding at a faster rate than services and reversing the decline recorded in 2011. Service exports rose by 3.9%, lower than the rate registered in the previous year. In nominal terms, re-exports of oil and exports of machinery & transport equipment and chemicals were the major contributors towards higher merchandise exports. Service exports were boosted mainly by tourism, financial services and personal, cultural & recreational activities.

Reflecting movements in exports, and despite the decline in domestic demand, imports of goods and services recovered strongly following a decline in 2011, to expand by 4.4% in real terms during 2012. Imports of goods and services both increased, by 5.7% and 2.3%, respectively, with goods being the major contributor in absolute terms. In contrast, in 2011 both goods and service imports had declined. Nominal data indicate that oil was the major item which boosted imports of goods, followed by food and beverages & tobacco imports. On the other hand, imports of machinery & transport equipment decreased significantly. Imports of services were mainly boosted by transport and travel.

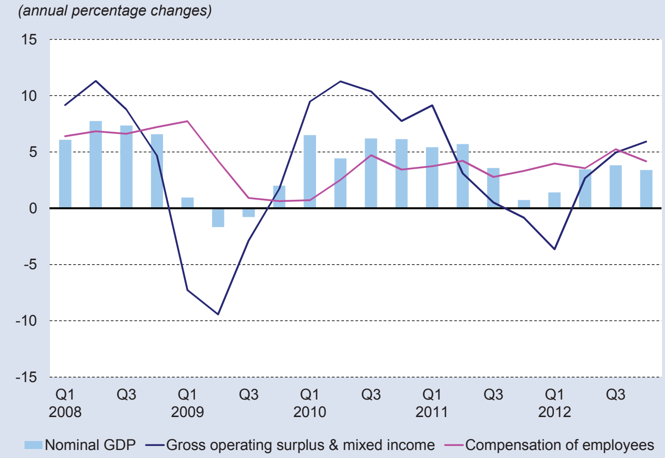
Nominal GDP

Nominal GDP growth slowed down to 3.0% in 2012, from 3.8% in the previous year and 5.8% in 2010.

On the income side of nominal GDP, growth in compensation of employees accelerated from 3.5% in 2011 to 4.2% in the year under review. This growth in compensation was broad-based, with the highest gains in absolute terms reflected in sectors comprising public administration & defence, wholesale & retail trade, transportation & accommodation and manufacturing. Compensation of employees only declined in the construction and information & communication sectors. Gross operating surplus & mixed income growth was resilient, increasing at a slightly slower rate of 2.6% compared with 2.7% in 2011, though with notable variation across quarters (see Chart 3.3).

On the output side, GVA grew by 3.4%, up from 3.2% in 2011. GVA contributed 2.9 percentage points to nominal GDP growth, with the remaining 0.1 percentage point attributable to net taxation on products (see Table 3.2).[4]

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



Source: NSO.

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

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

	2008	2009	2010	2011	2012
Agriculture, forestry & fishing	-0.4	0.2	0.1	-0.1	0.1
Mining & quarrying; utilities	-0.1	0.8	0.0	-1.0	-0.8
Manufacturing	1.8	-2.4	0.6	0.3	0.4
Construction	0.2	-0.2	-0.1	-0.1	-0.1
Wholesale & retail trade; repair of motor vehicles; transportation; accomodation & related activities	0.2	-0.9	1.1	0.7	0.8
Information & communication	0.3	0.1	-0.1	0.3	0.2
Financial & insurance activities	0.0	1.5	1.1	0.8	0.5
Real estate activities	0.1	0.2	0.1	0.2	0.1
Professional, scientific, administrative & related activities	0.8	0.2	0.6	0.4	0.4
Public administration & defence; education; health & related activities	1.1	0.8	1.0	0.7	0.8
Arts, entertainment; household repair & related services	2.9	-0.8	1.0	0.7	0.6
Gross value added	**6.9**	**-0.5**	**5.3**	**2.8**	**2.9**
Net taxation on products	**0.1**	**0.6**	**0.5**	**1.0**	**0.1**
Annual nominal GDP growth (%)	**7.0**	**0.1**	**5.8**	**3.8**	**3.0**

Source: NSO.

Services continued to be the main driver behind GVA growth, together adding 3.4 percentage points to nominal GDP. In particular, the sectors comprising public administration & defence and wholesale & retail, transportation & accommodation recorded the largest increases in absolute terms in their GVA and grew faster than in the previous year. More specifically, continued growth in tourism boosted the latter sector. As a result, these two sectors combined pushed nominal GDP growth up by 1.6 percentage points.

The financial & insurance and arts & entertainment sectors also performed strongly and recorded the highest growth rates in GVA during 2012, although at a slower pace compared with 2011. Their overall contribution to GDP growth amounted to 1.1 percentage points. The contribution from the professional & scientific activity sector remained stable at 0.4 percentage point. Information & communications and real estate activities made more moderate contributions of 0.2 and 0.1 percentage point, respectively, towards nominal GDP growth.

Turning to direct production, GVA in manufacturing continued to recover for the third year in a row. Manufacturing GVA went up by 3.3%, a higher growth rate compared with the previous year, and contributed 0.4 percentage point to nominal GDP growth.

In contrast, GVA in the mining & utilities and construction sectors contracted for the third and fourth consecutive year, respectively. GVA in the utilities sub-sector was adversely affected by rising costs of intermediate inputs. Together, these two sectors combined pulled down GDP growth by 0.9 of a percentage point.

Industrial production[5]

Growth in industrial production accelerated to 3.1% during 2012, following a slowdown to 1.3% in the previous year (see Table 3.3). Production in manufacturing, which accounts for most of industrial output, increased by 2.9%, up from 1.2% in 2011. Similarly, in the energy sector output growth accelerated from

[5] Industrial production data are based on a sample of firms engaged in quarrying, manufacturing and energy production. Methodological differences may account for divergences between developments in GVA in the manufacturing sector and industrial production. GVA nets input costs from output to arrive at value added and is expressed in nominal terms. Industrial production is a measure of the volume of output that takes no account of input costs. The sectoral coverage between the two measures also differs, since industrial production data capture the output of the energy sector.

Table 3.3
INDUSTRIAL PRODUCTION
Percentages; annual average percentage changes

	Shares	2010	2011	2012
Industrial production	**100.0**	**8.2**	**1.3**	**3.1**
Manufacturing	**91.4**	**9.3**	**1.2**	**2.9**
Of which:				
Computer, electronic & optical products	18.5	27.4	0.2	11.4
Food products	10.2	-12.1	-2.3	0.4
Wearing apparel	6.5	-12.3	4.6	-1.2
Rubber & plastic products	6.2	17.4	6.9	-10.8
Basic pharmaceutical products & pharmaceutical preparations	5.5	23.8	-5.9	1.2
Textiles	5.2	37.1	5.1	-6.1
Repair & installation of machinery and equipment	5.0	-16.6	-28.5	-1.8
Beverages	4.6	1.1	3.8	1.7
Energy	**8.0**	**-2.4**	**2.7**	**4.6**
Electricity, gas, steam & air conditioning supply	7.4	-2.5	2.6	4.6
Water collection, treatment and supply	0.6	-1.6	3.1	4.0
Mining and quarrying	**0.6**	**-22.6**	**-5.1**	**30.4**

Sources: NSO and Eurostat.

2.7% to 4.6% in 2012. During the year, production in the mining and quarrying sector recovered following four consecutive years of contraction.

In terms of manufacturing sub-sectors, production growth accelerated in the key computer & electronics sector. Moreover, drops in output of food and pharmaceutical products registered in 2011 were reversed during the year, while production slowed down but continued to expand in the beverage sub-sector. In contrast, production of textiles, wearing apparel and rubber & plastics declined in 2012 after increasing in the previous year, while output from the repair & installation sub-sector continued to fall, but at a slower pace.

Data on manufacturing sales show that turnover on average increased by 5.8% during 2012 after having slowed down to 0.5% in the previous year.[6] Both the export market and the domestic sector contributed to higher turnover. In the first three quarters of 2012, the level of employment in the manufacturing sector remained practically stable, increasing only by 0.1% after having expanded by 1.5% in the same period of 2011. The average wage in this sector rose by 3.3% in the first three quarters of the year, up from 3.0% in the same period a year earlier.

Tourism

During 2012 the tourism sector continued to expand, with higher tourist arrivals and a marked increase in tourism expenditure. While in Malta tourist numbers grew by 2.1%, according to the United Nations World Tourism Organisation the average growth registered in the Southern/Mediterranean Europe region was 2.0%.[7]

This notwithstanding, the growth in tourist arrivals in 2012 was lower than the increase of 5.7% recorded in 2011.[8] In the first quarter of 2012, tourist arrivals fell compared with the same period of 2011; however, in the following quarters a positive tourism performance was registered. Strong increases in tourist numbers were recorded in the summer months so that, by August, the cumulative number of tourists to Malta was higher than that registered over the same period of the previous year.

6 Data on industrial sales, employment and wages & salaries reported in this section are taken from Eurostat.
7 See United Nations World Tourism Organisation, *World Tourism Barometer* January 2013.
8 Figures are based on the NSO survey of inbound tourists referred to as “Departing Tourists” introduced in April 2004.

Table 3.4
TOURIST AND CRUISE PASSENGER ARRIVALS
Thousands

	2010	2011	2012
Tourist departures(1)	**1,338.8**	**1,414.5**	**1,444.0**
UK	415.1	437.7	440.3
Italy	219.7	201.3	201.8
Germany	126.2	133.9	137.2
France	86.5	103.3	107.5
Scandinavia(2)	92.9	93.9	97.2
Spain	67.8	62.8	60.4
Netherlands	33.4	38.9	39.4
Russia	22.7	24.3	31.7
Others	274.5	318.4	328.5
Cruise passengers	**474.3**	**541.6**	**594.4**
of which: overnight cruise passengers	**8.8**	**10.9**	**13.4**

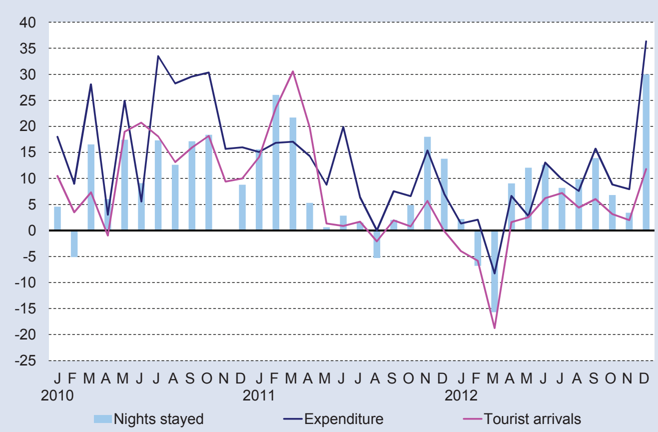
(1) Includes departures by air and by sea. Cruise passengers are shown separately.
(2) Scandinavia includes Denmark, Finland, Norway and Sweden.
Source: NSO.

With regard to Malta's tourist markets, during 2012 the United Kingdom remained the largest source and accounted for 30% of the year's total arrivals. The number of UK visitors rose slightly by 0.6% over the previous year. Italy remained the second largest source market, accounting for around 14.0% of total arrivals, with the number of visitors rising marginally over its year-ago level. At the same time, arrivals from Germany, another major source market, registered an increase of 2.5%. The number of tourists emanating from France and Scandinavia also rose, by 4.1% and 3.5%, respectively. This might reflect the introduction of additional routes to these countries, some by low cost carriers, during the course of the year. A particularly buoyant market was the Russian one, where tourist numbers increased by 30.8% over 2011 levels. The share of Russian visitors in the total, however, remains small. On the other hand, arrivals from Spain continued to drop on year-ago levels, with the number of tourists falling by 4.0%, possibly reflecting the economic downturn in this country (see Table 3.4).

Malta International Airport data on passenger movements provide further evidence of the continued expansion in tourism activity in 2012: incoming visitors, which include both residents and non-residents, were 4.5% higher, while aircraft landings were at their year-ago level. This was possibly due to continued efforts on the part of the authorities to increase connectivity to other destinations, as well as ongoing efforts by airlines to increase the seat-load factor.

The growth in arrivals was accompanied by higher tourism expenditure, which at 9.0% increased at the same rate of the previous year (see Chart 3.4).[9] The rise was broad-based

Chart 3.4
TOURISM INDICATORS
(annual percentage changes)



Source: NSO.

9 Total expenditure is composed of package, non-package and "other". Non-package spending is subdivided into spending on accommodation and travel, while the "other" component captures any additional expenditure that tourists incur during their stay in Malta.

across all spending categories, in particular the non-package holiday category, which went up by 13.6%. Within this component, spending on travel fares grew by 15.7%, while that on accommodation increased by 11.1%. The “other” component of tourist expenditure rose by 7.7%, while spending on package holidays increased by 7.0%.

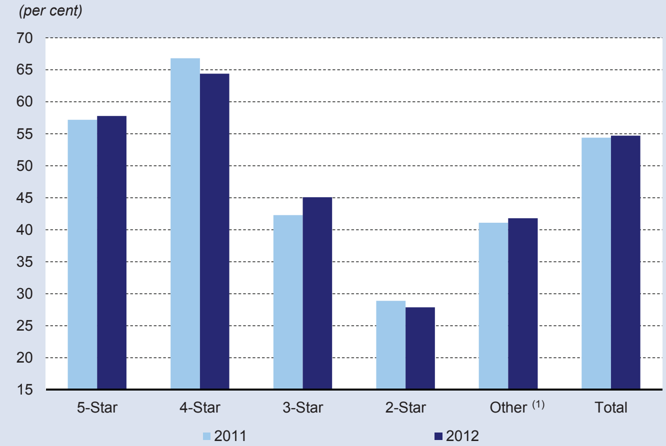
During 2012 nights stayed by tourists went up by 7.8% on a year earlier, signifying faster growth than tourist numbers. As a result, the average length of stay rose by 0.4 nights to 8.7. Around two-thirds of the additional number of nights spent reflected accommodation in private quarters, including self-catering apartments, farmhouses and private residences. The other third resided in collective accommodation, which is composed of hotels and “other” forms, such as aparthotels, guesthouses, hostels and tourist villages.

An industry survey shows that during 2012 there was an increase in occupancy in 5-star hotels, while occupancy in 4 and 3-star hotels fell when compared with the same period a year earlier. However, the highest overall occupancy rates were still recorded in 4-star hotels. The survey also shows that during 2012, significantly higher gross operating profits for all hotel categories were recorded. This, in part, reflects the higher average achieved room rates registered in all hotel categories.

National Statistics Office (NSO) data also confirm the increase in occupancy rates. These rose from 54.4% in 2011 to 54.7% in 2012. Occupancy was up in all accommodation categories, except in 4 and 2-star hotels, where occupancy rates declined by 2.4 and 1.0 percentage points, respectively (see Chart 3.5). However, accommodation in the 4-star hotel segment reflected an increase in supply as a hotel expanded its capacity during the year. Occupancy in 4-star hotels continued to record the highest rate, at 64.4%. Meanwhile, occupancy rates in 3 and 5-star hotels rose by 2.8 and 0.6 percentage points, respectively, on their year-ago levels.

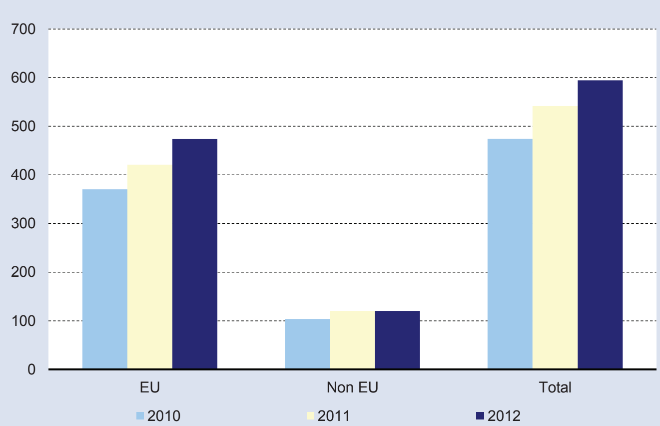
As in the previous year, the cruise liner industry continued to grow and generated further tourism activity. At 322, the number of port calls by cruise ships was 11 more than in 2011. Concurrently, cruise passenger arrivals rose by 9.7% to just below 600,000 (see Chart 3.6). Cruise passengers coming from the European Union (EU) continued to increase and accounted for almost four-fifths of total cruise liner visitors.

Chart 3.5
AVERAGE OCCUPANCY RATES
(per cent)



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

Chart 3.6
CRUISE PASSENGERS
(thousands)



Source: NSO.

Table 3.5
CONSTRUCTION ACTIVITY INDICATORS[1]

	2010	2011	2012
Gross value added (EUR millions)	**231.8**	**223.0**	**216.6**
Share of gross value added in GDP (%)	3.7	3.4	3.2
Total employment	**12,738**	**12,418**	**12,141**
Private employment	9,075	8,884	8,735
Share in total gainfully occupied population (%)	8.7	8.3	8.0

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

Source: NSO.

Construction

Construction activity continued to decline during 2012 as the annual output of the sector dropped by 2.5% in nominal terms after having contracted by 1.5% in the previous year. Intermediate consumption also fell, though to a lesser degree, shedding 2.3%. As intermediate consumption, such as purchases of materials, is deducted from output to arrive at GVA, the sector's GVA contracted by 2.8% in nominal terms, compared with a decline of 3.8% in 2011. Reflecting these developments, the sector's share in nominal GDP stood at 3.2% compared with 3.4% in the previous year (see Table 3.5).

Within the sector's GVA, employees' compensation, consisting of wages & salaries and employers' social contributions, fell by 2.5% when compared with the previous year. On the other hand, the profit element rose by 4.5%, in part making up for the decrease seen in the previous year.

In the first nine months of 2012, total employment in construction fell by 2.2%, or 277 jobs compared with the corresponding period of 2011 (see Table 3.5). Average private sector employment in the construction industry dropped by 1.7%, or 149 jobs, while in the public sector it fell by 3.6%. The industry's share in the total gainfully occupied population also declined to 8.0%, though it remained high relative to its share in GVA.

The drop in activity in the construction industry was also evidenced by developments in GFCF. The construction component in GFCF declined by 1.6% during 2012, compared with a 1.0% increase in the previous year. This drop emanated entirely from the private sector, as government construction investment increased.

Meanwhile, outlays on non-dwelling construction in nominal terms decreased by 0.4% over 2011. This was due to a fall in private investment of 4.5%, whereas government investment rose by 8.3%, as spending on a number of infrastructural projects, primarily roads, picked up.

On the other hand, investment on housing dropped by 4.1% following an annual increase of 0.9% in 2011. This substantial decline was solely related to private sector activity. Government investment in the construction of dwellings remained at a very low level during 2012.

Reflecting the decline in activity relating to housing construction, the number of dwelling permits issued by the Malta Environment & Planning Authority dropped by 22.5% in 2012, after having decreased by 11.0% in the previous year (see Table 3.6).

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

	2009	2010	2011	2012
Apartments	4,616	3,736	3,276	2,489
Maisonettes	400	375	401	298
Terraced houses	182	227	191	202
Other	100	106	87	75
Total	**5,298**	**4,444**	**3,955**	**3,064**

Source: Malta Environment & Planning Authority.

The number of permits granted for the largest residential category, apartments, which account for just over four-fifths of the total permits issued, dropped by almost a quarter. Moreover, those granted for the construction of maisonettes and for the "other" category dropped by 25.7% and 13.8%, respectively. On the other hand, permits for the construction of terraced houses rose by 5.8%.

Residential property prices

The Bank's index of advertised residential property prices increased on average by 0.5% in 2012, after having risen by 1.3% in the previous year (see Chart 3.7).[10]

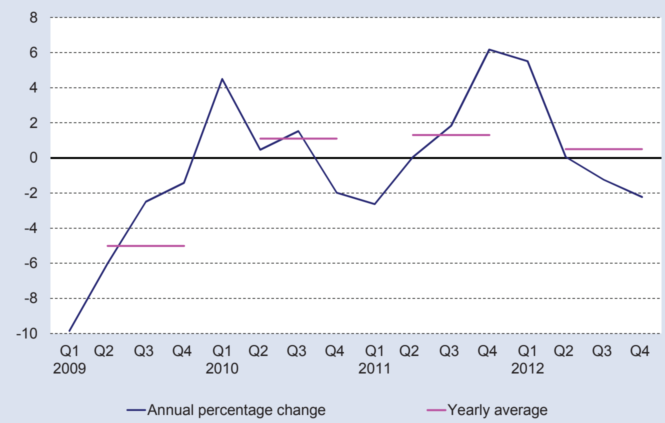
During the course of the year, the annual rate of change in property prices remained positive in the first half of the year, before turning negative in the second half.

Reflecting the deceleration in activity in the housing market, the number of advertised properties included in the Bank's survey declined by 15.4% in 2012. In the previous year, it had contracted by 1.7%.

The moderate rise in the overall price index during 2012 masks divergent movements in the different housing categories and also reflects changes in the composition of the sample. Asking prices for townhouses and houses of character, which form part of the "other" category, increased.[11] On the other hand, during 2012 asking prices for the remaining property types fell.

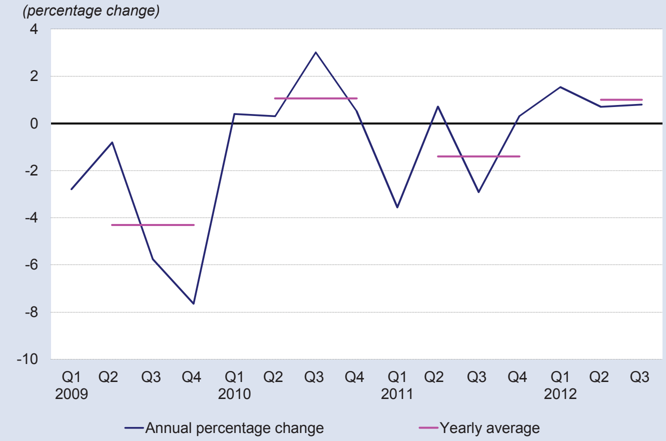
During the first three quarters of 2012, property prices based on the NSO Property Price Index grew by an average of 1.0% over the corresponding period a year earlier (see Chart 3.8). Similar to the Bank's advertised property price index, these data also point to weakening price pressures in the course of the year. Looking at the quarterly profile, property prices rose by 1.5% in the first quarter, and at a more moderate rate of 0.7% and of 0.8% in the second and third quarter, respectively.[12]

Chart 3.7
MOVEMENTS IN RESIDENTIAL PROPERTY PRICES BASED ON ADVERTISED PRICES
(percentage change)



Source: Central Bank of Malta.

Chart 3.8
MOVEMENTS IN RESIDENTIAL PROPERTY PRICES BASED ON CONTRACT PRICES
(percentage change)



Sources: NSO; Eurostat.

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

[11] Includes houses of character, villas and townhouses.

[12] See Eurostat Release 17/2013.

The labour market[13]

Labour market data for the year to September 2012 show that employment rose further, although the annual growth rates were lower than in 2011. The number of unemployed persons was generally higher in annual terms, as the labour supply grew at a faster pace than the number of employed persons.

Employment

Labour Force Survey (LFS) data indicate that, on average, employment in the first three quarters of the year was 2.1% higher than during the same period in 2011 (see Table 3.7). As a result, the employment rate rose by 1.3 percentage points to 58.9%, with the rate peaking at 59.6% in the third quarter of 2012.[14] Full-time jobs increased by 1.4% and remained the main source of employment growth, accounting for around 60 per cent of the total increase in the number of employed persons during this period. Part-time jobs increased by 7.4% on a year earlier.

In the year to September 2012, the labour force rose by 2.0%, when compared with the same period of 2011. The activity rate went up to 63.0%, thus adding 1.3 percentage points on a year earlier and reaching the highest level recorded since the inception of the survey in 2000.[15] The increase was driven by movements in the female activity rate, which increased by 3.3 percentage points, while that of males decreased by 0.6 percentage point. Although, the female activity in Malta remains among the lowest in the EU, the gap between the former and the EU average has narrowed from 26.7 percentage points in 2004 to 18.2 percentage points in 2012.

The administrative records of the Employment and Training Corporation (ETC) also point to an improved situation in the labour market. The gainfully occupied population, which consists of people who hold a full-time job, continued to post annual gains throughout the first nine months of the year (see Chart 3.9). Thus, on average, full-time employment rose by 1.5% in the year to September 2012, with the increase being completely driven by the private sector (see Table 3.8). In fact, full-time jobs in the private sector rose by 2.2%, whereas those in the public sector fell by 0.3% compared with the corresponding period of 2011.

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

	2011	2012	Annual change
	Jan.-Sep.	Jan.-Sep.	%
Labour force	**180,505**	**184,141**	**2.0**
Unemployed	11,634	11,766	1.1
Employed	168,871	172,375	2.1
By type of employment:			
Full-time	146,315	148,353	1.4
Full-time with reduced hours	4,084	4,177	2.3
Part-time	18,472	19,845	7.4
Activity rate (%)	**61.7**	**63.0**	**1.3**
Employment rate (%)	**57.6**	**58.9**	**1.3**
Unemployment rate (%)	**6.4**	**6.4**	**0.0**

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

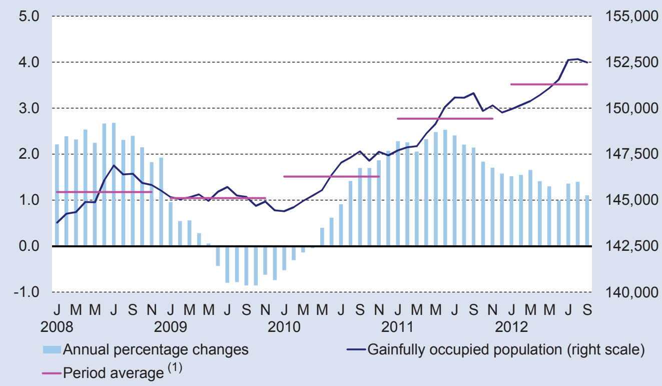
13 This section draws mainly on labour market statistics from two sources: the LFS, which is a household survey conducted by the NSO on the basis of definitions set by the International Labour Organization and Eurostat, and administrative records compiled by the ETC according to definitions established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

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

15 The activity rate measures the number of people in the labour force as a proportion of the working-age population, which is defined as all those aged between 15 and 64 years.

The increase in full-time private sector employment was spurred by job creation in market services, where jobs rose by 2,748 or 3.6%. Within this category, the largest absolute gains were recorded in land transport, administrative & support services and in the arts, entertainment & recreation sector. On the other hand, jobs decreased in the telecommunications sector and in wholesale trade. However, job losses in wholesale trade were offset by gains in retail trade, and thus overall employment in the wholesale & retail trade sector rose marginally. Meanwhile, the financial intermediation sector continued to generate new

Chart 3.9
GAINFULLY OCCUPIED POPULATION BASED ON ETC RECORDS
(annual percentage changes; persons)



(1) Period averages for 2008-2011 are based on averages for the whole year, while for 2012 the average is based on data for the first nine months of the year.

Source: NSO.

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

	2011 Jan.- Sep.	2012 Jan.- Sep.	Annual change %
Labour supply	**155,641**	**158,084**	**1.6**
Registered unemployed(2)	**6,568**	**6,791**	**3.4**
Gainfully occupied	**149,073**	**151,293**	**1.5**
Public sector	**40,819**	**40,711**	**-0.3**
Private sector	**107,585**	**109,970**	**2.2**
Private direct production(3)	**31,406**	**31,043**	**-1.2**
Manufacturing	19,759	19,772	0.1
Construction	9,051	8,735	-3.5
Private market services	**76,179**	**78,927**	**3.6**
Wholesale & retail	22,890	22,910	0.1
Transportation & storage	6,541	7,030	7.5
Accommodation & food service activities	9,614	9,615	0.0
Information & communication	4,566	4,487	-1.7
Financial & insurance activities	6,110	6,260	2.5
Real estate, professional & administrative activities(4)	13,618	14,955	9.8
Arts, entertainment & recreation	3,016	3,421	13.4
Other	9,824	10,249	4.3
Temporary employed	**669**	**613**	**-8.4**
Part-time employees	**51,543**	**54,512**	**5.8**
Part-time as a primary job	29,132	31,150	6.9
Part-time holding a full-time job	22,411	23,362	4.2

(1) Figures are based on averages for the first nine months.
(2) Statistics for all of 2012 are available for the number of registered unemployed. The average number increased by 4.1% between 2011 and 2012.
(3) This also includes employment in agriculture, fishing, mining & quarrying and electricity, gas & water supply.
(4) This includes employment in real estate activities, professional, scientific & technical activities and administrative & support service activities.
Source: NSO.

employment. Employment in direct production within the private sector fell by 364, or 1.2%, mainly reflecting decreases in the construction sector. In the public sector, full-time jobs were lost primarily in the areas of air transport and public administration, which outweighed gains in residential care activities and education.

ETC data also show that the number of persons holding a part-time job continued to increase. In the first nine months of 2012, the number of part-timers rose by 2,969, or 5.8%, driven by developments in the food & beverage sector, retail trade and accommodation. Most of the overall increase in part-time work was attributable to a higher number of employees holding a part-time job as their only form of employment.

Unemployment

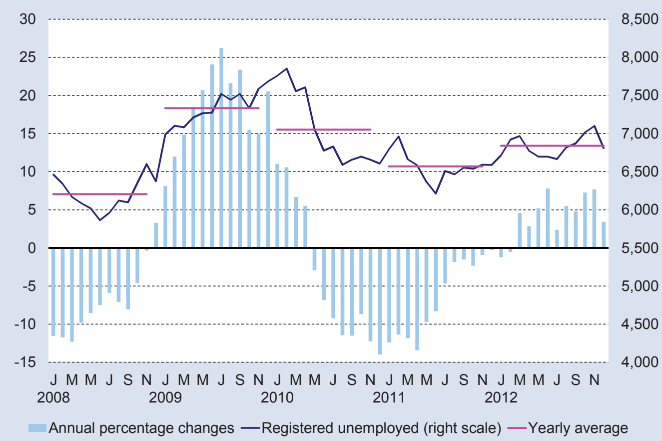
Over the year as a whole, the average number of unemployed persons increased by 4.1% compared with 2011 (see Chart 3.10). While in the first two months of the year unemployment declined, an increasing trend was evident over most of the remainder of the year. Regarding age categories, unemployment fell in the under 24 age bracket but increased among those aged 25 and over. In terms of duration of registration, both short-term and long-term unemployment increased, although the rise was stronger in the former.

In month-on-month terms, the number of people looking for a job increased in the first quarter of 2012, before falling up to July. During most of the second half of the year, the unemployment level rose. However, the number of job seekers fell significantly in December.

Likewise, LFS data for the first nine months of 2012 show an increase in the number of unemployed compared with the same period of 2011. However, as the labour supply also expanded, the jobless rate remained unchanged at 6.4%, compared with the same period of 2011.[16]

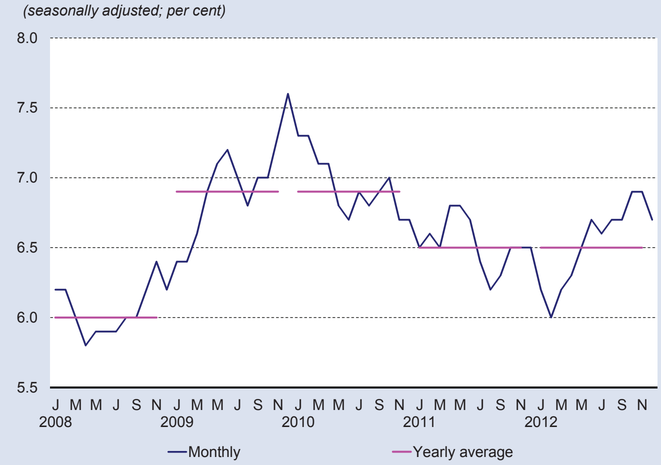
The seasonally adjusted unemployment rate, published by Eurostat, averaged 6.5% during 2012, unchanged from the level prevailing in 2011 (see Chart 3.11).[17] The rate generally increased as the year progressed, going from an average of 6.1% in the first quarter, to 6.9% in October and November, before easing to 6.7% by December.

Chart 3.10
REGISTERED UNEMPLOYED
(annual percentage changes; persons)



Source: NSO.

Chart 3.11
UNEMPLOYMENT RATE
(seasonally adjusted; per cent)



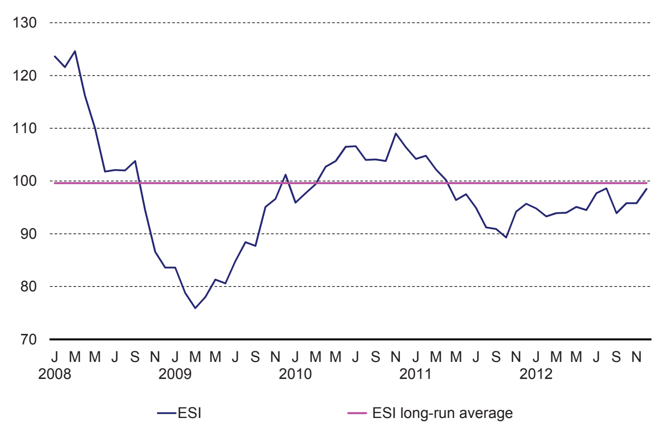
Source: Eurostat.

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

BOX 1: BUSINESS AND CONSUMER SURVEYS[1]

Survey data for 2012 show that confidence generally rose among firms operating in the manufacturing sector and among consumers. On the other hand, confidence declined in the services sector, while the confidence level in the construction sector at the end of the year was equal to the year-ago level. These movements brought about a gradual rise in the overall economic sentiment indicator (ESI), which increased to 98.5 in December 2012 from 95.7 a year earlier (see Chart 1).[2] At this level, the index was below its long-term average of 99.6.[3]

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

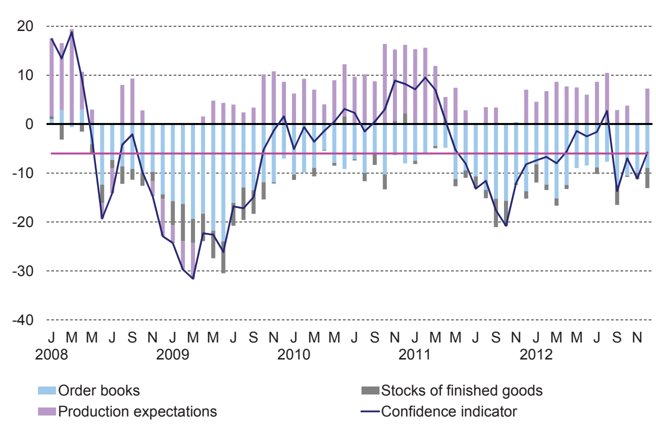


Source: European Commission.

Industrial confidence surveys[4]

After falling to relatively low levels towards the end of 2011, industrial confidence generally improved during the first eight months of 2012 and briefly moved into positive territory in August (see Chart 2). Thereafter, the index contracted again as sentiment declined in key areas of manufacturing, including electronics. Nonetheless, over the calendar year, the seasonally adjusted industrial confidence indicator rose by 2 percentage points, reaching -6 in December, and was thus exactly equal to its long-term average. For the year as a whole, its average value also stood at -6, unchanged compared with 2011.

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



Source: European Commission.

[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 ESI summarizes developments in confidence in the four surveyed sectors (industry, services, construction and consumers).

[3] Long-term averages are calculated over the entire period for which data are available. For the ESI and the consumer and industrial confidence indicators, data became available in November 2002, while the services and construction confidence indicator data became available in May 2007 and May 2008, respectively.

[4] 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.

The increase in confidence was mainly driven by an improvement in order books, leading to a rise in this sub-index of 14 percentage points over the year. Meanwhile, in December production expectations remained practically unchanged at the same high level of the previous year. On the other hand, an increase in stocks of finished goods at the end of the year had a negative impact on the overall industrial confidence indicator. However, stocks fluctuated over the year, with reported increases in some months partly counterbalanced by falling stocks in other months.

Survey responses also show that the share of respondents foreseeing a rise in their manpower levels was higher in December 2012 compared with a year earlier. Indeed, except in January and September, the majority of firms expected their labour complement to increase throughout the year. Turning to selling prices, respondents generally anticipated them to rise, but in the final quarter they expected them to decline. Throughout the year, a large number of respondents indicated insufficient demand as the main factor inhibiting business activity, while stating that production capacity was more than sufficient to meet demand.

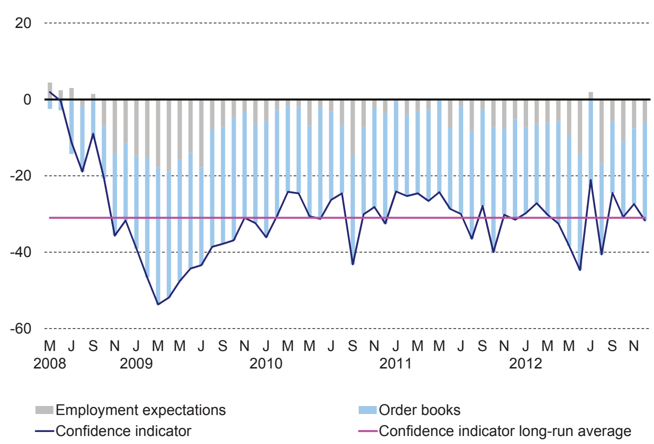
From a sectoral perspective, in December 2012 confidence improved further among manufacturers of pharmaceutical products compared with a year earlier, while confidence levels among those producing rubber & plastic products and computer & electronic equipment turned positive. Manufacturers of paper & paper products and non-metallic mineral products became less pessimistic than before. In contrast, firms operating in the wearing apparel and the reproduction of recorded media sectors, as well as in those producing food products were more pessimistic.

Construction industry confidence surveys[5]

Confidence among firms operating in the construction sector remained practically unchanged in the first four months of the year (see Chart 3). It then fell in May and June, rose sharply in July and dropped again in August. It somewhat improved in the final months of the year, to end 2012 at -32, exactly at the same level prevailing in December 2011. The indicator was marginally below its long-term average of -31. For 2012 as a whole, its average value also stood at -32, as against -29 in 2011.

During most of the year, the respondents generally expressed an intention to reduce the number of employees in their firm. In July, however, there was a short-lived rise in their employment expectations. All throughout the year, the majority of firms still considered their order books to be below normal. As with industrial firms, a large number of operators considered insufficient demand as the primary factor inhibiting activity.

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



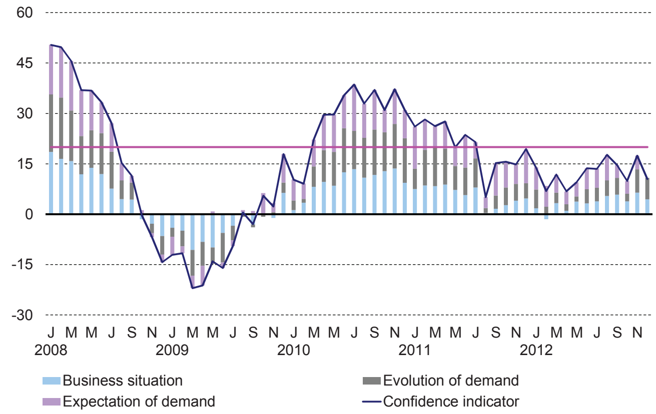
Source: European Commission.

[5] 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.

Services confidence surveys[6]

Confidence among service providers, which had improved towards the end of 2011, fluctuated in the first four months of 2012 (see Chart 4). Thereafter, the confidence level generally rose, before falling again at the end of the year. Nonetheless, firms generally remained optimistic, with the overall balance remaining positive throughout. The indicator registered a net loss of 9 percentage points over the course of the year and stood at 11 in December, which was below the long-term average of 20. The average level over the year stood at 12, as against 20 in 2011.

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

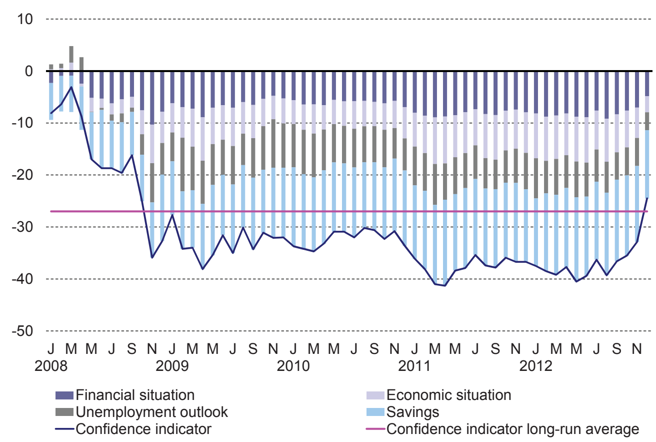


Source: European Commission.

The fall in the index was entirely due to firms' expectations about demand. Whereas the majority expected demand to rise during the first 11 months of 2012, by the end of the year the balance turned slightly negative. On the other hand, the proportion of respondents reporting positive developments in demand over the previous three months rose. The share of respondents anticipating a favourable business situation remained practically unchanged at the end of the year compared with the same period of 2011. Survey data also show that by the end of the year the majority of respondents, on balance, anticipated a reduction in their labour complement.

During 2012 confidence deteriorated among firms providing services related to warehousing & support activities, programming & broadcasting and real estate. In contrast, it improved in the accommodation, financial intermediation, food & beverage and arts, entertainment & recreation sectors.

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



Source: European Commission.

Consumer confidence surveys[7]

During 2012 consumer sentiment fluctuated within a narrow range, before improving

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[6] 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.

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

towards the end of the year (see Chart 5). While remaining in negative territory, the index rose to -25 in December, as against -37 a year earlier. Thus, it stood above its long-term average of -27. The average level for 2012 equalled -36, slightly up from -38 in 2011.

The improvement in confidence evident at the end of 2012 was spurred by all components of the index. Consumers, on balance, were less pessimistic about the general economic situation, their own financial position and their ability to save over the subsequent 12 months. Moreover, the share of respondents expecting a rise in unemployment decreased. Further survey information suggests that, while in 2011 the majority of consumers felt that given the existing economic situation the timing was not right to make major purchases, the opposite was true in 2012. On average, a smaller proportion of respondents expected prices to increase compared with 2011.

Consumer prices

HICP[18]

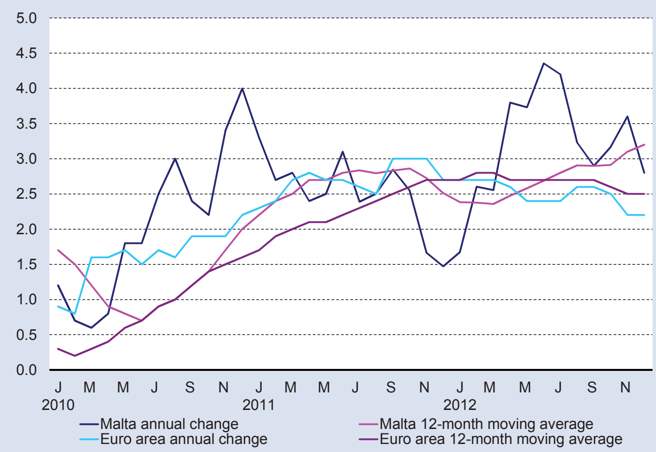
In 2012 the 12-month moving rate of inflation based on the Harmonised Index of Consumer Price (HICP) increased progressively to 3.2%, compared with 2.5% in 2011 (see Chart 3.12). The year-on-year inflation rate initially followed a generally upward path but this mostly moderated in the second half of the year.

Prices rose at a faster pace in Malta than in the euro area during most of the year with the inflation differential averaging 0.7 percentage point during the year as a whole.

The acceleration in Malta's average inflation rate between 2011 and 2012 was almost entirely due to developments in service prices, more specifically hotel accommodation rates (see Chart 3.13 and Box 2). Food prices and non-energy industrial goods prices rose to a smaller degree. On the other hand, there was an easing in the contribution of energy.

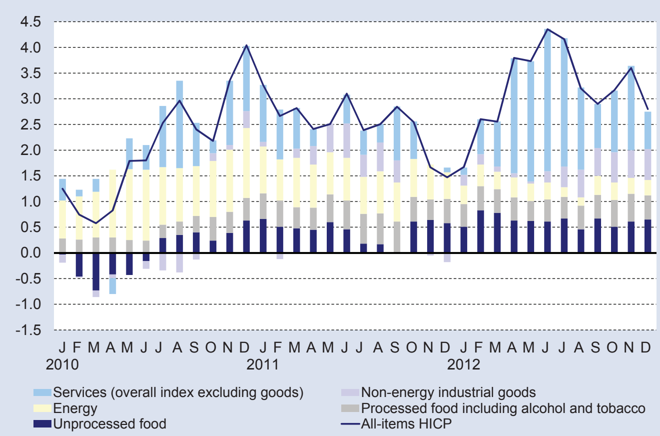
The services index of the HICP rose by 3.2% from 1.2% a year earlier. Given this acceleration, as well as the large weight of this category in the overall HICP index, in 2012 ser-

Chart 3.12
HICP INFLATION RATES IN MALTA AND IN THE EURO AREA
(annual percentage changes; annual average percentage changes)



Sources: NSO; Eurostat.

Chart 3.13
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION
(percentage points; annual percentage change)



Source: Eurostat.

[18] In January 2012 the HICP weights were revised to reflect changes in household consumption patterns. As a result, the weight of non-energy industrial goods was reduced by 1.6 pp to 29.9%. In addition, the weight related to food fell by 0.2 pp to 20.3%. In contrast, the share allocated to energy rose from 6.7% to 7.3% in 2012. Weights related to services rose by 1.2 pp, to 42.5%.

Table 3.9
CONTRIBUTIONS TO HICP INFLATION
Percentage points

	2010	2011	2012
Unprocessed food	0.0	0.4	0.6
Processed food including alcohol and tobacco	0.3	0.5	0.5
Energy	1.1	0.8	0.3
Non-energy industrial goods	-0.1	0.2	0.3
Services (overall index excluding goods)	0.7	0.5	1.5
HICP (annual average inflation rate)	**2.0**	**2.5**	**3.2**

Source: Eurostat.

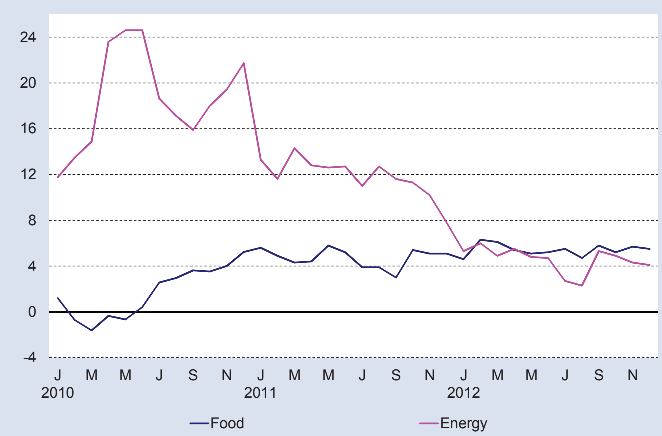
vices became the highest contributor to overall inflation, with 1.5 percentage points (see Table 3.9 and Box 2).

During 2012 food prices, which account for just over a fifth of the HICP, rose by 5.4% compared with an increase of 4.7% during 2011 (see Chart 3.14). Both unprocessed and processed food prices increased. Inflation in the former accelerated to 8.5% in 2012 from 5.9% in 2011, while that in the latter decelerated to 3.6% from 4.0% in the previous year. These two food categories contributed to overall price inflation in broadly equal measure, each adding around half a percentage point to the year's inflation. During most of the year, inflation in the unprocessed food category was mainly driven by meat and fish, although vegetable prices began to have a greater effect on overall inflation towards the end of the year (see Chart 3.15). Within the processed food category, bread & cereals, sugar, jam & honey, and tobacco accounted for most of the inflation.

Non-energy industrial goods inflation rose from 0.9% in 2011 to 1.1% in 2012. The contribution of this category to inflation edged up by 0.1 percentage point to 0.3 percentage point.

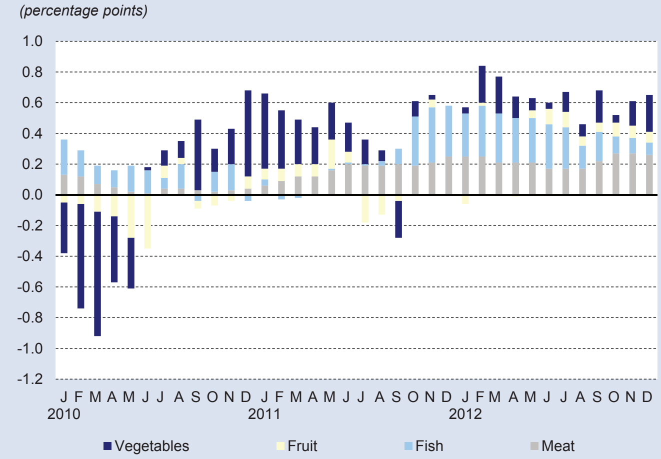
Energy inflation moderated significantly to 4.6% in 2012 from 11.8% in the previous year. As a result, its contribution to overall inflation was half a percentage point lower at 0.3 percentage point. This reflected the

Chart 3.14
FOOD AND ENERGY PRICE INFLATION
(annual percentage changes)



Sources: NSO; Eurostat.

Chart 3.15
CONTRIBUTION TO OVERALL HICP FROM UNPROCESSED FOOD
(percentage points)



Source: Eurostat.

stability of electricity and water tariffs and a less pronounced increase in international oil prices affecting the transport fuel component. In 2012 fuel prices were on average 6.9% higher in annual terms, and contributed 0.3 percentage point to inflation, 0.4 percentage point less than in 2011. Gas prices also increased in 2012, though at a more moderate rate than in the previous year. However, their impact on overall energy inflation was almost nil, reflecting the small weight of this component in the overall HICP index.

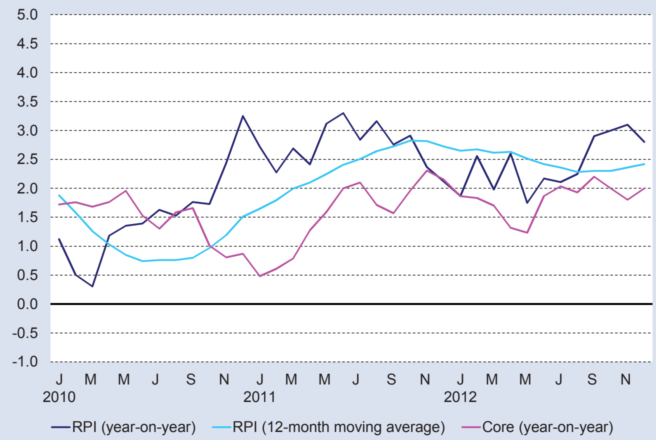
RPI and core inflation

The 12-month moving average inflation rate based on the Retail Price Index (RPI) dropped from 2.7% in 2011 to 2.4% during the year under review (see Chart 3.16). During the course of the year, the annual rate fluctuated widely, from a low of 1.7% in May to a high of 3.1% in November (see Table 3.10).[19]

The acceleration in RPI inflation towards the end of the year was driven by movements in food prices.

The food price sub-index rose by 4.7% in 2012 from 3.9% in 2011. It remained the main driver of RPI inflation during the year, contributing 1.0 percentage point to the overall inflation rate from 0.8 percentage point a year earlier. Meanwhile, beverages and tobacco added another 0.3 percentage point to overall inflation in 2012, with the inflation rate of this category doubling to 4.4% in 2012.[20] The other main contributor to overall

Chart 3.16
RPI AND CORE INFLATION
(annual percentage changes; annual average percentage change)



Sources: Central Bank of Malta estimates; NSO.

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

	Weights	2010	2011	2012
Food	21.23	0.2	0.8	1.0
Beverages & tobacco	6.09	0.1	0.1	0.3
Clothing & footwear	7.41	-0.3	0.0	-0.1
Housing	7.61	0.2	0.4	0.0
Water, electricity, gas & fuels	3.36	0.8	0.1	0.0
Household equipment & house maintenance costs	6.59	0.0	-0.1	0.1
Transport & communications	22.76	0.1	0.7	0.5
Personal care & health	8.57	0.2	0.1	0.1
Recreation & culture	9.28	0.2	0.1	0.1
Other goods & services	7.10	0.1	0.3	0.3
RPI (annual average inflation rate)	**100.00**	**1.5**	**2.7**	**2.4**

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

19 Diverse patterns in inflation as measured by the HICP and the RPI reflect differences in the way the two indices are compiled. 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 account for a significant weight in the HICP. The RPI also allocates a larger weight to the food component.

20 The food component in the RPI includes both processed and unprocessed food. Processed food in the RPI excludes beverages and tobacco, which however are part of the processed food sub-index of the HICP.

HICP inflation was the transport & communications category, which added half a percentage point to the overall RPI inflation rate.

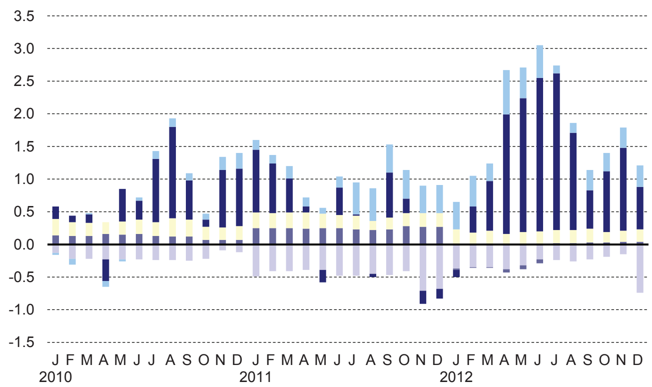
While miscellaneous goods and services contributed a further 0.3 percentage point to the overall inflation rate, the other remaining RPI sub-indices had only a marginal impact over this period.

On the basis of the Bank's core RPI inflation measure, which eliminates the impact of various volatile components, such as food and energy, the annual rate of underlying inflation averaged 1.8% in 2012 from an average of 1.5% in 2011.[21] The core rate reached a low of 1.2% in May, but then rose progressively to 2.2% in September, before easing to 2.0% by the year's end. The largest contributors to core inflation in 2012 were household equipment & house maintenance and "other goods and services", which contributed 0.6 percentage point each.

BOX 2: AN ANALYSIS OF HICP SERVICES INFLATION

This Box assesses in more detail price developments in services during 2012. The services category of the HICP is composed of five main sub-indices: recreation & personal, transport, miscellaneous, housing and communication services (see Chart 1). Recreation & personal services carry the largest weight, accounting for over one half of the services index.

Chart 1
CONTRIBUTIONS FROM SERVICES TO HICP INFLATION
(percentage points)



Source: Eurostat.

The contribution of services to the overall HICP inflation rate increased by 1.0 percentage point to 1.5 percentage points between 2011 and 2012. The main driver was the **recreation & personal** component, which contributed 1.2 points to overall HICP inflation in 2012, 0.9 point more than in 2011. The transport category and the miscellaneous category contributed 0.4 and 0.2 percentage point, respectively, to overall inflation. On the other hand, the impact of housing on HICP inflation was nil, while the communication category contributed a negative 0.3 point to overall inflation.

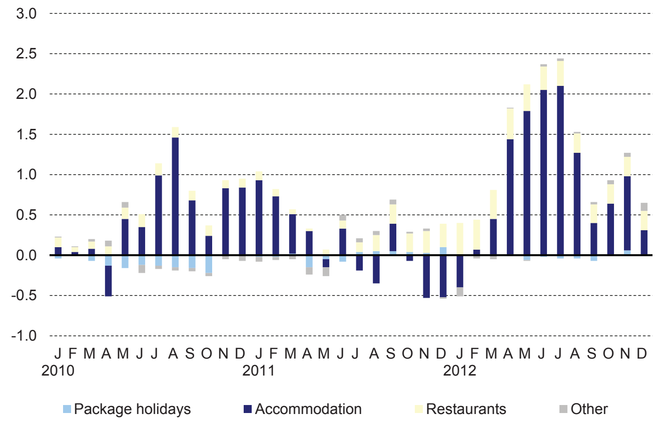
The price index for the recreation & personal category rose from 1.2% in 2011 to 4.3% in 2012, standing at 2.8% at the end of the year.

This path was heavily influenced by developments in the accommodation sub-index, which contributed 0.9 percentage point to overall HICP inflation (see Chart 2). The accommodation

[21] The core inflation rate reflects developments only in those sub-indices of the RPI that show persistent price changes. As measured by the Bank, the included sub-indices currently consist of: housing, durable household goods, personal care & health, education & entertainment and other goods & services.

sub-index rose by 7.3% in 2012 from 0.4% a year earlier, after accelerating strongly in the second quarter of 2012. While, to some extent, this reflected the buoyant performance of the tourism and hospitality sector during most of the year, it could also be attributed to the new method of observing tourist accommodation prices adopted by the NSO. In fact, official price data compiled on the basis of this new method show larger increases on average than rates based on surveys carried out by the Malta Hotels and Restaurants Association (MHRA) for 2012.

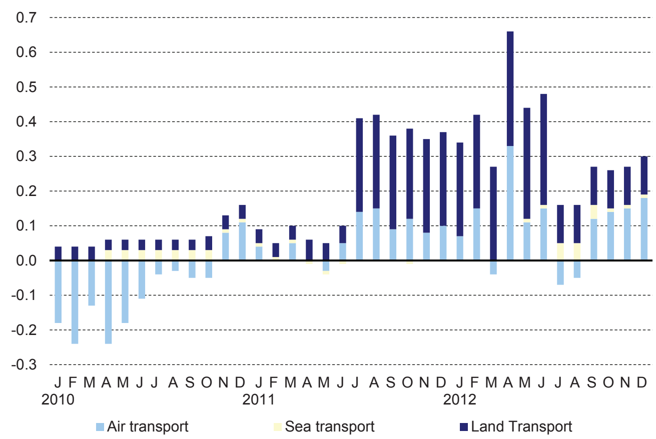
Chart 2
CONTRIBUTION TO OVERALL FROM RECREATIONAL SERVICES
(percentage points)



Source: Eurostat.

Restaurants contributed 0.3 points to overall HICP inflation in 2012. Overall, therefore, the two tourism-related sectors accounted for almost two-fifths of the overall HICP inflation rate for 2012.

Chart 3
CONTRIBUTION TO OVERALL FROM TRANSPORT SERVICES
(percentage points)



Source: Eurostat.

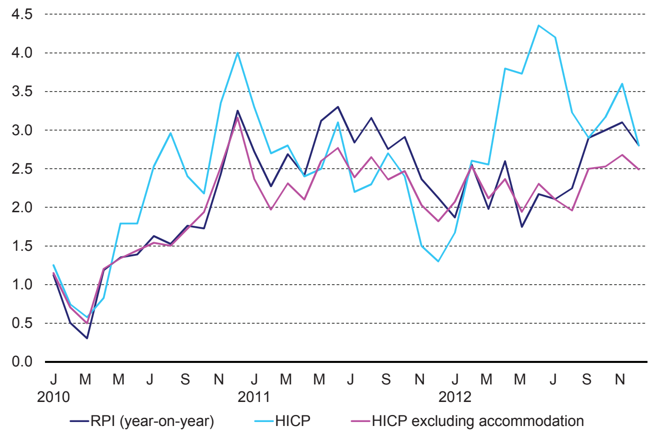
Chart 3 shows developments related to the transport sub-index, which rose by 6.3% in 2012 from 5.3% in 2011. This acceleration was mainly driven by developments in the land **transport** component, which was affected by the upward revision of the bus fare structure as from July 2011. This base effect ceased after June 2012. As a result, the contribution of the transport category to the overall inflation rate rose only marginally, from 0.3 percentage point in 2011 to 0.4 percentage point in the year under review. Developments in airfares also contributed somewhat to the acceleration in prices in the transport category.

The price index of **miscellaneous** services, which cover such items as medical, financial services and education related expenditure, rose by 4.1% in 2012, with its contribution to overall inflation remaining unchanged at 0.2 percentage point. Meanwhile, the **communication** price index continued to fall, registering a drop of 6.6% in 2012 but having a smaller impact on the overall inflation rate. Prices of **housing** services declined by 0.1% in 2012, after an average increase of 5.2% in 2011.

As a result the contribution of this component to the headline inflation rate contracted to around zero over this period.

In summary, the acceleration of services inflation in 2012 was mainly attributable to developments in accommodation rates. Indeed, in 2012 the HICP inflation rate excluding accommodation, as estimated by the Central Bank of Malta, stood at 2.3%, unchanged from 2011. The latter also followed more closely developments in the RPI, which excludes accommodation rates (see Chart 4).

Chart 4
RPI AND HICP
(annual percentage changes)



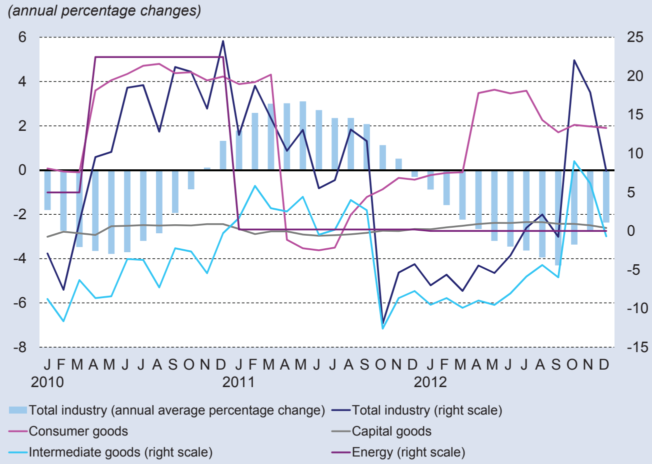
Sources: Central Bank of Malta estimates; NSO.

Costs and competitiveness

Producer prices[22]

During 2012 the industrial producer price index (PPI) declined during the first nine months of the year when compared with 2011, before increasing in the fourth quarter. Reflecting these developments, the 12-month moving average inflation rate based on this index remained in negative territory at -2.3% in 2012 compared with -0.3% a year earlier (see Chart 3.17).

Chart 3.17
INDUSTRIAL PRODUCER PRICE INFLATION
(annual percentage changes)



Source: NSO.

Turning to the components of the PPI, the drop in producer price inflation in 2012 largely resulted from movements in the intermediate goods category, where prices contracted at a faster rate of 4.7%, after having declined by 0.4% in 2011. As a result, their contribution to overall producer price inflation became more negative, falling to 2.6 percentage points from -0.2 percentage point in 2011. Intermediate goods mainly include the cost of semiconductors, pharmaceutical, paper and plastic products.

On the other hand, producer prices of consumer goods increased by 2.0% in 2012 after they had contracted by 0.5% a year earlier. The contribution of this category to overall producer price inflation was 0.3 percentage point. At the same time, prices of capital goods rose slightly by 0.8%, after dropping by 0.2% in 2011. Their

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

Table 3.11
ESTIMATED CHANGE IN AVERAGE NEGOTIATED WAGES[(1)]
Annual percentage changes

	2009	2010	2011	2012
Private sector	4.0	4.5	2.4	2.4
Public sector	5.2	5.2	2.8	2.5
Overall	4.3	4.7	2.7	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.

impact on the overall inflation rate was marginal. As electricity tariffs remained unchanged over the year, energy prices had no effect on producer price inflation.

Labour costs

Central Bank of Malta estimates of wage inflation based on collective agreements show that wage growth on average moderated slightly to 2.5% in 2012 from 2.7% in 2011 (see Table 3.11).

Private sector wage growth was estimated to have remained unchanged at 2.4% in the year under review, while in the public sector it was estimated to have decelerated to 2.5% from 2.8% in 2011.

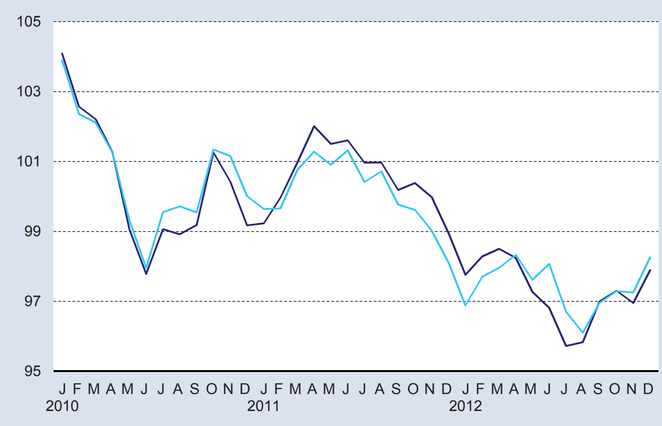
Meanwhile, national accounts data for 2012 show that overall compensation per employee grew by 2.4% in nominal terms, following an increase of 0.5% in the same period a year earlier.[23] Further indicators on wage developments emerge from the LFS. According to the survey, over the first three quarters of 2012 the average annual salary per employee increased by 3.2% in 2012, compared with a rise of 4.0% over the same period of 2011.

External competitiveness

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

In 2012 the HCI index, both in nominal and real terms, edged up in the first quarter but declined in the subsequent period, before following an upward trend in the last few months of the year (see Chart 3.18).[24] The increase in the nominal index during the first quarter of the year reflected the appreciation of the euro against major currencies.[25] In

Chart 3.18
HARMONISED COMPETITIVENESS INDICATORS
(May 2004 = 100)



Source: ECB.

[23] 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.
[24] 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. The HCIs are compiled by the European Central Bank.
[25] Following the adoption of the euro in Estonia in January 2011, the HCI now measures Malta's competitiveness vis-à-vis the other 16 countries in the euro area plus the EER-40 group of trading partners. Previously, Malta's HCI was compiled on the basis of 15 other countries in the euro area and the EER-41 group of trading partners.

real terms the HCI rose more markedly, reflecting the impact of a widening inflation differential relative to Malta's main trading partners. However, as from the second quarter until July, both the real index and, particularly, the nominal index fell to very low levels, owing to the depreciation of the euro. Thereafter, as the euro appreciated against major currencies, both the nominal and the real index began to trend upwards. By the end of the year the nominal HCI index was 1.1% below the 2011 level, while the real index had risen by 0.2% over the previous year's level.

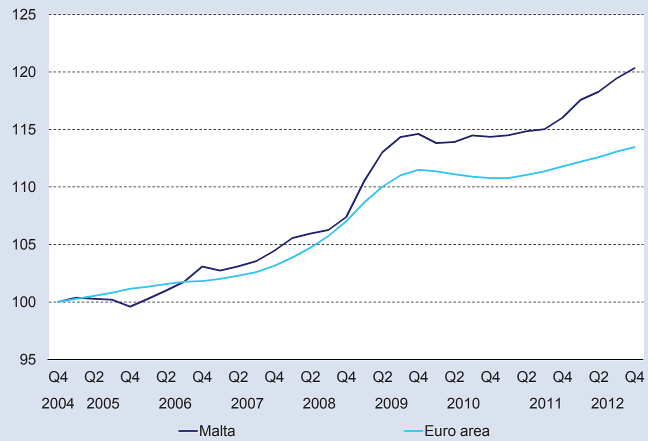
Unit labour costs[26]

Malta's ULC index, measured as a four-quarter moving average, continued to rise, increasing by 3.7% during 2012, following a growth of 1.5% in 2011 (see Chart 3.19).

The increase in ULC resulted from both a drop in labour productivity and a rise in compensation per employee (see Charts 3.20 and 3.21). During 2012 compensation per employee grew by 2.4%, after it had increased by 0.5% in the previous year. Labour productivity continued to fall, going down by 1.2%, following a drop of 1.0% in 2011.

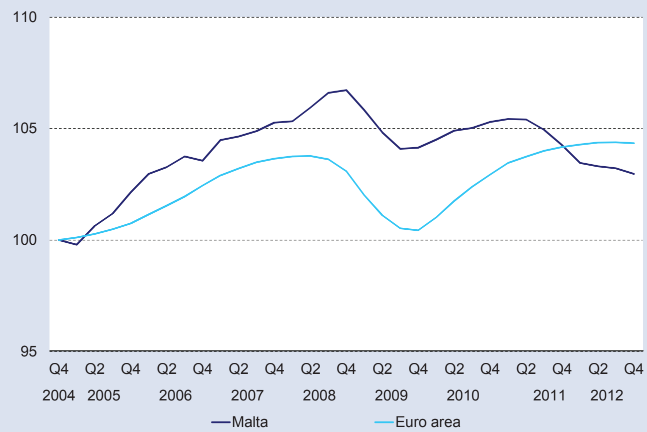
In the euro area ULC also increased in 2012, going up by 1.5%. This increase was driven by developments in compensation per employee. The latter went up by 1.7% on an annual basis, and was only partly offset by a 0.2% increase in productivity.

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



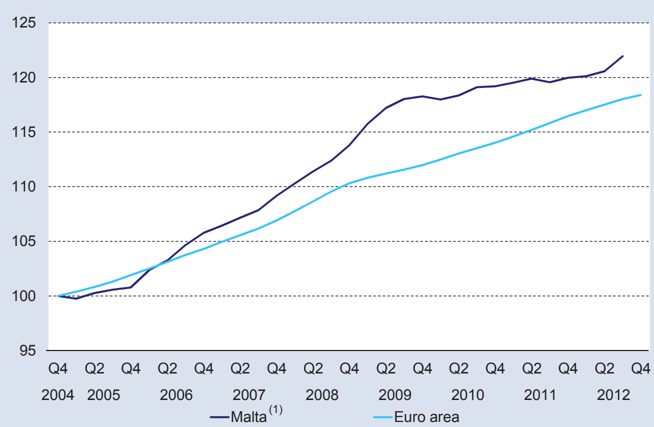
Sources: ECB; Eurostat.

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



Source: ECB.

Chart 3.21
COMPENSATION PER EMPLOYEE IN MALTA AND THE EURO AREA
(four-quarter moving average indices; 2004 Q4 = 100)



(1) Seasonally adjusted data for Malta for Q4 2012 are not available.
Source: ECB.

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

BOX 3: ECONOMIC PROJECTIONS FOR 2013 AND 2014

Outlook for the Maltese economy[1]

The Bank's latest economic projections indicate that activity is expected to accelerate in 2013 and again in 2014. Compared with the Bank's previous projection exercise, which was concluded in November 2012, the latest exercise foresees a stronger acceleration in 2013.[2]

Real GDP growth is expected to accelerate from 0.8% in 2012 to 1.4% in 2013 (see Table 1). The Bank projects GDP growth to reach 1.8% in 2014.

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA

	2011(1)	2012(1)	2013(2)	2014(2)
Real economic activity (% change)				
GDP	1.7	0.8	1.4	1.8
Private consumption expenditure	3.3	-0.6	1.0	1.8
Government consumption expenditure	3.8	5.5	1.8	1.7
Gross fixed capital formation	-14.1	-2.5	2.0	-0.3
Inventories (% of GDP)	-1.7	-2.2	-2.2	-2.0
Exports of goods & services	0.8	5.2	2.0	2.8
Imports of goods & services	-2.0	4.4	2.0	2.6
Contribution to real GDP growth (in percentage pts)(3)				
Final domestic demand	0.4	0.4	1.3	1.4
Net exports	2.6	1.0	0.1	0.3
Changes in inventories	-1.3	-0.6	0.0	0.1
Balance of payments (% of GDP)				
Goods and services balance	5.2	5.7	6.1	6.1
Current account balance	-0.1	0.4	0.7	0.6
Labour market (% change)				
Total employment	2.7	2.1	1.2	1.3
Unemployment rate (% of labour force)(4)	6.5	6.5	6.6	6.6
Prices and costs (% change)				
RPI	2.7	2.4	2.0	1.5
Overall HICP	2.5	3.2	2.2	1.7
HICP excluding energy	1.8	3.1	2.4	2.0
Compensation per employee	0.5	2.4	1.7	2.4
ULC	1.5	3.7	1.5	2.0
Public finances (% of GDP)(4)				
General government balance	-2.7	-2.7	-2.6	-2.6
General government debt	70.3	72.1	72.5	72.9
Technical assumptions				
EUR/USD exchange rate	1.392	1.286	1.346	1.348
Oil price (USD per barrel)	111.0	111.9	114.1	106.8

(1) Data on GDP were sourced from NSO *News Release 049/2013* published on 11 March 2013. Data on the current account balance were sourced from NSO *News Release 055/2013*.
(2) Central Bank of Malta projections.
(3) The contributions to GDP growth in this Table are estimated using GDP expenditure aggregates expressed in the previous year's prices. This approach yields different results from those reported elsewhere in this *Report*.
(4) Data for 2012 are Central Bank of Malta estimates.

[1] The Bank's outlook for the Maltese economy is based on information available up to 15 March 2013 and is conditional on the technical assumptions included in Table 1.
[2] See *Quarterly Review 2012:4*, pages 64-71.

The upward revisions to GDP growth in 2013 and 2014 are mainly prompted by the release of GDP and trade data covering the whole of 2012. These show that GDP growth in the second half of the year was better than in the first half, suggesting an incipient recovery going forward. More specifically, while the outcome for private consumption for the year as a whole was in line with previous expectations, private consumption growth picked up towards the end of the year. Furthermore, government consumption also increased more strongly than previously foreseen in 2012. This is expected to have a positive carry-over effect in the forecast horizon. At the same time, net exports are expected to contribute slightly more to the expansion in GDP compared with the previous exercise. Although both exports and imports are now projected to grow less rapidly than before, exports, which had been envisaged to grow slightly less than imports in 2013, are now expected to grow at broadly the same pace this year and at a slightly higher pace in 2014. The outlook for exports takes into account a slightly more positive assessment concerning the tourist sector in Malta, reflecting the solid performance recorded in 2012 and improved expectations concerning the semiconductors industry.

Final domestic demand expected to drive growth

In its latest exercise, the Bank expects growth in 2013 and 2014 to be driven by domestic demand, particularly private consumption, which should recover in the first year of the projection horizon and accelerate further in the second. Government consumption is also set to support the expansion over the forecast horizon, while investment is projected to boost activity in 2013. Net exports are foreseen to expand over the projection horizon, although at a more moderate pace compared with 2012.

After having dropped by 0.6% in 2012, private consumption is set to increase by 1.0% in 2013 and by 1.8% in 2014. The recovery is expected to be driven by a projected acceleration in real disposable income due to developments in taxes in 2013 and to stronger growth in employment income in 2014. Over the forecast horizon, private consumption should also benefit from a reduction in uncertainty about the orientation of domestic economic policies.

Government consumption is also expected to support the expansion in 2013 and 2014. However, its contribution is set to moderate relative to 2012 as expenditure restraint is assumed to continue in the context of the need, also under EU rules, for Malta to make progress towards the medium-term objective of a balanced budget. Moreover, the increase in government consumption in 2012 appears to be related to one-off factors that pushed up wage-related costs.

Following a sharp fall in 2011 and a further contraction in 2012, investment is expected to partially recover. The profile for gross fixed capital formation reflects the Bank's expectations about two specific projects. In particular, the Bank expects the Valletta City Gate project to carry over into 2013, while capital expenditure related to the electricity connection between Malta and Sicily is assumed to peak during the year. The remaining components of private investment are on aggregate set to contract slightly in 2013, reflecting continued weakness in the construction sector that offsets the impact of an underlying recovery in investment on machinery & equipment and in IT-related spending. In 2014 investment is set to contract slightly, owing to the envisaged completion of the Valletta City Gate project in 2013, and to lower expenditure in the energy sector. Moreover, real government investment rose strongly in 2012, when a critical mass of infrastructure projects was under way, but is foreseen to grow more moderately in 2013 and again in 2014.

Export growth is set to moderate in 2013, as merchandise exports, which rose significantly a year earlier, grow more slowly. The projection for 2013 also takes into account available projections for private consumption and real GDP growth in Malta's main trading partners, which point to subdued growth in non-travel exports. In 2014, however, overall export growth should accelerate as prospects in Malta's main trading partners improve.

Imports are also set to decelerate in 2013. Although the recovery in private consumption and private investment are expected to support imports of consumer and capital goods, the projected deceleration in exports limits the pace of expansion of other import categories. The profile for 2013 is also influenced by a negative base effect in merchandise imports, which increased exceptionally strongly in the second quarter of 2012. In 2014 import growth is expected to pick up, in line with the anticipated recovery in domestic demand and exports.

Current account set to remain in surplus

The surplus on the goods and services balance is expected to increase in 2013, mainly reflecting growth in travel receipts and a small improvement in the terms of trade.[3] In 2014 the trade balance is expected to widen slightly, though it would stabilise as a share of GDP, as nominal imports and exports are expected to grow at broadly similar rates. The effect of lower imports of capital goods, in line with the projected drop in investment, is counterbalanced by higher imports of other goods and services driven by the acceleration in demand.

Having moved into surplus in 2012, the current account balance is expected to increase further in 2013 as the trade balance improves. The current account surplus is set to narrow slightly in 2014, mainly owing to higher net outflows on the income account.

Wage and employment growth expected to moderate up to 2013

Following relatively strong growth in ULCs observed in 2012, which arose as both employment and average employee compensation outpaced real GDP growth, firms are expected to take a more cautious attitude towards recruitment in 2013 and 2014. Moreover, the number of employees in the general government sector is expected to be stable in 2013 and drop slightly in 2014. As a result, overall employment growth is expected to moderate in 2013, before edging up marginally in 2014. In turn, the unemployment rate is expected to increase slightly, from 6.5% in 2012 to 6.6% in 2013 and 2014.[4]

Productivity is set to pick up slightly in 2013, and to increase further in 2014. This reflects stronger growth in activity than in employment. After the relatively rapid rise in 2012, nominal compensation per employee is set to moderate in 2013, but should recover in 2014 in response to the improvement in productivity foreseen over the projection horizon.

ULC growth is expected to ease in 2013, mainly owing to the projected easing in wage growth that year. However, it is set to accelerate again in 2014, as the recovery in productivity is expected to be weaker than the rise in compensation per employee.

Inflation

The average year-on-year growth in HICP inflation rose to 3.2% in 2012 from 2.5% in the previous year. A key contributor to this acceleration was inflation in accommodation prices, which rose from 0.4% in 2011 to 7.3% in 2012. Further price increases in food and non-energy industrial goods also contributed, although to a lesser extent.

The projections for inflation in 2013 and 2014 are driven by technical assumptions, which include particularly favourable expectations on exchange rate developments, as well as a declining price for

[3] Data on the trade balance used in this Box are consistent with NSO *News Release 049/2013* and the projections for real exports and imports reported in Table 1. The current account projections are based on balance of payments data published in NSO *News Release 055/2013*.

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

Brent crude oil. In 2013 inflation is projected to moderate to 2.2%, driven by lower inflation in service prices and, to a lesser extent, in energy and food prices. The projections assume unchanged utility tariffs throughout the forecast horizon. In 2014 inflation is anticipated to drop further to 1.7%, as lower import prices are expected to result in an easing of inflationary pressures in non-energy industrial goods and food. Energy prices are expected to fall slightly, on the assumption that crude oil prices will be lower.

Fiscal deficit to narrow slightly in 2013, stable in 2014[5]

The Bank estimated the general government deficit-to-GDP ratio to have remained unchanged at 2.7% in 2012, but this is expected to narrow slightly to 2.6% in 2013 and 2014.

The foreseen improvement in 2013 is partly driven by restrained growth in selected items of current expenditure, particularly the compensation of employees and retirement pensions. The latter reflects the impact of the pension reform, as the retirement age for certain cohorts is postponed. The general government debt-to-GDP ratio is expected to increase over the projection horizon. Partly as a result of increased borrowing associated with EU commitments to extend financial support to euro area countries experiencing financing problems, the debt ratio is estimated to have risen from 70.3% in 2011 to 72.1% in 2012. Thereafter, it is set to increase further, though at a slower pace, to end the projection horizon at 72.9%.

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 is concerned.

On balance, risks to the GDP projections remain broadly balanced. The fragile situation in the euro area and the possibility that demand in Malta's main trading partners turns out to be weaker than expected remains a negative risk, which would weigh on external demand. On the other hand, export growth may accelerate if the ongoing expansion of the business and financial service sectors is maintained and extended into new export markets. A weaker than expected exchange rate would also have a favourable impact on exports. In addition, the incoming Government's policies for the energy sector would imply some upside risks to investment, though the resultant impact on GDP would be offset to some extent by increased imports.

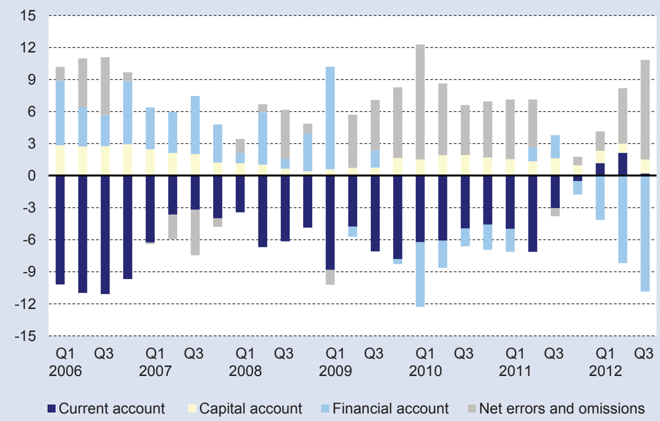
Risks to the inflation projections are judged to be slightly on the downside, driven by the possibility of a reduction in utility tariffs.

[5] These fiscal projections may differ from forecasts prepared by other institutions, partly owing to differences in the underlying macroeconomic projections and partly because they incorporate an independent assessment of revenue and expenditure by the Bank.

4. BALANCE OF PAYMENTS

In the year to September 2012, the current account of the balance of payments recorded a surplus equivalent to 0.2% of nominal gross domestic product (GDP), as against a deficit of 3.0% in the four quarters to September 2011 (see Chart 4.1). A sizeable contraction in the visible trade gap and higher net receipts on services contributed to the reversal in the negative balance, as did a slight increase in net inward current transfers and marginally lower net income outflows.

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



Source: NSO.

Meanwhile, net outflows were recorded on the capital and financial account.[1] These outflows rose to 9.5% of GDP, in contrast with net inflows of 3.8% of GDP in the year to September 2011. The outflows were recorded mostly in the financial account, while the capital account registered a surplus which was lower than in the 12 months to September 2011. Over the same period, however, net errors and omissions were significantly large and positive.[2]

The current account

In the four quarters to September 2012, the current account swung to a surplus of €13.1 million from a deficit of €198.8 million in the year to September 2011 (see Table 4.1). This was mainly due to a significant fall in the

Table 4.1
BALANCE OF PAYMENTS
EUR millions

	2009	2010	2011	Four-quarter moving sums 2011 Q3	2012 Q3
Current account	**-466.6**	**-288.6**	**-33.2**	**-198.8**	**13.1**
Goods	-1,083.5	-1,119.3	-1,048.9	-1,198.0	-1,010.1
Services	998.0	1,245.6	1,391.4	1,407.8	1,427.2
Income	-423.8	-441.4	-401.4	-452.8	-452.6
Current transfers	42.7	26.5	25.8	44.2	48.6
Capital and financial account	**71.4**	**-42.9**	**-19.2**	**248.2**	**-637.9**
Capital account	99.2	107.3	63.9	106.1	88.8
Financial account	-27.8	-150.2	-83.1	142.1	-726.7
Direct investment	220.6	701.2	294.5	253.4	60.7
Portfolio investment	-1,932.4	-3,210.5	-3,103.5	-1,711.0	-3,012.3
Financial derivatives	-118.9	27.8	24.3	37.6	11.7
Other investment	1,805.3	2,354.9	2,648.8	1,498.6	2,326.6
Reserve assets	-2.4	-23.6	52.9	63.6	-113.4
Errors and omissions	395.3	331.4	52.4	-49.4	624.8

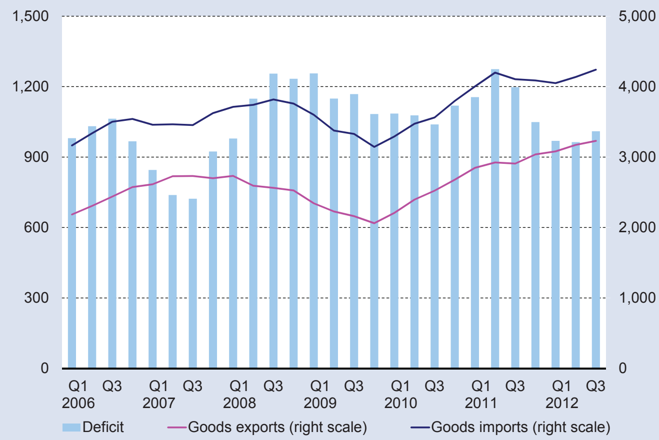
Source: NSO.

[1] In the financial account of the balance of payments, additions to assets and decreases in liabilities are considered as outflows. Conversely, increases in liabilities and decreases in assets are considered as inflows.

[2] Positive net errors and omissions imply an underestimation of the current account surplus and/or overestimation of the net outflows on the capital and financial account.

merchandise trade deficit, although higher net receipts on services and current transfers, as well as marginally lower net outflows on the income component, also contributed.

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



Source: NSO.

Goods

Balance of payments data indicate that, in the year to September 2012, both exports and imports rose over the corresponding months to September 2011.[3] This reflected an expansion of €321.7 million in exports that outweighed a €133.8 million increase in foreign purchases of goods. The improvement was primarily driven by a rise in exports of fuels, semiconductors, pharmaceuticals and "other manufactured articles". Concurrently, import growth reflected increased purchases of fuels, food and beverages. Further details on merchandise trade developments are given in Box 4.

On a four-quarter moving sum basis, the visible trade gap narrowed by €187.9 million, or 15.7%, when compared with the value over the year to September 2011 (see Chart 4.2).

BOX 4: MERCHANDISE TRADE DEVELOPMENTS IN 2012

Customs data show that the merchandise trade gap increased by 26.4% to €1,915.1 million in 2012, following a slight narrowing in 2011. The widening resulted from a surge in imports, which outpaced the rise in exports. This was mostly the result of a large increase in trade in fuels, which led to the marked expansion in both imports and exports, with the former rising to a greater extent (see Table 1).[1]

Over the year as a whole, the value of imported goods rose by €789.4 million, or 14.8%. This almost entirely reflected higher fuel imports, which went up by 43.8%, or €846.6 million. In addition, imports of consumer goods grew by 1.7%, or €16.7 million, with higher imports of goods in the food & beverage category and in the "others" category outweighing the drop in durable goods imports. On the other hand, "capital goods & others" imports dropped by €67.8 million, or by 7.7%. Meanwhile, imports of industrial supplies fell by €6.0 million, or 0.4%. Developments in these two components dampened the rise in overall imports.

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

[3] 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 1
MERCHANDISE TRADE BY BROAD ECONOMIC CATEGORY
EUR millions; annual percentage changes

	2010[1]	2011[1]	2012[1]	2011	2012
		Amount		%	
Imports	**4,328.1**	**5,334.4**	**6,123.8**	**23.3**	**14.8**
Industrial supplies	1,499.9	1,548.4	1,542.4	3.2	-0.4
Capital goods & others	838.8	875.8	808.0	4.4	-7.7
Consumer goods	933.8	976.3	993.0	4.6	1.7
Fuel & lubricants	1,055.6	1,933.8	2,780.4	83.2	43.8
Exports	**2,809.3**	**3,818.9**	**4,208.7**	**35.9**	**10.2**
Trade deficit	**1,518.8**	**1,515.5**	**1,915.1**	**-0.2**	**26.4**

(1) Provisional.
Source: NSO.

During 2012 the value of exports rose by €389.8 million, or 10.2% over the previous year. Fuel re-exports accounted for almost half of the increase, with the remaining rise being broad-based across the major commodity groups. Notable increases were seen in exports of machinery & transport equipment, chemicals and food (see Table 2).

During 2012 the European Union (EU) remained Malta's major trading partner, accounting for 63.6% of total goods imported and 28.8% of merchandise exports (see Charts 1 and 2). This compares with 62.8% and 34.1%, respectively, in 2011. Trade with the euro area alone accounted for 54.0% and 22.8% of the total value of merchandise imports and exports, respectively.

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

	2010[1]	2011[1]	2012[1]	2011	2012
Imports	**4,328.1**	**5,334.4**	**6,123.8**	**23.3**	**14.8**
Food, beverages and tobacco	456.1	486.7	566.5	6.7	16.4
Mineral fuels, lubricants & related materials	1,057.7	1,943.2	2,783.5	83.7	43.2
Chemicals	376.1	434.0	442.6	15.4	2.0
Semi-manufactured goods	326.2	330.8	311.0	1.4	-6.0
Machinery and transport equipment	1,640.6	1,694.6	1,557.7	3.3	-8.1
Miscellaneous manufactured articles	393.6	378.4	396.4	-3.9	4.8
Others	77.8	66.7	66.1	-14.3	-0.9
Exports	**2,809.3**	**3,818.9**	**4,208.7**	**35.9**	**10.2**
Food, beverages and tobacco	158.2	151.5	219.6	-4.2	45.0
Mineral fuels, lubricants & related materials	718.9	1,621.7	1,812.4	125.6	11.8
Chemicals	273.8	258.7	318.5	-5.5	23.1
Semi-manufactured goods	123.5	132.9	125.9	7.6	-5.3
Machinery and transport equipment	1,180.5	1,241.3	1,304.4	5.2	5.1
Miscellaneous manufactured articles	331.1	383.2	398.1	15.7	3.9
Others	23.3	29.6	29.8	27.0	0.7

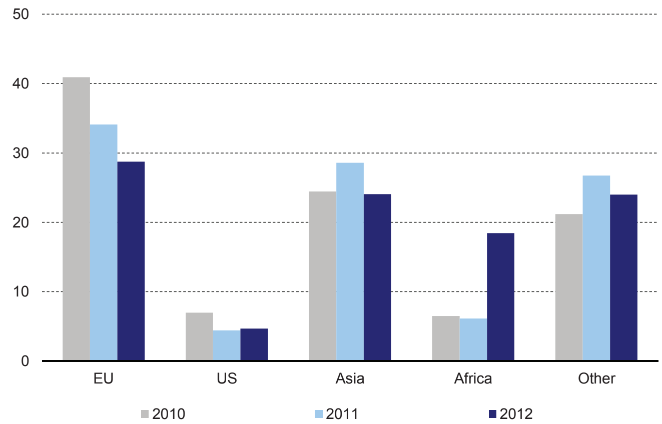
(1) Provisional.
Source: NSO.

Although the value of goods exported to the euro area fell when compared with 2011, exports to the Netherlands and Germany, amongst others, rose. However, exports to the United Kingdom were below 2011 levels.

Exports to Asia declined by 7.3%, with the region's share in aggregate exports contracting to 24.1% from 28.6% a year earlier. Increases in exports to Singapore and Japan were offset by drops in exports to other Asian countries. On the other hand, exports to Africa rose by €524.5 million, pushing their share in the total up to 18.1%, with part of the increase reflected in exports to Libya. Meanwhile, merchandise sales to ships & aircraft stores continued to be boosted by fuel re-exports. Such sales represented almost 15% of total exports.

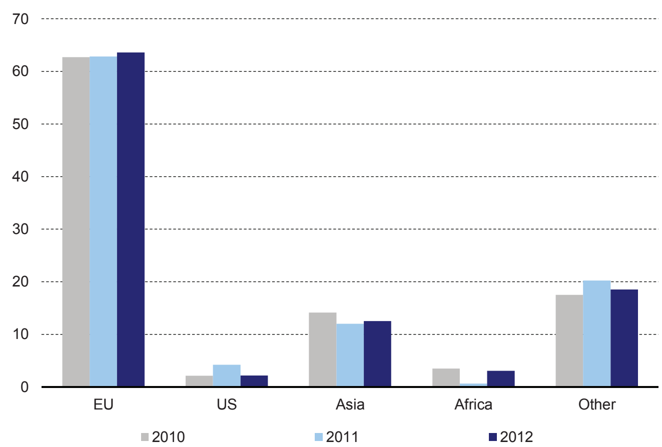
Imports from the EU rose as a result of an increase in purchases from the euro area, mainly Italy, Spain and the Netherlands. In contrast, those from the rest of the EU, in particular the United Kingdom, declined.

Chart 1
DIRECTION OF EXPORTS
(percentage shares of total)



Source: NSO.

Chart 2
DIRECTION OF IMPORTS
(percentage shares of total)



Source: NSO.

Imports from Asia rose by €126.8 million, owing to an increase in imports from China and Korea. The region's share in total merchandise imports rose slightly to 12.6%.

Imports from Africa also rose, growing by €153.5 million, with the region's share in the total expanding to 3.1% from 0.7% in 2011. Almost three-fifths of this increase resulted from higher imports from Libya.

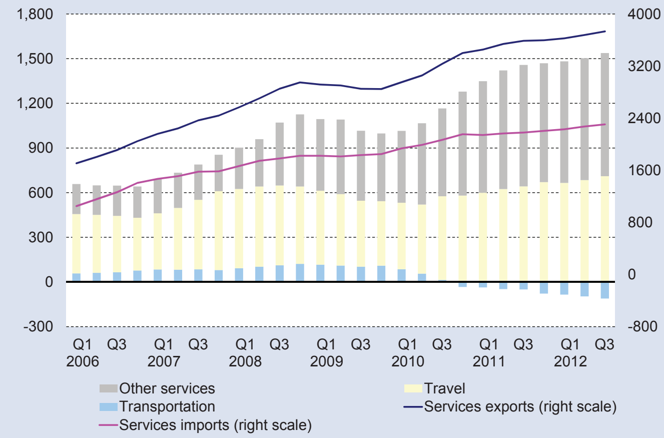
On the other hand, both the value and the proportion of imports from the United States and "other" countries fell when compared with year-ago levels.

Services

The surplus on services rose by €19.4 million, or 1.4%, during the four quarters to September 2012 compared with same period of 2011, to reach €1,427.2 million. This gain reflected a 4.1% rise in receipts and was partly offset by a 5.8% increase in payments (see Chart 4.3).

Higher net tourism earnings, reflecting the positive performance of the tourism industry, were the main factor behind the improved services balance. The earnings increased by €68.4 million on a year earlier, to €711.0 million. During the period under review, spending by inbound tourists rose by €72.0 million.

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



Source: NSO.

Net inflows on the "other services" component also rose, by €11.5 million to €826.8 million. These were driven by higher earnings on personal, cultural and recreational services, and by an improvement in the financial services component. The latter reflected higher fees and commissions earned by resident banks and other financial institutions and a parallel drop in payments to financial institutions abroad. Together, these movements offset lower receipts from trade-related services, which mainly include commissions on trade outside Malta and increased outflows on business and management consulting services.

The increased net inflows from the tourism industry and higher earnings on the "other services" categories were partly dampened by a rise in the transportation component. This reflected an increase in net freight payments as the volume of merchandise trade flows continued to grow. Such payments went up by €60.5 million to €110.6 million over the four quarters to September 2012.

Income account

In the period under review, net outflows on the income component of the current account amounted to €452.6 million, broadly unchanged from the level recorded in the four quarters to September 2011. Outflows related to direct investment income, mainly reflecting profits due to non-resident investors, increased substantially in a continuation of the general upward trend that has been observed in recent years. A significant share of these profits is then reinvested in Malta, as is reflected in the financial account. During the period reviewed, these outflows were matched by higher earnings on portfolio investment. The latter reflected an increase in net interest earnings on portfolio holdings of cross-border debt instruments, primarily held by banks. Lower net outflows on the "other investment" income component also contributed.

Current transfers

In the four quarters to September 2012, the positive balance on current transfers stood at €48.6 million, as against €44.2 million in the corresponding period of 2011. This component continued to be heavily influenced by 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

In the period under review, the capital and financial account registered net outflows of €637.9 million as opposed to inflows of €248.2 million a year earlier (see Table 4.1). The sharp reversal on the balance was mostly due to financial transactions, although net inflows on the capital account also fell, mainly in response to lower receipts of EU structural and cohesion funds, particularly in the final quarter of 2011.

Thus, in the four quarters to September 2012, the surplus on the capital account dropped by €17.4 million, to €88.8 million. Meanwhile, net outflows of €726.7 million were recorded on the financial account as against net inflows of €142.1 million a year earlier.

Net outflows on portfolio investment almost doubled to €3,012.3 million, an increase of €1,301.3 million on a year earlier, resulting from a substantial rise in holdings of foreign debt securities by resident investors, primarily international banks.

The rise in net outflows on portfolio investment was accompanied by a substantial increase in net inflows on the "other investment" component. The latter rose to €2,326.6 million from €1,498.6 million a year earlier. Additional net inflows largely reflected the repayment of short-term loans by non-residents to resident banks and an increase in banks' non-resident deposit liabilities. International banks were mainly responsible for these inflows.

On the other hand, net inflows related to direct investment were lower at €60.7 million, compared with €253.4 million in the four quarters to September 2011. This mainly reflected a drop in preference shares issued by a foreign-owned bank.

Meanwhile, net inflows arising from financial derivatives dropped by €25.9 million to €11.7 million, thus contributing to the rise in outflows on the financial account.

In the four quarters to September 2012, reserve assets expanded by €113.4 million, compared with a contraction of €63.6 million in the comparable quarters up to September 2011. At the same time, positive net errors and omissions rose substantially to €624.8 million.

International investment position

During the first half of 2012, Malta's net creditor position vis-à-vis the rest of the world expanded notably. Data on the international investment position (IIP) show that Maltese residents' holdings of external financial assets as at end-June 2012 stood at €47,631.9 million, while the corresponding foreign liabilities amounted to €46,072.7 million (see Table 4.2).[4] Thus, at the end of June, the net creditor position stood at €1,559.2 million, up by €1,065.3 million from the end-December 2011 level, and by €1,012.1 million on June 2011.

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

	2010 June	2010 Dec.	2011 June	2011 Dec.	2012 June
Net international investment position	**817.6**	**583.6**	**547.1**	**493.9**	**1,559.2**
Total assets	**45,374.3**	**44,438.7**	**44,697.6**	**44,697.2**	**47,631.9**
Direct investment abroad	1,283.3	1,265.6	1,276.5	1,247.9	1,303.2
Portfolio investment	15,127.2	15,577.4	14,676.3	17,168.6	19,117.9
Financial derivatives	218.5	217.3	166.5	301.4	298.5
Other investment	28,455.1	26,973.5	28,205.9	25,583.4	26,362.4
Reserve assets	290.2	404.9	372.2	395.9	549.8
Total liabilities	**44,556.7**	**43,855.1**	**44,150.5**	**44,203.4**	**46,072.7**
Direct investment in Malta	11,574.2	12,145.9	11,868.1	12,097.7	12,063.3
Portfolio investment	638.5	486.6	501.1	452.5	458.1
Financial derivatives	337.0	307.6	215.7	377.3	469.1
Other investment	32,007.0	30,915.0	31,565.7	31,275.8	33,082.2

Source: NSO.

[4] 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 exchange rate movements and valuation changes.

The increase mirrored the net financial account outflows for the year to June 2012, as well as positive valuation changes on almost all components of the financial account, in broadly equal measure.[5]

The strengthening in Malta's net creditor position was attributable to robust growth in financial assets, which offset a smaller rise in financial liabilities. Assets rose by €2,934.7 million, or 6.6%, on end-December 2011. This reflected a surge in banks' portfolio holdings of foreign debt securities, which surge was reinforced by increased holdings of assets classified on the "other investment" component, including short-term loans and deposits held with banks abroad. Banks predominantly engaged in international business accounted for most of these changes. In addition, official reserve assets expanded by €153.9 million over the six months to end-June 2012.

Meanwhile, external liabilities rose by €1,869.3 million, or 4.2%, when compared with the position recorded at end-December 2011. An increase of €1,637.8 million in currency and deposits accounted for most of the rise.

[5] Valuation changes arise from exchange rate movements and movements in market prices of assets and liabilities, as well as changes in the value of financial derivative contracts. Other valuation changes may be caused by changes in accounting treatment or policies.

5. GOVERNMENT FINANCE

According to the latest Central Bank of Malta projections, the general government deficit for 2012 was estimated to have remained unchanged from the previous year at 2.7% of GDP.[1] Revenue was forecast to grow by slightly more than expenditure, partly reflecting temporary measures, but also strong underlying growth in direct tax revenue as reported for the first three quarters. General government debt was estimated to have reached 72.1% in 2012, up from 70.3% in 2011.[2]

General government balance outcome

In the first nine months of 2012, the total revenue of the general government sector grew by €130.2 million, or 7.1%, driven by higher inflows from current taxes on income and wealth (see Table 5.1). The latter rose by 11.3% owing to a higher intake from taxes on corporate profits.

Concurrently, taxes on production and imports rose by 4.2% as a result of higher expenditure by tourists in Malta, as well as from the intake from an amnesty scheme offering lower interest and reduced administrative penalties on arrears.

Together, these two revenue components accounted for around three quarters of the overall increase in revenue. At the same time, revenue from social contributions rose marginally by 1.8%.

Table 5.1
GENERAL GOVERNMENT BALANCE
EUR millions

	2011	2012	Change Q1 - Q3	
	Q1-Q3	Q1-Q3	Amount	%
Revenue	**1,844.2**	**1,974.3**	**130.2**	**7.1**
Taxes on production and imports	646.8	673.7	26.9	4.2
Current taxes on income and wealth	606.4	674.8	68.4	11.3
Social contributions	351.9	358.2	6.3	1.8
Capital and current transfers	89.5	101.6	12.1	13.5
Other(1)	149.6	166.0	16.5	11.0
Expenditure	**2,015.4**	**2,174.6**	**159.2**	**7.9**
Compensation of employees	652.9	678.6	25.7	3.9
Intermediate consumption	285.8	337.6	51.8	18.1
Social benefits	651.2	676.2	25.0	3.8
Subsidies	44.4	57.0	12.6	28.3
Interest	148.3	162.8	14.5	9.8
Current transfers payable	82.2	98.3	16.1	19.6
Gross fixed capital formation	118.4	133.0	14.6	12.4
Capital transfers payable	33.7	58.2	24.5	72.6
Other(2)	-1.5	-27.1	-25.6	-
Primary balance	**-23.0**	**-37.5**	**-14.5**	**-**
General government balance	**-171.3**	**-200.3**	**-29.0**	**-**

(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.

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 Further information about the Bank's latest fiscal projections is available in Box 3 in this *Annual Report*.

"Other" revenue went up by 11.0%, led by an increase in market output reported by extra-budgetary units, particularly in the first three months of the year. Meanwhile, inflows from capital and current transfers grew by 13.5%, reflecting higher investment grants received from the European Union (EU).

In the first three quarters of 2012, general government expenditure was €159.2 million, or 7.9% higher than in the same period of 2011. This stemmed mainly from higher outlays on recurrent expenditure.

Spending on intermediate consumption went up by 18.1%, whilst compensation of employees increased by 3.9%, in both cases largely owing to commitments on health and education. Social benefits went up by 3.8% mainly owing to higher outlays on retirement pensions. At the same time, subsidies rose by 28.3%, mostly owing to government transfers to Enemalta.

In line with an increased level of government debt, interest payable went up by 9.8% compared with the first three quarters of 2011. Current transfers payable also rose by 19.6% during the period.

With regard to capital expenditure, capital transfers payable almost doubled, mainly due to the injection of equity capital by Government into Air Malta at the beginning of the year. At the same time, spending on gross fixed capital formation rose by 12.4%, featuring higher spending on the ongoing road infrastructure project, most of which is co-financed by the EU.

In contrast, "other" expenditure faced a substantial decline. This component includes the concession fee paid during the year by a private firm to Government to operate the National Lottery. These proceeds were not classified as part of general government revenue but rather as negative expenditure, in line with the methodology applied for such transactions.

Consolidated Fund

Between January and November 2012, revenue grew by 6.0% on a year earlier, while expenditure grew by 8.0%. Consequently, the Consolidated Fund deficit widened by €63.8 million (see Table 5.2).

The increase in revenue stemmed mainly from higher direct tax receipts, which went up by 11.5%. This was due to larger income tax revenues, partly reflecting higher nominal incomes. Increased social security contributions also contributed towards the rise in direct tax receipts, in line with continued growth in employment.

Conversely, revenue from indirect taxes went down by 2.5% as a decline in customs and excise duties, mainly duties on petroleum, offset an increase in VAT receipts. The latter were boosted by greater expenditure by incoming tourists.

The increase in expenditure mainly reflected larger recurrent spending, which rose by 6.3%. Spending on programmes and operations went up by 7.1%, largely owing to increased outlays on social benefits and health. Interest payments rose by 6.3%, reflecting a higher debt level relative to the previous year. At the same time, contributions to government entities went up by 7.8%, primarily related to transfers to the University of Malta. Outlays on personal emoluments rose by 3.7%, driven by additional spending in the health and education sectors, partly under the impact of newly signed collective agreements.

Meanwhile, capital expenditure grew by 22.5%, owing to higher spending on EU-backed road infrastructure projects, as mentioned above.

Government debt

Between the end of 2011 and November 2012 government debt, excluding debt issued by extra-budgetary units and local councils, as well as debt held by Sinking Funds, increased by €272.1 million. At the end of November the outstanding amount stood at €4,756.6 million (see Table 5.3).

Additional borrowing by Government over this period was lower than the deficit recorded in the Consolidated Fund, as Government met part of its financing needs by drawing from its stock of financial assets, notably its bank deposits.

Table 5.2
CONSOLIDATED FUND BALANCE
EUR millions

	2011	2012	Change	
	Jan.-Nov.	Jan.-Nov.	Amount	%
Revenue	**2,080.8**	**2,205.6**	**124.9**	**6.0**
Direct tax	**961.5**	**1,072.2**	**110.7**	**11.5**
Income tax	620.7	718.7	98.0	15.8
Social security contributions(1)	340.8	353.5	12.7	3.7
Indirect tax	**880.6**	**858.2**	**-22.4**	**-2.5**
Value Added Tax	491.0	501.8	10.7	2.2
Customs and excise duties	179.3	145.2	-34.2	-19.1
Licences, taxes and fines	210.2	211.3	1.0	0.5
Non-tax(2)	**238.7**	**275.2**	**36.5**	**15.3**
Expenditure	**2,359.0**	**2,547.7**	**188.6**	**8.0**
Recurrent(1)	**2,109.8**	**2,242.4**	**132.6**	**6.3**
Personal emoluments	492.7	510.8	18.1	3.7
Programmes and other operational expenditure(3)	1,245.6	1,334.1	88.5	7.1
Contributions to entities	178.8	192.8	13.9	7.8
Interest payments	192.7	204.8	12.1	6.3
Capital	**249.2**	**305.2**	**56.0**	**22.5**
Primary balance(4)	**-85.5**	**-137.2**	**-51.7**	**-**
Consolidated Fund balance	**-278.2**	**-342.0**	**-63.8**	**-**

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

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

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

(4) Revenue less expenditure excluding interest payments.

Source: NSO.

In the current environment of comparatively low interest rates, the debt structure continued to move away from short-term instruments, in the form of Treasury bills, in favour of medium to long-term securities, that is, Malta Government Stocks (MGS). By November 2012, MGS issued went up by €282.1 million so that their share in the total central government debt amounted to 91.1%, up from 90.3% at the end of 2011. Conversely, Treasury bills accounted for 5.3% of total debt, down from 5.8% at the end of 2011.

Over the same period, foreign loans decreased by €9.9 million as Government continued to repay external debt. Meanwhile, the value of euro coins in issue, which represent a liability for Government, increased by €4.2 million.

Table 5.3
GOVERNMENT DEBT (1)
EUR millions

	2011	2012	Change
	end-Dec.	end-Nov.	Dec. 11-Nov. 12
Government debt(1)	**4,484.5**	**4,756.6**	**272.1**
Euro coins issued in name of the Treasury	45.8	50.1	4.2
Treasury bills	257.9	253.6	-4.3
Malta Government Stocks	4,049.8	4,331.9	282.1
Local loans	56.4	56.4	0.0
Foreign loans	74.6	64.6	-9.9

(1) Excluding government debt issued by extra-budgetary units and local councils and debt held by Sinking Funds.

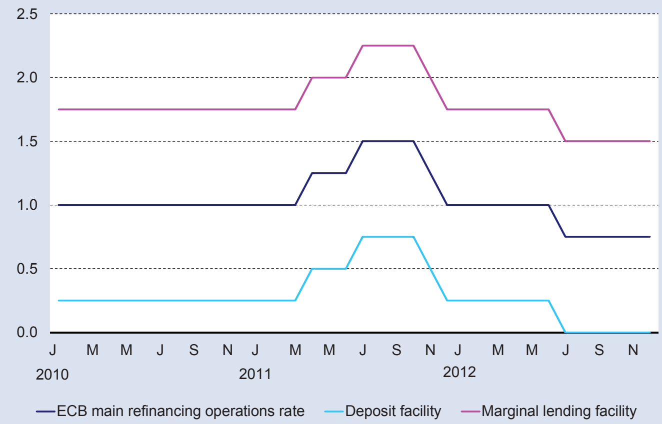
Source: Central Bank of Malta.

PART II

BANK POLICIES, OPERATIONS AND ACTIVITIES

1. THE CONDUCT OF MONETARY POLICY

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



Source: ECB.

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.

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, 2.0% over the medium term.

During 2012 the Eurosystem eased the monetary policy stance. In July the Governing Council of the ECB decided to lower the rate on the main refinancing operations (MRO) by 25 basis points to 0.75%, bringing key ECB rates to the lowest level since the introduction of the single currency (see Chart 1.1). Official interest rates were then left unchanged over the rest of the year. Hence, at the end of 2012, the MRO stood at 0.75%, while the interest rates on the deposit facility and on the marginal lending facility stood at 0.00% and 1.50%, respectively.

Monetary policy operations

The Central Bank of Malta implements the single monetary policy decisions of the Eurosystem in Malta according to guidelines laid down by the 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. During 2012 the Bank continued to participate in the implementation of the Securities Markets Programme (SMP) on behalf of the Eurosystem. The SMP was terminated in September 2012.

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. MROs are short-term liquidity-providing reverse transactions, which are executed according to a pre-specified calendar and take place on a weekly basis with a normal maturity of one week. The Eurosystem also undertakes long-term refinancing operations (LTRO), which consist of reverse transactions at a monthly frequency and with a normal maturity of three months. In addition, the Eurosystem uses fine-tuning operations with no fixed maturity, which can be either liquidity-providing or liquidity-absorbing, to deal with unexpected liquidity fluctuations in the market.

Similar to the previous year, 2012 was characterised by the Eurosystem's efforts to address persistent market tensions in the euro area, and to support bank lending and financial market activity through a range of non-standard measures, including refinancing operations with a three-year maturity. The latter, which are sometimes referred to as very long-term refinancing operations (VLTRO), were carried out to mitigate the effects of strains in financial markets on credit supply by ensuring that banks in the euro area had access to ample liquidity.

Table 1.1
PARTICIPATION OF ELIGIBLE DOMESTIC CREDIT INSTITUTIONS IN EUROSYSTEM OPEN MARKET OPERATIONS[1]
EUR billions

Type of operation	2011 Amount bid	2011 Amount allotted	2012 Amount bid	2012 Amount allotted
Main refinancing operations	16.50	16.50	6.19	6.19
Longer-term refinancing operations				
Maintenance period	0.12	0.12	0.03	0.03
3-month	1.86	1.86	0.35	0.35
6-month	0.05	0.05	-	-
12-month	0.07	0.07	-	-
36-month	0.15	0.15	0.21	0.21
Fine-tuning operations				
Liquidity-providing fine-tuning operations	0.00	0.00	-	-
Liquidity-absorbing fine-tuning operations	1.58	1.58	-	-
Liquidity-absorbing operations (SMP-related)	1.00	0.14	6.98	3.79
US dollar collateralised operations				
7-day	-	-	0.29	0.29
84-day	-	-	0.32	0.32

[1] A dash "-" indicates either that the Eurosystem did not conduct the relevant operations or that domestic credit institutions did not take part in them.

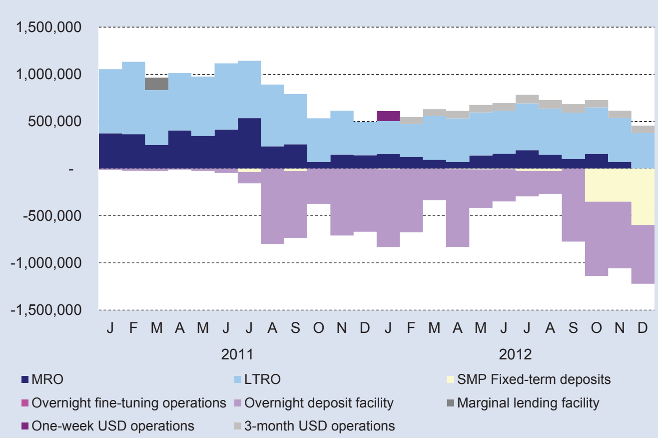
Source: Central Bank of Malta.

The Eurosystem continued to provide the financial system with sufficient liquidity through fixed rate tender procedures with full allotment in its MROs and LTROs. A total of 52 MROs were conducted during the year. Eligible domestic credit institutions participated in all these weekly operations, bidding for a total of €6.2 billion worth of funds (see Table 1.1). This compared with a total of €16.5 billion in the previous year. The decline in bids for the weekly operations could reflect the fact that credit institutions were able to obtain liquidity over longer-term horizons, particularly through the three-year LTROs (see Chart 1.2).

During the year the ECB also conducted 25 operations providing liquidity at longer terms to maturity. These included 12 special-term refinancing operations with a duration equivalent to the length of the relevant reserve maintenance period. The fixed rate tender procedure with full allotment was also applied to these operations.

Moreover, the ECB conducted 12 regular three-month LTROs at a fixed rate with full allotment, with the rate fixed at the average rate of the MROs over the lifetime of the operations. In addition, in February the ECB conducted an LTRO with a maturity of 36 months, with the option of early repayment after one year. This oper-

Chart 1.2
OUTSTANDING LIQUIDITY-PROVIDING AND ABSORBING OPERATIONS
(EUR millions; end of month)



Source: Central Bank of Malta.

ation was conducted as a fixed rate tender procedure with full allotment, with the rate also fixed at the average rate of the MROs over the lifetime of the operation.

During 2012 resident credit institutions obtained longer-term liquidity at various tenors to the tune of €0.6 billion, with 60% of this funding provided through three-month LTROs. The corresponding amount for 2011 was €1.9 billion. The amount obtained through VLTROs amounted to 35% of the total LTROs.

The SMP, launched by the ECB on 10 May 2010, continued up to September 2012. Through the SMP the Eurosystem intervened in the euro area debt securities market to ensure depth and liquidity in certain market segments to maintain the smooth functioning of 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 settled by the end of the previous week.

However, on 6 September, the Governing Council announced the framework governing the introduction of the Outright Monetary Transactions (OMT) and the concurrent end of the SMP. OMTs are expected to be activated in the secondary sovereign bond markets. They will be conducted within a framework designed to ensure effective conditionality, to safeguard an appropriate monetary policy transmission and to conserve the unity of monetary policy in the euro area.

The Eurosystem also took measures in conjunction with other major central banks. In September the ECB extended the liquidity swap arrangement with the Bank of England until 30 September 2013. Moreover, the ECB decided, in cooperation with other central banks, to extend the temporary network of reciprocal US dollar liquidity swaps until 1 February 2014. This will enable the Eurosystem to provide euro to these central banks when required, and, in turn, to provide eligible credit institutions in the euro area with selected major foreign currencies should the need arise. The Governing Council also decided that the ECB would, until further notice, continue to conduct regular US dollar liquidity-providing operations with maturities of approximately one week and three months.

To enable the Eurosystem to determine liquidity needs, the Bank continued to provide the ECB with daily forecasts of items on its balance sheet that are not related to monetary policy instruments, such as banknotes in circulation, government deposits and net foreign assets.

Standing facilities

During 2012 credit institutions with temporary liquidity needs continued to use the marginal lending facility on their own initiative to obtain overnight liquidity from the Bank against eligible assets. Conversely, institutions with surplus liquidity placed overnight deposits with the Bank.

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 2012, the width of the interest rate corridor was maintained at 150 basis points. As from July 2012, the rate on the overnight deposit facility fell to zero, while that on the marginal lending facility dropped to 1.50%.

During 2012 recourse to the overnight deposit facility almost doubled, rising from €81.8 billion in 2011 to €156.8 billion. On the other hand, recourse to the marginal lending facility fell sharply and amounted to €37.2 million, compared with €662.0 million borrowed in 2011. Trends in operations related to standing facilities are shown in Chart 1.2.

Collateral management

The Eurosystem requires the lodgement of collateral by eligible counterparties for all its liquidity-providing operations. To ensure equal treatment of counterparties, the collateral framework sets certain criteria that assets must satisfy to be eligible for use.

The Central Bank of Malta is responsible for assessing the eligibility of domestically-issued assets and reporting them to the ECB for inclusion in the Eligible Assets Database. As at end-December 2012, the nominal amount outstanding of eligible domestic marketable assets totalled €4.6 billion.

The market value after haircuts of securities, which domestic counterparties actually pledged in their pool of collateral with the Bank, stood at €1.1 billion as at end-December 2012. This amount consisted of both domestic and cross-border securities.

During the course of 2012 the Bank adopted the new measures that were introduced by the Eurosystem with regard to the collateral framework. It began to participate in the Common European Pricing Hub, which was launched in September to provide Eurosystem central banks with a daily price for each eligible market asset, thus enabling them to value marketable assets submitted as collateral in the Eurosystem credit operations.

Several changes with regard to the Greek Government-linked collateral occurred during the year. In addition, during 2012 the Governing Council of the ECB also announced measures related to government-guaranteed bank bonds. In some cases, these decisions affected the collateral that counterparties placed with the Central Bank of Malta.

In June the Governing Council decided on certain additional measures to improve the access of the banking sector to Eurosystem operations. In particular, it reduced the rating threshold and amended the eligibility requirements for certain asset-backed securities. Later in the year, the Governing Council decided on additional measures to preserve collateral availability for counterparties to maintain their access to Eurosystem's liquidity-providing operations.

Reserve requirements

The ECB requires credit institutions established in the euro area to hold reserve deposits with national central banks (NCB). The objective of the Eurosystem's minimum reserve system is to stabilise money market interest rates and to help ensure the efficient operation of the Eurosystem as a liquidity supplier.

Each credit institution in Malta is accordingly obliged to hold minimum reserve deposits with the Bank. As part of the measures to support bank lending and money market activity, the Governing Council decided to lower the reserve ratio – which is applied to certain categories of deposits and debt securities issued by banks – from 2.0% to 1.0% commencing on 18 January 2012.

Reserve management

The Central Bank of Malta manages a financial assets portfolio, which has two components.[1] 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 and the maximisation of their return. With regard to credit and interest rate exposure, the Bank's risk profile continued to be gauged in terms of credit rating and modified duration, with foreign exchange risk being almost totally hedged.

During 2012 the Central Bank of Malta embarked upon a number of initiatives related to reserve asset management, including a revision of the credit analysis framework for the granting of investment limits, a country-limits model and a new investment benchmark for portfolio management, based on the construction of a synthetic portfolio that mirrors the Bank's risk-neutral position on a bond-by-bond basis. The Bank also engaged external asset managers prior to the end of the year and drafted related investment guidelines.

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

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 and reviewed the operational and risk framework. The IPC met on a monthly basis, with occasional *ad hoc* meetings 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 provide advisory services on external financing and debt management to Government.

In terms of the European Exchange Rate Mechanism II (ERM II) agreement, and as an NCB acting on behalf of the ECB, the Bank is obliged to intervene in those currencies participating in the ERM II regime. However, no such interventions were necessary during 2012.[2]

The Central Bank of Malta's foreign currency spot purchases during 2012 amounted to €862 million, a substantial increase when compared with the amount of €452 million reported in 2011. Meanwhile, spot foreign currency sales rose to €903 million from €489 million in the previous year.

The Bank undertakes foreign exchange swap transactions to hedge its foreign currency positions and to enhance its income. Foreign exchange swap purchases increased to €5.2 billion in 2012, from €2.1 billion in the year before. At the same time, swap sales in 2012 rose to €2.5 billion from €1.3 billion in 2011.

The Bank monitors developments in the foreign exchange market in Malta. The value of foreign exchange transactions between resident credit and financial institutions and unrelated third parties stood at €16.6 billion, down from €18.8 billion in the previous year. This turnover partly stemmed from spot transactions, and, to a lesser extent, new swaps amounting to €7.6 billion and €4.2 billion, respectively. In turn, just under half of the spot deals transacted in 2012 involved the corporate and household sectors as counterparties, and largely reflected transactions relating to payments for trade, tourism, personal transfers and financial portfolio flows.

During the year foreign exchange transactions effected locally between resident credit and financial institutions amounted to €56.1 million, significantly above the €35.7 million reported in 2011.

Throughout the year the Bank was the prime source in Malta for the publication of daily reference rates of exchange for the euro that the ECB established daily, as well as other indicative exchange rates.

Market-making operations

During 2012 the Central Bank of Malta continued to act as market-maker in the secondary market for Malta Government Stocks (MGS) and Treasury bills. In line with the provisions of the Central Bank of Malta Act and of the Treaty on the Functioning of the European Union,[3] the Bank did not participate in the primary market for government securities and did not provide any other form of financing to government.

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[2] 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. The pegged exchange rates may fluctuate within very limited bands.

[3] 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.

The Bank continued to publish daily opening bid and offer prices and the respective yields on all listed MGS, as well as the daily buying and selling rates for Treasury bills. In addition, the Bank quoted International Securities Market Association (ISMA) redemption yields on MGS on a daily basis.[4]

The Financial Markets Committee, which provides a forum for the Bank and all credit institutions operating in Malta to discuss various market-related issues, held three meetings during 2012. Discussions revolved mostly around the Eurosystem monetary policy operations framework, including the collateral framework. The Committee also discussed developments in the domestic primary and secondary markets for MGS, the foreign exchange markets, and developments in the domestic interbank market.

[4] 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 statutory mandate to ensure financial stability, the Central Bank of Malta continued to monitor the financial system to evaluate potential systemic risks and vulnerabilities to which the latter could be exposed. Trends in the domestic corporate and household sectors were also observed to detect any possible developments that might impact on the financial system. All developments which could have systemic implications were closely followed and discussed by the Bank's Financial Stability Committee.[1] The Bank also consulted the Malta Financial Services Authority (MFSA) and other relevant authorities to discuss financial stability issues and to identify appropriate measures to address weaknesses in the financial system.

To enhance its analysis of the banking sector the Bank introduced a new methodology that classifies banks into three different categories, namely, core domestic banks, non-core domestic banks and international banks according to their importance in the domestic economy. As in previous years, the Bank published on its website the *Financial Stability Report* in August and an *Update* to this *Report* in December.

During 2012 the Bank carried out stress-testing exercises of individual financial credit institutions and a scenario analysis to evaluate the resilience of the banking system to extreme, yet plausible, shocks or scenarios. It also undertook an analysis of the resilience of the securities' portfolio of relevant domestic banks in reaction to hypothetical scenarios emerging in European Union-International Monetary Fund (EU-IMF) programme countries. These exercises confirmed the overall resistance of the domestic banks to the selected shocks, even in circumstances when the plausibility of the shock was rather extreme. The results of the stress tests on the banks' balance sheets were published in the *Financial Stability Report*.

In the area of quantification of risk, the Bank developed a macro-stress-testing model which incorporates the effect of macroeconomic shocks on banks' balance sheets through the credit, market risk and contagion risk channels. The model provides further information on the adequacy of bank capital to withstand the impact of assumed macroeconomic shocks. Work is also at an advanced stage on a credit risk model, which quantifies credit risk in banks' loan portfolios.

In line with the Recommendation of the European Systemic Risk Board (ESRB) on the macro-prudential mandate of national authorities, the Bank, in conjunction with the MFSA, proposed a legal framework for the setting up of a Joint Financial Stability Board (JFSB). The ESRB considered the proposed structure to be fully compliant with the Recommendation. Consequently, the JFSB started operating in 2013 and held its first meeting in January. The objectives and tasks of the Board were described in more detail in a recent article in the Bank's *Quarterly Review*.[2]

The Bank and the MFSA maintained their regular exchange of information on financial sector issues of common interest, including policy issues and major regulatory developments affecting the financial sector, in particular through regular meetings of the Standing Committee set up between them. Together with the MFSA, the Bank conducted further rounds of the Quantitative Impact Study under the guidance of the Bank for International Settlements. In 2012 a larger number of local banks participated voluntarily in this exercise which, apart from estimating the effects of the implementation of stricter global regulatory standards on bank capital adequacy, stress-testing and market liquidity risk in line with the Basel III requirements, helped to identify any unintended consequences of the new regulation prior to its full implementation.

Regular meetings of the Domestic Standing Group were also held, during which senior officials of the Bank, the MFSA, and the Ministry of Finance, the Economy and Investment discussed issues related to crisis management. The Bank also participated actively in the domestic tripartite Joint Task Force on Bank Resolution since the proposed EU Directive for Bank Recovery and Resolution will have major implications on the way a crisis is handled by the Maltese authorities.

1 The Financial Stability Committee is chaired by the Governor and includes a number of senior officials of the Bank.

2 See the article entitled "The Joint Financial Stability Board", Central Bank of Malta, *Quarterly Review 2012:4* pages 84-86.

During the year senior Bank officials participated in the work of the ESRB and of the European Central Bank (ECB), as well as in the activities of the related substructures. The Bank was also represented at meetings of the European Banking Authority. In conjunction with the MFSA, the Bank also participated in discussions on the transfer, to the ECB, of supervisory powers over the banking sector in the euro area.

During 2012 the Bank continued to convene the Forum for Financial Stability, which is composed of representatives of relevant authorities and major stakeholders in the financial services sector, to foster a structured dialogue on issues of common interest, with particular emphasis on the identification and management of risks within the financial system. During these sessions participants were also briefed on the main policy developments affecting the sector.

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). The Bank issues coins on behalf of the Government. Additionally, the Bank is the authority responsible for the regulation and oversight of the payment and securities settlement systems in Malta, while providing various banking services to Government and to credit institutions in Malta.

Currency operations

The Bank continued to meet the banks' currency requirements, ensuring the authenticity and suitability of banknotes and coins in circulation.

Circulation of notes and coins

The value of euro currency issued by the Bank dropped by 1.7% to €898.5 million during 2012, as against a rise of 8.6% in the previous year. This contrasts with moderate currency growth in the euro area as a whole.

The overall decline reflected a 2.2% reduction in the value of banknotes issued by the Bank during the year. Net issuance of banknotes generally followed the established seasonal pattern, with contractions in January and in the summer months, and an expansion in December. The latter related to the increase in consumer spending over the Christmas period, while the contraction in the summer and autumn months reflected the buoyancy of the tourism industry during 2012, which generally led to substantial inflows of currency brought by visitors to Malta (see Table 3.1).

All banknotes deposited at the Bank were examined for their authenticity and quality. During 2012 the Bank examined a total of 82 million banknotes with a value of €1.9 billion. This was more than the 76.6 million banknotes examined in 2011, with the value of notes being €0.2 billion higher than in 2011. Slightly less than 8% of banknotes examined by the Bank were deemed unfit for re-issue and subsequently destroyed. In 2011 the proportion was higher at 10.3%. During the year the Bank continued to enhance its banknote examination capabilities to increase operational efficiency.

Table 3.1
BANKNOTES ISSUED BY AND PAID INTO THE BANK IN 2012
EUR thousands

		Issued	Paid in	Net issue	Issued and outstanding
2011		1,823,220	1,761,294	61,926	867,610
2012	Jan.	138,483	147,497	-9,014	858,596
	Feb.	133,519	129,995	3,524	862,121
	Mar.	151,287	142,573	8,714	870,834
	Apr.	168,923	167,184	1,739	872,573
	May	155,907	162,953	-7,046	865,527
	June	160,736	147,408	13,328	878,855
	July	166,354	181,700	-15,345	863,510
	Aug.	159,043	176,991	-17,948	845,562
	Sep.	143,740	149,750	-6,010	839,552
	Oct.	165,329	177,047	-11,718	827,834
	Nov.	154,005	156,516	-2,511	825,323
	Dec.	176,443	153,622	22,821	848,144
2012		1,912,799	1,928,004	-19,466	848,144

Source: Central Bank of Malta.

The Bank also began implementing its project plan for the introduction of the Eurosystem's second euro banknote series (ES2). This series will be launched in May 2013 with the issue of the new €5 denomination banknote. In each of the subsequent years, one further denomination of the series will be launched until all are issued by 2020. The new series of euro banknotes will include further enhanced security features in the fight against counterfeiting. An internal working group was set up to focus on various issues in connection with the introduction of the new ES2 notes, including improvements to the Bank's banknote processing machines.

The Bank acts as agent for the Government in the issuing of euro coins in Malta. The Bank is responsible for the procurement, storage and issuance of euro coins, while the seigniorage revenue arising from coin issuance is due to Government. The value of coin issuance is subject to a limit laid down by the ECB. In 2012 this limit was €10.5 million, implying an overall ceiling of €56.3 million.

As can be seen in Table 3.2, the value of coins issued by the Bank rose by 9.2% during 2012. As a result, the amount outstanding at the end of the year stood at €50.4 million.

During 2012, 60.6 million euro coins with a value of €35.2 million were examined by the Bank. The volume was lower than in the previous year, which amounted to 65.1 million coins but, in value terms, they exceeded the 2011 level of €32.9 million.

In the context of the European framework for the recycling of euro banknotes, the Bank amended Directive No 10 on their authenticity, fitness checking and recirculation. This brought the Directive in line with the latest ECB decisions prior to the issuance of the ES2. Regular meetings were held with local credit institutions to update them on developments in this area.

With regard to cash handling processes, the Bank continued to monitor closely the operations of credit institutions and of professional cash handlers, as well as the testing of various types of banknote handling machines.

In April 2012 the Bank joined the Cash Single Shared Platform (CashSSP), a cash management system designed by the National Bank of Belgium to handle the exchange of notes and coins. At the end of the year,

Table 3.2
COINS ISSUED BY AND PAID INTO THE BANK IN 2012
EUR thousands

		Issued	Paid in	Net issue	Issued and outstanding
2011		36,959	31,890	5,069	46,113
2012	Jan.	2,457	2,969	-513	45,600
	Feb.	2,366	2,670	-303	45,297
	Mar.	2,736	2,562	175	45,472
	Apr.	3,269	2,673	597	46,068
	May	3,504	3,010	494	46,562
	June	3,258	2,502	756	47,319
	July	4,352	3,178	1,174	48,493
	Aug.	4,160	3,415	745	49,239
	Sep.	2,876	2,986	-110	49,129
	Oct.	3,556	3,139	417	49,546
	Nov.	3,718	2,935	783	50,329
	Dec.	2,776	2,730	46	50,375
2012		39,029	34,767	4,262	50,375

Source: Central Bank of Malta.

seven other Eurosystem central banks were participating fully in the CashSSP. The system makes extensive use of modern information technology to handle the exchange of notes and coins with commercial banks and transit companies, and to automate related processes. It also supports a number of ESCB functions, including reporting and data exchange.

Collection and disposal of the Maltese lira

During 2012 the Bank continued to collect and dispose of Maltese lira banknotes. In total, over 86,000 banknotes denominated in Maltese lira with a face value of over Lm0.9 million (equivalent to €2.0 million) were collected during the year. By the end of the year, the value of Maltese lira banknotes still in circulation amounted to Lm19.2 million, equivalent to €44.6 million.

Numismatic and commemorative coins

In April 2012 the Bank issued a numismatic coin commemorating the Maltese artist Antonio Sciortino. The coin, available in silver and gold, featured the sculpture known as *"Les Gavroches"*, and was issued under the Europa Programme 2012. The Bank also issued two commemorative €2 coins, one in March to commemorate the launching of euro banknotes and coins in 2002, and the other in October bearing the inscription "Majority Representation, 1887." The latter was the second coin in a series of five relating to Malta's constitutional history, and was issued both in circulation and in proof quality.

In August the Bank also issued a new euro coin set dated 2012, which, besides the eight Maltese euro coins, incorporated the €2 commemorative coin issued in October. The new set also included a replica of a coin of the Roman period, the original of which is currently exhibited in the Bank's museum.

In June 2012 the Bank issued a medal featuring the portrait of Grandmaster Jean de La Valette and on the reverse the facade of Saint John's Co-Cathedral.

Anti-counterfeit measures

During 2012 the Bank's Currency Surveillance Unit, which is responsible for promoting awareness on counterfeiting and for the analysis of suspected counterfeit currency, continued to examine banknotes and coins, and liaising with the ECB.

The total amount of counterfeit banknotes withdrawn from circulation in 2012 was 1,664, or 7.8% more than the 2011 level. The counterfeit value was €78,045. The Unit analysed over 1,600 suspect banknotes and shared its findings with the ECB's Counterfeit Monitoring System.

Payment and securities settlement systems

Payment system

In terms of the Central Bank of Malta Act, the Bank is responsible for the regulation and oversight of the payment and securities settlement systems in Malta.

In line with its mandate, during 2012 the Bank, as the overseer of payment and securities settlement systems, finalised the assessment of the local securities settlement system, MaltaClear, and also of the link between MaltaClear and Clearstream Banking, Frankfurt. This assessment, which was part of an ESCB coordinated exercise, was carried out against the ESCB Standards for Eurosystem Credit Operations.

In 2012 the Bank continued to manage the Malta Clearing House, through which most cheques issued in Malta are settled. As other forms of payment become more widespread, the total number of cheques cleared during the year by the general public and the Government was lower by 0.8% compared with the previous year, though the overall value rose by 3.2%.

The Bank's operations in TARGET2, which is the payment system through which Eurosystem central bank operations and large-value interbank transfers are settled, continued to increase during 2012. The total payment flows through TARGET2 Malta rose by 21,800 in volume terms and by €153.1 billion in value terms to stand at 40,357 and €263.8 billion, respectively, over the year. This significant increase was primarily due to a rise in overnight deposits placed by credit institutions with the Bank, and a full year's participation by two credit institutions that joined the system during 2011. Another credit institution, FCM Bank, joined the system in 2012, bringing the total number of direct participants to five.

The Bank also continued to participate in the Eurosystem's TARGET2-Securities (T2S) project, which is a single IT platform for securities settlement aimed at maximising safety and efficiency in the settlement of euro-denominated securities transactions. Both the Bank and the Malta Stock Exchange will join the T2S in the first migration wave in 2015. Locally, the development, assessment, and implementation of the T2S project is overseen by a T2S National User Group set up in 2012, bringing together various local providers and users of securities settlement services.

During the year the Minister of Finance, the Economy and Investment appointed the Bank as the competent authority for Malta to ensure compliance with EU legislation establishing the requirements for credit transfers and direct debits in euro.[1] Hence, as part of the Single Euro Payments Area (SEPA) project, the Bank became responsible for ensuring that the various payment instruments, including SEPA credit transfers and SEPA direct debits, are implemented in Malta. This project is aimed at increasing the efficiency of payments in the European Union through the adoption of a single standard for credit transfers and direct debits. The project also brings cross-border transactions in terms of efficiency and charges in line with domestic transactions. The SEPA migration is expected to be concluded by 1 February 2014, with all legacy credit transfers and direct debits being converted to the SEPA format.

During the year the Bank started testing SEPA credit transfers involving the Government's social security payments, which are envisaged to go live during the first quarter of 2013. Meanwhile, local banks continued to offer SEPA credit transfer facilities to their household and corporate customers. As a result of the removal of the limit on the amount of each SEPA Credit Transfer (SCT) the total value of outgoing SCTs processed by the Bank increased substantially to €914.3 million during 2012.

In August 2012 a National SEPA Coordination Committee was set up to coordinate the SEPA migration among the different stakeholders, given the approaching migration deadline for SCTs and SEPA Direct Debits (SDD). It was noted that 16 local banks were compliant with regard to SCTs, four of them with regard to core SDDs, while two of them were also business-to-business SDD compliant. During the second half of the year, the share of credit transfers and direct debits migrating to SEPA stood at 12.0% and 37.6%, respectively.

During 2012 the Bank also continued to chair the Payment Systems User Group, responsible for the implementation of SEPA in the local banking sector.[2]

Banker to the public sector

In its role as banker to Government, the Central Bank of Malta maintains various accounts in euro and foreign currencies for the Treasury, for other government departments, and for a number of public sector corporations. It offers several banking services to the public sector, including encashment and deposit facilities. The Bank also effects, on behalf of Government, SEPA formatted credit transfers and provides it with night safe and safe custody facilities.

The Government's efforts in resorting to non-cash methods of payment was reflected in the lower number of cheques it issued. In 2012 these declined by 2.3% compared with the previous year, while their total value decreased by 1.0%. Meanwhile, the number of Government payments effected by the Bank through credit transfers increased by 15.7% in 2012, while their overall value rose by 27.3%, to €1.4 billion.

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[1] Regulation (EU) No 260/2012 of the European Parliament and of the Council of 14 March 2012.

[2] The Payment System User Group is set up with the participation of credit institutions operating in the domestic market and the Malta Bankers' Association. It is a consultative body responsible for the definition of policies and strategies relating to payments for the Maltese banking community.

During the same period, payments effected by the Bank in connection with the servicing of the Government's external debt amounted to €15.9 million. Meanwhile, allocations to external debt sinking funds during 2012 stood at €46.7 million.

The Bank also offers foreign exchange services to Government and public corporations. During the year, the total value of foreign exchange receipts processed by the Bank on behalf of Government and public sector entities decreased by 9.2% in 2012 when compared with 2011, to €315.4 million. With regard to foreign exchange payments effected on behalf of Government and public sector entities, these declined by 11.5% to €278.8 million. Both receipts and payments were mainly driven by tax payments and refunds related to internationally-oriented companies operating in Malta.

Banker to the banking system

In its role as banker to the banking system, and in order to perform its Eurosystem tasks related to monetary policy operations, the Central Bank of Malta continued to provide deposit and lending facilities to credit institutions. Credit institutions maintain balances at the Bank to meet their reserve deposit requirements and to carry out interbank transactions.

Other financial services

Throughout 2012 the Bank continued to provide portfolio management services in relation with the Investor Compensation and Depositor Compensation Schemes[3] on the basis of parameters set by the respective management committees appointed by the Malta Financial Services Authority (MFSA) to regulate such schemes. It continued to hold accounts pledged in favour of the two schemes, while performing financial, accounting, and other related support services. Furthermore, as the custodian of assets under the Insurance Business Act, the Bank held, in its name and on behalf of insurance companies, certain specified assets representing guaranteed funds, while it continued to report regularly on the position of such holdings to the MFSA.

[3] The Investor Compensation Scheme protects clients of licensed investment service providers that are unable to satisfy their obligations towards investors, while the Depositor Compensation Scheme compensates depositors in the event of a bank failure. These two schemes were established by Legal Notice 7 of 2003, which designated the Bank as investments manager for both schemes.

4. INTERNAL MANAGEMENT

Governance

Board of Directors

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

During 2012 the Board was composed of Professor Josef Bonnici, Governor and Chairman, Mr Alfred DeMarco, Deputy Governor, and Mr Victor Busuttil, Ms Antoinette Caruana and Ms Philomena Meli as non-executive Directors. Dr Bernadette Muscat was Secretary to the Board of Directors. During the year the Board met 12 times.

Management and Internal Organisation

The Policy Advisory Committee 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. There were no changes in the composition of this Committee during 2012. The Management Committee, which is composed of the Bank's Heads of Department, is mandated to ensure that the Bank's operations are carried out economically, effectively and efficiently. Both Committees met 22 times during the year.

Governors' activities in Malta

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

At a press launch in April, the Governor presented the Bank's *Annual Report 2011*. Also in April, he delivered a speech during a workshop organised by the Islands and Small States Institute on banking issues and policies in a small state.

In May the Governor delivered speeches during the Malta Chapter Conference of the Information Systems Audit and Control Association on good governance and at the 5th Annual Conference of Finance Malta on financial and economic challenges in the euro area and beyond. Also during the same month, he addressed the Congress of the *Association Internationale des Anciens des Communautés Européennes* on current developments in the euro area and the Maltese economy.

In June during a seminar organised by the National Audit Office, the Governor presented a speech entitled "Background to the financial crisis". In July he addressed the European Public Law Conference on new economic governance for Europe. In September the Governor participated at the Cooperative Banking Seminar, presenting a paper about developing an alternative model for banking in Malta. In November he delivered a speech entitled "Malta's economy under the lens" during a conference organised by the Malta Institute of Management.

The Governor was also the keynote speaker at the annual dinner of the Institute of Financial Services held in December, during which he spoke about economic growth in turbulent times.

In addition, the Governor also appeared on public broadcasting and gave various interviews to local and international media.

Governors' activities overseas

With regard to international commitments, the Governor also participated in meetings of the ECB's Governing Council, General Council and the European Systemic Risk Board (ESRB). The Governor also attended two informal ECOFIN Council meetings during the year.

In April the Governor participated in the International Monetary Fund (IMF) and World Bank Spring meetings in Washington and, later in the month, attended a seminar organised by the ECB on financial integration and stability. In June the Governor attended a summit in London organised by the Official Monetary and Financial Institutions Forum, during which he gave a speech on the global economic situation in 2012 and the challenges ahead. During the month, he also visited Libya to explore areas of cooperation between the Central Bank of Malta and the Central Bank of Libya.

In July the Governor chaired a panel at a high-level seminar in Morocco held between the Eurosystem and central banks of the Mediterranean region. Participants reviewed economic and financial developments in their respective areas, monetary policy implementation and challenges to financial stability. In August he attended an economic policy symposium in Jackson Hole, Wyoming, organised by the Federal Reserve Bank of Kansas City. During the symposium international central bankers, policymakers, academics and economists discussed current economic issues, focusing on financial stability and monetary policy.

In October the Governor attended the IMF and World Bank Annual Meetings in Tokyo, and later participated at a seminar organised by the ECB on "Risk control frameworks". In November he attended a conference in Helsinki on European economic integration organised jointly by the Bank of Finland and the National Bank of Austria.

During the year the Deputy Governor accompanied the Governor to meetings of the ECB's Governing Council and the Annual Meeting of the IMF and World Bank. He also participated in meetings of the ECB's Monetary Policy Committee and of its International Relations Committee. The Deputy Governor is also the Bank's representative on the Economic and Financial Committee (EFC) and on the Malta Enterprise Consultative Council.

On various occasions the Director General accompanied the Governor and the Deputy Governor to Governing Council and the General Council meetings. He also attended meetings of the EFC and EFC alternates in Brussels.

Governor's Office

The newly established Governor's Office provides expert support for the Governor's participation in the Governing and General Councils of the ECB, as well as in consultative or regulatory bodies. The Office focuses on research and other preparation as required for the development of policy positions of the Bank, particularly those related to Malta and the euro area. It also engages in the preparation of speeches, presentations and interviews.

Audit Committee

The Audit Committee of the Board, 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 2012 the Committee was chaired by Mr Victor Busuttil, with Mr Alfred DeMarco and Ms Philomena Meli as members.

The Committee met on seven occasions during the year and addressed various topics, including internal audit operations, exposures to risk, particularly at a Bank-wide level, and other related policy matters. The Committee also held a number of meetings with the Bank's external auditors.

Internal audit

In line with its Internal Audit Charter, the Bank's Internal Audit Department provides independent assurance to the Bank's management and, through the Audit Committee, to the Board of Directors, of a robust and comprehensively deployed risk management framework. In the process, internal auditors objectively evaluate the effectiveness and efficiency of governance, risk management and internal control processes. In fulfilling its assurance role, Internal Audit recommends cost-effective improvements in different areas of the Bank and follows up on their implementation.

During the year Internal Audit carried out audit assignments relating to a wide range of internal activities, giving priority to higher-risk areas. Besides following up issues raised by the Bank's external auditors, Internal Audit undertook a number of procedural and asset audits, and provided advice to support business areas within the Bank, particularly in connection with the implementation of controls, project management and issues relating to strategic planning.

Internal Audit reports its findings to the Audit Committee. In fulfilling its ESCB responsibilities, Internal Audit participated in the ESCB's Internal Auditors' Committee and undertook audit assignments on its behalf, thereby providing the necessary assurances to the Governing Council.

In compliance with standards set by the Institute of Internal Auditors and its code of ethics, during 2012 the Bank's Internal Audit Department undertook an internal quality self-assessment review of its activities.

In addition, given the intensity of the audit programme and its obligation to participate more actively in the Eurosystem audits, the Internal Audit Department was split into two sections, one handling compliance audits and the other dealing with performance audits. The staff complement was also increased to allow the Department to further strengthen its assurance provision role.

Risk assessment

During 2012 the initial phase of the Operational Risk Management (ORM) framework continued across almost all business operations at the Bank. This process is expected to be finalised by early 2013.

The first phase of the ORM process will lead to a detailed Business Impact Analysis (BIA) of all Bank processes to determine the impact of any disruption. The BIA will determine which critical processes require a Business Continuity Plan and which current plans need review. Furthermore, the incident reporting framework will be reviewed in line with best practice.

The Bank carried out a crisis scenario simulation exercise, involving the Operational Crisis Committee and the Crisis Coordination Working Group, aimed at enhancing its response to a crisis. The former is chaired by the Deputy Governor and includes two senior Bank officials, while the latter brings together a number of Heads of Department. The Operational Crisis Committee would have the responsibility to lead the Bank through a crisis situation, determine the response to the crisis and coordinate the dissemination of information about the crisis both within and outside the Bank.

Data Protection and Freedom of Information

During 2012 the Bank carried out the annual review of personal data held and processed and ensured that legal requirements were respected.

The Freedom of Information Act came into force during the year. In 2012 all Bank employees attended in-house training seminars highlighting the Bank's obligations and practices to be adopted by employees with respect to both the Data Protection Act and the Freedom of Information Act.

Legal issues

During 2012 the Bank was involved in drafting changes to Maltese legislation that related to the Bank's functions and responsibilities or to the activities of the financial system in general. In 2012 the Bank's legal staff advised senior management on issues related to the Bank's governance structure and to various activities and projects, notably the setting up of an asset management programme.

The Central Bank of Malta Act also empowers the Bank to issue directives governing activities falling under its responsibility. During 2012 a number of directives were amended to implement guidelines issued by the ECB. Directive No 8 relating to the Documentation on Monetary Policy Instruments and Procedures was amended twice, in September and November. In September, a new Annex was added to the Directive providing for additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral. The November amendments extended the eligibility criteria to assets denominated in foreign currency.

The Bank also amended Directive No 2, which deals with payments and securities settlement systems, to refer directly to the European Union (EU) Finality Directive (Directive 98/26/EC) and to clarify a reference made to shareholders' and creditors' winding up procedures.

In 2012 the Bank also carried out preparatory work on further amendments to various Directives, which entered into effect in early January 2013. They included Directive No1 on the provision and use of payment services. This directive was amended to include a provision on the recognition of legacy (pre-SEPA) direct debit mandates. Amendments to Directives No 6 and No 7 on participation in TARGET 2 and on the provision of intra-day credit, respectively, reflected changes in the relevant ECB Guideline. A new set of amendments to Directive No 8 was also undertaken reflecting the outcome of the general review of the ECB's General Documentation on monetary policy procedures. Directive No 10 was amended to supplement the rules concerning the authentication of euro coins and the handling of euro coins unfit for circulation.

The Bank also prepared formal documentation for the creation of a Joint Financial Stability Board (JFSB) between the Bank and the MFSA, with the objective of facilitating cooperation on matters relating to financial stability and the implementation of macro-prudential policy.

As in previous years, the Bank is legally represented on the Board of Governors of the Financial Intelligence Unit and its Joint Committee, which are responsible for the analysis of information to combat money laundering and funding of terrorism. The Bank is also represented on the Sanctions Monitoring Board, which implements international sanctions imposed by the EU and also ensures compliance with those laid down by the Security Council of the United Nations.

Economic analysis and research

The Bank regularly analyses economic and financial developments in Malta and abroad. Members of staff provide inputs into the monetary policy process by briefing the Governor on economic and financial developments in the euro area ahead of his participation in both the Governing Council and the General Council of the ECB. Developments in the Maltese economy were also assessed. The Bank publishes its analysis of economic developments in its *Quarterly Review* and *Annual Report*. It also releases a monthly commentary on monetary developments in Malta.

During 2012 the Bank contributed to Eurosystem research projects on labour market developments and the crisis; competitiveness and external imbalances in the euro area; and euro area corporate finance and economic activity. 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. Analytical work was also undertaken on a number of economic and financial issues, notably inflation differentials between Malta and the euro area, the household savings ratio and the economic impact of structural reforms.

The Bank regularly participates in the preparation of euro area-wide macroeconomic projections. A comprehensive projection 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 every quarter. Another summary projection exercise is also undertaken in the context of the Bank's *Annual Report*. The Bank also prepares detailed fiscal forecasts as part of the ESCB's forecast exercises. Further work was carried out during the year to strengthen the Bank's short-term forecasting capability and to overhaul its structural econometric model (see Box 6).

Statistics

The Bank collects and disseminates a wide range of monetary, financial and other macroeconomic statistics for advisory, analytical and research purposes. The Bank is primarily responsible for monetary and financial statistics in Malta, while it contributes to the compilation of balance of payments and financial accounts statistics in cooperation with the National Statistics Office (NSO).

The Bank continued to fulfil its international statistical reporting obligations, mainly those stemming from the ECB and the ESRB. It also continued to participate in the compilation of statistics by the IMF, in particular in respect of the Special Data Dissemination Standard, the General Data Dissemination System and the Financial Soundness Indicators. Preparations are well under way to implement, in liaison with the NSO, the requirements of the new edition of the IMF's Balance of Payments Manual, scheduled to enter into force in 2014.

In view of the envisaged enactment of the Regulation on the European system of national and regional accounts in the EU (ESA 2010), and new or amended ECB regulations on statistics, the Bank carried out fact finding and cost assessment exercises in cooperation with monetary financial institutions, investment funds and insurance corporations. The Bank will be reviewing and implementing the necessary amendments to its statutory returns in order to meet the revised ESA 2010 standards. The Bank also began the process of identifying and collecting information on financial vehicle corporations.

During 2012 the Bank produced the final results of a survey on households' finances and consumption patterns in Malta. This survey reached the quality benchmarks set by the ECB and will form part of a cross-country study across the euro area that is being coordinated by the Eurosystem's Household Finance and Consumption Network. The planned publication of the findings will document the survey's methodology and will shed light on the financial situation, wealth and consumption behaviour of Maltese households.

Meanwhile, the Bank continued to strengthen the security-by-security dimension in its compilation of financial statistics, particularly through the development of the necessary regulations and guidelines. Moreover, preparations were under way to fulfil the data quality framework related to the ESCB's Centralised Securities Database as stipulated in the related ECB Guideline.

At the beginning of 2012 the Bank broadened the range of historical data on money and banking that are available on its website. Later during the year, the Bank also made available additional historical economic statistics.

Moreover, the Bank, together with other central banks, provided expert support to the National Bank of the Former Yugoslav Republic of Macedonia in areas related to balance of payments and international investment position statistics. The Bank also shared its experiences on the Household Finance and Consumption Survey with other national central banks.

The Bank stepped up its efforts to centralise the statistical functions within the Bank. In this respect, during the year the processing of financial stability statistics was shifted to the Statistics Department.

Furthermore, the Bank, in consultation with the *Banca d'Italia*, is assessing potential IT solutions to strengthen its statistical and analytical capabilities, as part of the Business Applications Architecture project.

At a national level, the Bank continued to be represented on a Steering Committee, that includes officials from the NSO and the Ministry of Finance, the Economy and Investment (MFEI), which oversees a programme for improvement in the quality of Malta's national accounts and of other economic statistics. Moreover, the Bank and the NSO continued to cooperate in the determination of criteria to identify special purpose entities and to improve the quality of the National Business Register. The two institutions also enhanced the compilation of non-financial companies' balance sheet statistics as an input for the EU Commission's *Scoreboard for the Surveillance of Macroeconomic Imbalances*.

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 institutions, the MFSA, the NSO and the Malta Bankers' Association, coordinates the smooth transition to new reporting systems while seeking to enhance existing ones, such as those related to the measurement of residential and commercial property prices.

Human resources

At end-2012 the Bank employed a total of 321 full-time staff, seven more than a year earlier, while the number of part-timers stood at 20, 15 more than at end-2011. The staff complement in terms of full-time equivalents rose to 317 from 294 in 2011.

During 2012 the Bank recruited six economists, along with three financial analysts, four information technology employees and 18 part-timers who were allocated to various areas of the Bank. At the same time, three employees resigned from the Bank, two of whom had worked on a part-time basis. In addition, two employees retired on reaching pensionable age. Three other staff members left under a voluntary severance scheme, while one was boarded out on medical grounds. One part-time staff member switched to full-time employment.

In 2012 the Bank continued the secondment of two employees to offices within the public sector. In addition, five employees took up short-term contracts with the ECB, in the areas of librarianship, secretarial support, risk management, market operations and currency. The Bank also hosted an ECB employee who carried out duties across a range of offices.

During the summer the Bank offered temporary employment to ten University of Malta students majoring in economics, banking, law, marketing, engineering and architecture. In addition, the Bank participated in a scheme administered by the Malta College of Arts, Science and Technology, offering a five-week work placement at the Bank to three students.

During 2012 the Bank signed collective agreements with the *Union Ħaddiema Bank Ċentrali* and the General Workers Union, representing executive and clerical staff and the non-clerical category, respectively. The collective agreements cover the period until 2015.

The Bank also renewed its agreement with Caritas Malta to provide support to Bank employees. Similarly, the Bank extended the support programme offered by the Richmond Foundation.

In 2012 the Bank also initiated the upgrade process of the payroll system and began testing a new employee intranet portal.

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. The in-house training programme covered 24 areas, offering 44 different courses, mainly on IT, economics and statistics, money laundering, health and safety, data protection and staff development programs. Induction programmes were also provided to all new employees.

The in-house training programme was complemented by the launch in 2012 of a development programme designed to equip employees with management and leadership qualities and to provide a stronger educational foundation for career development.

As Table 4.1 shows, the number of staff members who participated in external courses was higher than in 2011. A rise in the number of participants attending courses taken in Malta more than offset a drop in those attending courses abroad. Domestic, as well as overseas courses, covered topics relating to economics, investment, law, risk management, accounting, IT and human resources. Foreign courses were organised by various central banks, the ECB, and other institutions.

Table 4.1
STAFF TRAINING DURING 2012

Type of training	Number of courses/seminars		Number of participants	
	2011	2012	2011	2012
In-house	52	44	1021	587
External	156	140	213	223
Local	72	81	120	160
Overseas	84	59	93	63

Source: Central Bank of Malta.

Table 4.2
ACADEMIC AND PROFESSIONAL COURSES
Number of employees

Type of programme	Courses completed		Courses being pursued	
	2011	2012	2011	2012
Postgraduate courses	2	13	19 (1)	18 (1)
Honours first degree courses	5	5	4	3
Diploma courses		2	7	3

(1) Includes 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.

During the second half of the year, the Bank hosted an ESCB training course in leadership, which was attended by several central bank officials from the ESCB.

During the year a number of employees benefited from the Bank's various study programmes (see Table 4.2). A total of 20 beneficiaries successfully completed their studies, while 24 were continuing their degree programmes, mostly at postgraduate level.

In addition, the Bank continued to provide financial support under its Learning, Research and Development Study Programme to selected staff members wishing to pursue academic studies at foreign universities at post-graduate level in areas relevant to the Bank's work. During 2012 one staff member was selected to pursue studies in economics, while two successfully completed the courses they were following.

Health and safety

In 2012 health and safety measures were given special attention owing to the reconstruction works carried out at St James Counterguard Annex and the building of the new Annex.

In addition, in its effort to ensure safety and work continuity, automatic fire extinguishing systems were installed in sensitive areas of the Bank's buildings. Refresher courses on first aid and courses on safety equipment were also organised.

Information Systems and Knowledge Management

In 2012 the Bank continued to develop in-house software solutions and to strengthen its knowledge management services to enhance the exchange and management of information.

The Bank implemented a number of new projects. One project provided the Bank's management with secure remote access for selective services, while a new infrastructure, based on virtualisation technology to improve the effective use of information technology resources, was implemented. Further progress was made in the design of the Business Applications Architecture, a project earmarked to replace the Bank's major IT systems. At the same time, the ground work for the replacement of the Bank's emailing system was completed, and the new system will be operational early in 2013.

The SWIFT communications infrastructure continued to be upgraded, while the Single Euro Payments Area application system was enhanced to support the management of standing orders and the settlement of government pensions by the Social Services Department. In addition, the Bank's Performance Management System was upgraded and will be in operation in 2013.

The Bank continued to meet ESCB/ECB related demands in the area of information systems. These included upgrades of applications related to collateral management and daily financial reporting systems. Moreover, the Bank assisted the Bank of Latvia in launching its Household Finance and Consumption Survey questionnaire.

As in previous years, the Bank's Library offered its services to staff and met requests from external users pursuing economic and financial research. It continued to enhance its print and electronic collections on 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. Many of these services are now available electronically within the Bank through the library portal.

Premises and procurement

During 2012 reconstruction works were carried out on the Bank's St James Counterguard Annex, particularly on the roof of the building. Moreover, the preliminary planning procedures of the project related to the development of the space adjacent to the Annex continued, with initial building works starting towards the end of the year.

Throughout the year, the Bank continued to participate in a Eurosystem Procurement Coordination initiative mostly in areas related to software and market data. The initiative enables members 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 at source, energy efficiency, water consumption reduction and environment-friendly procurement. Measures included the recycling of paper, through which 45 tonnes of paper were recycled. The outcome of an energy management audit was presented to the Bank's senior management, setting out a ten-year plan for more efficient use of electricity and water.

For the third consecutive year a number of trees were donated to the 34U campaign.

Social commitments

The Bank continued to provide financial support to a number of institutions in areas connected to its functions. In this regard, in 2012 the Bank sponsored the establishment of the Central Bank of Malta Chair in Economics at the University of Malta, through the latter's Research, Innovation and Development Trust.

The Bank continued its support for various philanthropic organisations through donations and sponsorships. In particular, in the cultural sphere it assisted the *Fondazzjoni Patrimonju Malti* and *Din l-Art Ħelwa*, among others. It also provided assistance to various charities, including the Malta Community Chest Fund, *Kummissjoni Emigranti*, *Dar tal-Providenza*, *Aġenzija SAPPORT* and the *Arka* Foundation. Moreover, one staff member was seconded to a charitable institution, and another to a conservationist NGO. A further employee was seconded on a part-time basis to another voluntary organisation. The Bank sponsored the participation of staff members in the fourth edition of the President's Charity Fun Walk/Run, which was held in December.

The Governor, on behalf of the Governing Council of the ECB, officially inaugurated a new computer room for refugees residing at *Dar ir-Refuġjati* in July 2012. The funds for this project were provided by the ECB Charity Initiative.

His Grace the Archbishop of Malta visited the Bank in June and blessed an altar and lectern which were specifically designed for the Bank to facilitate the celebration of religious services for staff.

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 latter also carries press and statistical releases, and official publications issued by the Bank. 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, including tours to the Bank's coin museum.

In February the Bank organised a symposium to introduce the second of a series of five €2 commemorative coins featuring milestones in Malta's constitutional history. In September, for the third consecutive time, the Bank opened its premises to the public during the *Notte Bianca*, an evening event organised by public authorities in Valletta. Visitors could tour the currency museum and view a selection of works of art belonging to the Bank.

In the course of the year the Bank hosted four ESCB meetings. It also hosted, in conjunction with the MFEI, a constituency meeting of the European Bank for Reconstruction and Development.

BOX 5: THE BANK'S STRATEGIC PLAN 2013 – 2015

The Strategic Plan for 2013-2015 outlines the key strategic priorities of the Bank. These priorities are closely aligned with the aims underpinning the Bank's Mission and the statutory objectives outlined in the Central Bank of Malta Act.

The current Plan builds on the Bank's Strategic Plan for 2009-2013, which paved the way for the Bank to become a fully functional national central bank (NCB) within the Eurosystem.

The initiatives undertaken since 2009 to attain this objective included:

- sustained progress in adapting to Eurosystem responsibilities;
- upgrading in the quality of its human resources;
- restructuring of the organisation;
- closer relations with Eurosystem NCBs;
- broader harmonisation of methodologies/processes.

The above initiatives were achieved through improved teamwork, enhanced internal communication, as well as a better corporate governance framework.

Taking into account financial and economic developments, the overarching strategic objective of the Bank has been reviewed and expanded for 2013-2015 to provide greater clarity and direction. This is stated as follows:

> "A fully engaged NCB effectively contributing to monetary policy in the Eurosystem and, at a domestic level, ensuring the stability of the financial system and providing independent advice on economic policy."

This strategic objective supports the Bank's monetary policy and its financial stability, advisory and advocacy role.

Within the parameters set by the Central Bank of Malta Act, the ESCB's Statute and the Treaty on the Functioning of the European Union, the Bank will further integrate with the Eurosystem. It will also refocus more actively on domestic responsibilities, particularly the Bank's working relations with Government, the MFSA, credit institutions, the NSO and the public at large. The Bank will play a leading role on economic and financial stability issues and enhance its capacity for providing independent advice through in-depth research and analysis in the economic and financial fields.

The strategic priorities, built on five pillars, are outlined below.

(i) To enable the Bank to effectively contribute to the formulation and implementation of Eurosystem monetary policy.

The Bank will undertake enhanced research, analyses and forecasting exercises to underpin the Governor's contribution to monetary policy decisions at Governing Council level. The Bank will also take measures to ensure that it is in a better position to implement effectively and efficiently monetary policy decisions taken by the Governing Council, and will continually assess the functioning of the financial system to ensure that the monetary transmission mechanism is not impaired.

(ii) To enable the Bank to provide independent advice on economic and financial policy matters by playing a leading role in economic and financial analysis.

The Bank will strengthen its capacity to undertake in-depth economic research and analysis to enable it to build its expertise on economic and financial issues. It will prepare and publish more regularly working papers and other studies on relevant issues. It will also interact more actively with the University of Malta and institutes overseas with the aim of undertaking joint studies on relevant topics.

(iii) To enable the Bank to fulfil its financial stability function by assuming a leadership role in macro-prudential decisions.

In carrying out its financial stability function the Bank will continue to enhance its macro-prudential mandate through the recently established JFSB and through the implementation of the JFSB's policy measures to address systemic risks. It will broaden and deepen its assessment of financial stability issues and, together with the MFSA, contribute to a strengthening of the supervisory architecture in Malta.

(iv) To enable the Bank to ensure the robustness and smooth functioning of the financial market and of the development of the payment system, and to effectively manage currency issuance.

The Bank will participate in the market for Malta Government securities to provide efficient market-making facilities and collaborate closely with the Malta Stock Exchange to enable the latter to integrate more effectively with European capital markets. To ensure the effectiveness of the payment systems, the Bank will establish a secure environment in which the currency supply system can operate smoothly through high quality, cost-efficient provision and distribution of currency. It will continue to actively promote the introduction of new non-cash payment instruments while strengthening the payment system infrastructure to ensure that it provides an efficient and secure channel for payment transmission.

(v) To allow the Bank to actively manage its resources and financial assets and liabilities in an economic, effective and efficient way, thus ensuring a sustainable financial position in compliance with sound governance, planning and performance management.

The Bank will operate in a cost-efficient manner to achieve a reasonably high and stable level of profits over time. It will strive to preserve and increase the value of its financial assets through the implementation of appropriate investment and risk management strategies. It will strengthen its corporate governance, performance management system and its support facilities (information technology, administration and human resource services). It will also enhance its longer-term planning and budgetary processes, ensuring that major projects are managed efficiently and that net benefits are maximised.

BOX 6: A STRUCTURAL MACRO-ECONOMETRIC MODEL OF THE MALTESE ECONOMY

During 2012 the Central Bank of Malta's Modelling and Research Office upgraded a structural macro-econometric model of the Maltese economy to help analyse economic developments, prepare macroeconomic forecasts and evaluate the potential impact of different economic shocks. The model is just one of the tools used by the Bank to analyse and forecast economic developments. For instance, the Bank uses two satellite models to forecast changes in the Harmonised Index of Consumer Prices (HICP) in a disaggregated manner and to make fiscal projections.

The model is partly inspired by the European System of Central Banks' Multi-Country Model.[1] It is built around the neo-classical synthesis, with the economy tending towards a long-run equilibrium but also including a sluggish adjustment of wages and prices in the short run, and some real inertia in response to shocks. Economic agents are assumed to have adaptive expectations.

The structural macro-econometric model is similar to the Bank's previous model, but includes a number of modifications to reflect the structural changes the Maltese economy has experienced since EU accession and euro adoption. The growing importance of the services sector compared with the more capital-intensive manufacturing and construction sectors necessitated a revisiting of the labour demand and investment functions of the model. Recent financial developments also required a more disaggregated financial sector block and a more realistic monetary policy transmission mechanism.

The model is on a small scale, and consists of 19 behavioural equations (estimated on quarterly data from 2000 to 2011) and 130 identities. The equations are specified in error-correction form. There are 33 exogenous variables, mostly variables for trading partners, commodity prices, demographic developments and fiscal variables.

There are four blocks. The supply block is composed of a Cobb-Douglas production function and a demand for labour equation. The aggregate demand block has six behavioural equations explaining the components of real gross domestic product (GDP), including private consumption, private investment (split into dwelling and other), exports (split into tourism and other) and imports. The wage/price block includes four equations for the deflators of the major aggregate demand components of real GDP, a private wage function and a house price equation. The financial block models consumer credit and mortgage credit, with three other equations determining the pass-through of the policy interest rate to bank lending rates.

A fuller description of the model is presented in a paper found on the Central Bank of Malta website.[2] The paper also presents estimates of the impact of four simulated shocks: an increase in the policy rate, a rise in oil prices, an appreciation of the euro against the US dollar and higher world demand. The simulations indicate that the impact of monetary policy is relatively weak in Malta while that of higher foreign demand is quite strong and favourable. The exposure of the Maltese economy to shocks in oil prices and in the value of the US dollar also appears to be relatively significant.

This is meant to be an intermediate stage in the structural model's development. In the future Bank staff will be working on further refinements, such as an enhanced integration of the supply side, the inclusion of an endogenous fiscal block, a more detailed financial block and further sectorial disaggregation.

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1 For information on the Multi-Country Model, see http://www.ecb.int/home/html/researcher_mcm.en.html.

2 http://www.centralbankmalta.org/site/macroeconometric.html

5. INTERNATIONAL RELATIONS

During 2012 the Central Bank of Malta continued to carry out its obligations as a member of both the European System of Central Banks (ESCB) and the Eurosystem, working in close collaboration with the European Central Bank (ECB). Close relations between the Bank and other international institutions, notably the European Commission (EC), the International Monetary Fund (IMF), the World Bank Group, and the European Bank for Reconstruction and Development (EBRD), were sustained throughout the year.

Table 5.1
EUROSYSTEM/ESCB COMMITTEES

Accounting and Monetary Income Committee (AMICO)
Banknote Committee (BANCO)
Budget Committee (BUCOM)
Committee on Controlling (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 the year the Governor continued to participate in the proceedings of the Governing Council of the ECB, which comprises the ECB's Executive Board and the Governors of the national central banks (NCB) of euro area Member States. The Council is responsible for monetary policy and decides on the implementation of tasks entrusted to the Eurosystem across the euro area. The Governor also continued to undertake duties as a member of the General Council of the ECB, which meets on a quarterly basis and mainly performs an advisory role. The Council comprises the President and Vice-President of the ECB, and the central bank Governors of all European Union (EU) Member States.

The Governing Council and the General Council are supported by a number of ESCB committees and working groups. Thus, senior officials of the Central Bank of Malta participated actively in meetings of the 17 Eurosystem/ESCB committees, while technical experts contributed to the work undertaken by the working groups and task forces supporting these committees.

In 2012 the Governor signed several agreements that regulate the operations of the ESCB. These included an agreement on the development and operation of a Common Eurosystem Pricing Hub between Eurosystem central banks; a TARGET2 Securities currency participation agreement between the Eurosystem NCBs and the Danmarks National Bank; an agreement on the exchange of information between the ECB, on behalf of NCBs, and the Croatian National Bank prior to Croatia's impending EU accession in 2013, and an agreement on the exchange of government-guaranteed bonds between Greece and Eurosystem NCBs.

During the year the Governor also attended high-level seminars organised by the ECB and other NCBs on financial integration and stability, risk control frameworks, and on European economic integration. He also participated in a seminar for central banks in the Eurosystem and in the Mediterranean, which was held in Casablanca, Morocco.

With regard to the Bank's shareholding in the ECB, following the decision taken on 13 December 2010 to increase the subscribed capital of the ECB to €10.76 billion, the Bank paid the third and final instalment of €1.05 million, bringing its paid-in capital to €6.8 million by the end of 2012, in line with the capital key.

European Systemic Risk Board

The Governor, as a member of the General Board of the European Systemic Risk Board (ESRB), participated in the four meetings of the Board that were held during 2012, while senior officials of the Bank participated in the ESRB's Advisory Technical Committee and its substructures.

During the year the ESRB continued to work on developing a sound macro-prudential policy and the necessary instruments, both at EU and national levels. The ESRB also published a risk dashboard, which provides both quantitative and qualitative indicators to assess risks and vulnerabilities in the EU financial system. The ESRB also exchanged views on the EC's proposals for a banking union, particularly in respect of macro-prudential aspects regarding the setting up of a Single Supervisory Mechanism for the euro area.

Other EU institutions

During 2012 the Governor attended two informal meetings of the Economic and Financial Affairs Council, while the Deputy Governor and other senior officials of the Bank continued to participate in meetings of the Economic and Financial Committee (EFC) and two of its sub-committees, one related to IMF matters and the other on EU government bills and bonds.

EFC discussions mainly focused on developing the appropriate policy response to challenges posed by the sovereign debt crisis in Europe. These, in turn, were largely centred on financial sector issues, including crisis management, on financial regulation and the setting up of a Single Supervisory Mechanism. The Committee also continued to play a leading role in the coordination of EU positions within the G20, the IMF, the Financial Stability Board and other relevant international fora.

Senior officials of the Bank participated in discussions in the EU on Malta's *Update of Stability Programme* prepared by the Ministry of Finance, the Economy and Investment (MFEI) for 2012-2015. In April and October, the Bank also exchanged views with the EC on projections for the Maltese economy as part of the EC's forecasting process. Later in the year, the Bank participated in discussions with EC officials on an in-depth review of the Maltese economy within the European Semester framework.

Under a technical assistance programme sponsored by the ECB, the Central Bank of Malta, together with other Eurosystem NCBs, started providing technical assistance to the National Bank of the Former Yugoslav Republic of Macedonia. The Bank's contribution is in the field of balance of payments statistics and the compilation of the international investment position.

European Bank for Reconstruction and Development

The Bank continued to monitor developments at the EBRD and collaborated with the MFEI on issues related to Malta's membership in this institution. These included decisions on Executive Board resolutions and amendments to the EBRD's statute. The membership of Kosovo and the establishment of recipient country status for Jordan, Morocco and Tunisia were important developments during the year.

The EBRD constituency led by Austria, which includes Malta, Bosnia Herzegovina, Cyprus, Kazakhstan and Israel, held its annual meeting in Malta in February to discuss current developments in the EBRD ahead of its annual meeting. In May the Deputy Governor represented Malta at the EBRD's annual meeting held in London.

International Monetary Fund

The Governor, in his position as Governor for Malta on the Board of Governors of the IMF, voted on a number of resolutions proposed by the Fund's Executive Board in consultation with the MFEI. During the year the Fund appealed to members to allocate their share of windfall profits from IMF gold sales to the Poverty Reduction and Growth Trust in order to augment its resources. Such funds will be made available to Low Income Countries. Thus, in April Malta transferred its share of profits amounting to SDR0.3 million, while in December it transferred a further SDR0.75 million.[1]

The IMF Resolution concerning the 14th General Review of Quotas had not yet come into effect at the end of 2012. As a result, Malta's quota in the IMF in 2012 remained unchanged at SDR102 million. The increase in quotas is expected to come into effect only after the relevant proposed amendments to the IMF's Articles

[1] On 28 December 2012, 1 SDR was equivalent to €1.16583.

of Agreement concerning the reform of its Executive Board are ratified. Under the quota review resolution, Malta's quota share will increase by SDR66.3 million to SDR168.3 million.

In January 2012, IMF staff visited Malta in connection with the 2012 Article IV consultation with Malta. The IMF mission held a number of meetings with senior officials of the Central Bank of Malta, the Government, the Malta Financial Services Authority and with a number of public and private sector organisations. On 23 January the IMF released a concluding statement of its mission to Malta and on 7 May it published a detailed report on the findings of the Article IV consultation held in January.

During 2012 Malta's allocation of SDRs, which is computed in proportion to its quota share, remained unchanged at SDR95.4 million, though the Bank's holdings increased marginally from SDR90.7 million at the end of December 2011 to SDR91.0 million a year later. This reflected purchases under the Bank's two-way voluntary arrangement with the Fund. Transactions under such an arrangement are subject to limits such that Malta's SDR holdings are no less than 65%, but no more than 117%, of its net cumulative allocations.

The Bank also continued to carry out transactions related to the IMF's operational budget. The amount of new loans extended by the Bank continued to exceed repayments. As a result, Malta's reserve tranche rose from SDR31.7 million to SDR33.2 million, while the Fund's holdings of the national currency with the Bank decreased from SDR70.3 million to SDR68.8 million by the end of the year.

During 2012 the Bank's loan commitment to the IMF up to €120 million remained in effect and was extended for another year to January 2014. By the end of 2012 the Fund had withdrawn a total of €18.0 million (amounting to about SDR15.7 million) under this bilateral loan agreement.

The Bank concluded a second bilateral loan agreement with the Fund during 2012. Thus, under the agreement the Bank is obliged to provide loans up to an equivalent of €260 million. The Fund may extend the term of the agreement for additional one-year periods, up to a maximum of four years. The maximum period allowable for the repayment of loans under this agreement has been set at ten years. The agreement was signed in early 2013.

World Bank Group

The Bank assists the MFEI in monitoring developments in the World Bank Group, providing advice on resolutions proposed by the Group. In particular, during 2012 the Bank supported World Bank representatives during their visit to Malta to include Malta for the first time in the World Bank's *Doing Business 2013 Report*.

Other matters

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.

While Malta is not a member of the Bank for International Settlements (BIS), the Bank continued to monitor developments related to initiatives endorsed by the BIS and the Financial Stability Institute, which is a joint institution of the BIS and the Basel Committee on Banking Supervision.

ECONOMIC AND FINANCIAL POLICY CALENDAR 2012

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

Monetary policy measures of the Eurosystem

5 July: The Governing Council of the European Central Bank (ECB) decided to lower key interest rates by 25 basis points, bringing the rate on the main refinancing operations to a new historical low of 0.75%. The interest rates on the marginal lending facility and the deposit facility were lowered to 1.50% and 0.00%, respectively.

6 September: The Governing Council of the ECB decided on a number of technical features regarding the Eurosystem's outright transactions in secondary sovereign bond markets. These transactions, which are known as "Outright Monetary Transactions" (OMT), aim at safeguarding monetary policy transmission and the unity of monetary policy in the euro area. Through OMTs, the ECB will purchase government-issued bonds that mature in the one to three-year range, provided the bond-issuing countries agree to certain domestic economic measures, known as "conditionality". The ECB will only conduct OMTs if warranted from a monetary policy perspective, and as long as programme conditionality by the countries concerned is fully respected. OMTs aim to increase investor confidence in the integrity of the euro area, which will bring long-term bond yields down.

European Systemic Risk Board

16 January: The European Systemic Risk Board (ESRB) published a recommendation addressed to national supervisory authorities of European Union (EU) Member States concerning US dollar-denominated funding of banks. It also published a set of recommendations addressed to EU Member States on the macro-prudential mandate of national authorities.

2 April: The ESRB published a letter aimed at helping EU legislators to further develop the legal basis for policies to address future threats to financial stability in the EU. The ESRB stated its support for the establishment of a set of commonly defined prudential rules on the supervision of banks within the EU. At the same time, the ESRB considered it essential, from a macro-prudential perspective, that these rules could be tightened temporarily if needed. The ESRB identified three principles to underpin this macro-prudential framework: flexibility to undertake a broad range of actions; scope to act early and effectively; and efficient coordination of actions by Member States.

Institutional developments regarding financial stability in Europe

2 February: The Treaty establishing the European Stability Mechanism (ESM) was signed by euro area Member States. The ESM would be an international financial institution based in Luxembourg, providing financial assistance to euro area Member States experiencing, or being threatened by, severe financing problems. This would safeguard financial stability in the euro area as a whole. With a subscribed capital of €700 billion, the initial maximum lending capacity of the ESM was set at €500 billion. Malta's share of the subscribed capital of the ESM was set at €511.7 million.

21 February: The ECOFIN Council agreed on a general approach for two draft regulations to further improve economic governance in the euro area. These provide for enhanced monitoring of euro area

countries' budgetary policies and for strengthened surveillance of euro area Member States that encounter financial disturbance or request financial assistance. The Council also adopted a regulation harmonising rules for short selling and credit default swaps.

2 March: The Treaty on Stability, Coordination and Governance, also known as the "fiscal compact" in the Economic and Monetary Union was signed by the Heads of State or Government of 25 EU countries. It has three objectives: strengthening budgetary rules, fostering economic policy coordination and convergence, and improving the governance of the euro area. On the fiscal front, Member States committed themselves to introduce a balanced budget rule in national law.

15 May: The Economic and Financial Affairs (ECOFIN) Council reached agreement on a general approach to the so-called "CRD 4" package, amending EU rules on capital requirements for banks and investment firms. The proposals aim at amending and replacing existing bank capital rules and prudential requirements. They also aim at transposing into EU law an international agreement, the Basel 3 agreement, approved by the G20 in November 2010.

28 and 29 June: During a European Council meeting, the Heads of State or Government noted that when an effective single supervisory mechanism involving the ECB was established for banks in the euro area, the ESM could directly recapitalise banks. This would depend on appropriate conditionality, including compliance with state-aid rules, and would be formalised in a Memorandum of Understanding.

12 September: The European Commission announced proposals for a single supervisory mechanism for banks in the euro area. In the new mechanism, ultimate responsibility for specific supervisory tasks related to financial stability of all euro area banks will lie with the ECB. National supervisors will continue to play an important role in day-to-day supervision and in preparing and implementing ECB decisions.

Fiscal policy

Malta's Stability Programme for 2012-2015

30 May: The European Commission published its recommendation for a Council recommendation on Malta's 2012 national reform programme and for a Council opinion on Malta's stability programme for 2012-2015. The recommendation was sent to the European Council.

6 July: The Council recommended that Malta take action in 2012 and 2013 to reinforce its budgetary strategy with additional permanent measures to ensure adequate progress towards the medium-term budgetary objective. The Council also made other recommendations regarding the long-term sustainability of the pension system, skill mismatches in the labour market, and the reform of the system of wage bargaining and wage indexation. It also drew attention to the promotion of energy efficiency and the strengthening of the banking sector.

Air Malta restructuring

27 June: The European Commission approved the granting of aid amounting to €130 million to the national airline, Air Malta. It noted that the restructuring plan adequately addressed the financial problems at Air Malta through a significant reduction in capacity and the sale of assets. The restructuring plan, which runs up to November 2015, is expected to ensure that the airline becomes viable within a reasonable time.

Budget estimates for 2013

28 November: The Minister of Finance, the Economy and Investment presented the Budget Estimates for 2013. The Budget aimed at a general government deficit equivalent to 1.7% of gross domestic product (GDP) in 2013, while the general government debt-to-GDP ratio was set to decline to 70.4%. On 10 December the House of Representatives voted against these Estimates, leading to the dissolution of Parliament.

Closure of Excessive Deficit Procedure for Malta

4 December: The ECOFIN Council closed the Excessive Deficit Procedure (EDP) for Malta, confirming that Malta's deficit-to-GDP ratio had fallen below the 3% reference value by the 2011 deadline.

Issue of Malta Government Stocks

24 January: The Government, through Legal Notice 37 of 2012, announced the issue of €150 million worth of Malta Government Stock (MGS). The issue was divided into the 4.25% MGS 2017(III) Fungible Issue, the 4.3% MGS 2022(II), and the 5.2% MGS 2031(I) Fungible Issue.

5 June: The Government, through Legal Notice 201 of 2012, announced the issue of €120 million worth of MGS. The issue consisted of the 3.75% MGS 2017 (IV), the 4.3% MGS 2022 (II) Fungible Issue, and the 5.1% MGS 2029 (I).

17 August: The Government, through Legal Notice 273 of 2012, announced the issue of €50 million worth of floating rate bonds. The issue consisted of a Floating Rate MGS 2017 (V) and a Floating Rate MGS 2018 (IV), both linked to the six-month EURIBOR.

21 August: The Government, through Legal Notice 275 of 2012, announced the issue of €1.3 million worth of 7% MGS 2022 (III) under the Local Loans (Registered Stock and Securities) Ordinance (Cap. 161), which was issued directly to the Foundation for Church Schools.

19 October: The Government, through Legal Notice 352 of 2012, announced the issue of €100 million worth of MGS. The issue was divided into the 3.75% MGS 2017 (IV) Fungible Issue, the 4.30% MGS 2022 (II) Fungible Issue, and the 4.80% MGS 2028 (I).

Conversion of Stock

4 December: The Government, through Legal Notice 428 of 2012, announced the second stage of the three-year MGS Switch Auction Programme, aimed at lengthening and smoothing the interest and redemption profile of existing debt. The switch allows the conversion of part of the 3.6% MGS 2013 (IV) stock into the 3.75% MGS 2017 (IV) Fungible Issue, the 3.85% MGS 2018 (V), or a combination of the two.

Double taxation relief agreements

20 January: Legal Notice 14 of 2012 amended the double taxation relief agreement with Poland.

6 March: Legal Notice 82 of 2012 afforded relief from double taxation in relation to income tax payable in the Kingdom of Bahrain and income tax payable in Malta.

28 September: Legal Notice 321 of 2012 afforded relief from double taxation on tax on profits, salaries, and property imposed by the Hong Kong Special Administrative Region of the People's Republic of China and from income tax in Malta.

28 September: Legal Notice 322 of 2012 afforded relief from double taxation on federal, cantonal, and communal taxes on income in the Swiss Confederation and, in Malta's case, on income tax.

Financial sector

New banks licensed

12 September: Ferratum Bank (Malta) Limited was granted a licence as a credit institution by the Malta Financial Services Authority (MFSA). The bank is a subsidiary of the Ferratum Group, which is a company based in Finland.

30 October: AgriBank plc was granted a licence as a credit institution by the MFSA. The bank is a Malta-based lender targeting agricultural businesses in the United Kingdom.

Legislation related to banking and finance

Acts

30 March: Act No. III of 2012 was enacted to amend the Government Borrowing and Granting of Loans to the Hellenic Republic Act (Cap. 502). Its objective was to cater for the agreement entered into on 27 February 2012 in Brussels, amending the previous agreement of 14 June 2011. The amendments included an extension of the term to maturity of the loan and a reduction in the interest rates charged.

8 May: Act No. IV of 2012 was enacted to amend the Malta Council for Economic and Social Development Act to implement changes to the composition of the Council. These mainly related to the establishment of the Civil Society Committee and the Gozo Regional Committee.

14 May: Act No. V of 2012 was enacted enabling the Government to implement Budget measures for the financial year 2012 to authorise the issue of additional government debt and to bring into force other administrative measures.

10 July: Act No. XII of 2012, entitled the Participation and Granting of Financial Stability Support under the European Stability Mechanism Act, 2012, was enacted. The Act authorised the participation of Malta within the ESM and the possibility to grant financial stability support through financial instruments or by entering into financial or other agreements or arrangements with members of the ESM, financial institutions, or other third parties.

Legal Notices

16 March: Legal Notice 95 of 2012, titled European Union Directives (Amendment) Regulations, 2012, implemented EU Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries situated in different Member States in relation to the Income Tax Acts.

17 April: Legal Notice 119 of 2012, titled the Companies Act (Recognised Incorporated Cell Companies) Regulations, 2012, included provisions for the constitution of a recognised incorporated cell company and incorporated cells.

22 May: Legal Notice 159 of 2012, titled Depositor Compensation Scheme (Amendment) Regulations, 2012, aimed to enhance the coverage level of the Depositor Compensation Scheme. It prescribed higher percentage rates that banks had to apply in determining their contributions to the Scheme and gave banks more flexibility with regard to the pledging of assets in favour of the Scheme.

25 May: Legal Notice 172 of 2012, titled Investment Services Act (Financial Capital Adequacy Consolidation) (Amendment) Regulations, 2012, aimed to implement paragraph 10 of Article 1 of Directive 2010/76/EU, which amended capital requirements for investment firms as well as their remuneration policies.

25 May: Legal Notice 174 of 2012, titled European Passport Rights for Investment Firms (Amendment) Regulations, 2012, aimed to transpose Article 6(27)(a) and (b) of Directive 2010/78/EU, which cater for the establishment of the European Securities and Markets Authority (ESMA) in the context of precautionary measures that the competent authority in Malta could take with respect to investment firms.

5 June: Legal Notice 202 of 2012, titled Prevention of Money Laundering and Funding of Terrorism (Amendment) Regulations, 2012, extended the definition of relevant financial business to include long-term insurance business, while the definition of supervisory authority would include the Quality Assurance Oversight Committee appointed by the Accountancy Board under the Accountancy Profession Act.

22 June: Legal Notice 214 of 2012, titled Companies Act (Investment Companies with Variable Share Capital) (Amendment) Regulations, 2012, included within the ambit of these Regulations undertakings for collective investment in transferable securities (UCITS) set up in terms of the Directive 2009/65/EC.

28 August: Legal Notice 278 of 2012, titled Banking Act (Capital Adequacy) (Amendment) Regulations, 2012, implemented paragraphs (4) and (5) of Article 10 of Directive 2010/78/EU, which amended several directives in respect of powers of the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority, and the ESMA. It introduced several changes into national law, including cooperation on capital adequacy matters and the provision of all information necessary from the MFSA to the EBA.

9 October: Legal Notice 335 of 2012 amended the Investment Services Act (UCITS Management Company Passport) Regulations. The Regulations changed the definition of a branch and required the home competent authority to notify the European counterpart of any difficulties identified at the level of the Maltese UCITS managed by a European management company, which might materially affect the ability of the latter company to perform its duties properly or to comply with the requirements of these regulations.

9 October: Legal Notice 337 of 2012, titled Companies Act (Amendment of Second Schedule) (No 2) Regulations, 2012, and Legal Notice 338 of 2012, titled European Union Act (Amendment of the Companies Act) Order, 2012, referred to the prospectus to be published when securities were offered to the public or admitted to trading, and to the harmonisation of transparency requirements in relation to information about issuers whose securities were admitted to trading on a regulated market.

12 October: Legal Notice 344 of 2012, titled Financial Markets Act (Short Selling) Regulations, 2012, implemented the relevant provisions of the EU Regulation on short selling and on certain aspects of credit default. These regulations included provisions establishing the MFSA as the competent authority to implement and exercise all the functions, obligations and powers imposed by the EU Regulation.

6 November: Legal Notice 380 of 2012, titled Designated Financial Instruments Regulations, 2012, defined the categories or classes of financial instruments to be considered "designated financial instruments" for the purposes of Part IV of the Financial Markets Act (Cap. 345).

Malta Membership of the EBRD Act

14 February: As a member of the European Bank for Reconstruction and Development (EBRD), Malta approved the amendment to the EBRD's Articles of Agreement to enable the bank to extend its operations to countries of the Southern and Eastern Mediterranean. This was done through Legal Notice 68 of 2012, entitled Malta Membership of the EBRD Act (Amendment of Schedule) Regulations 2012.

International ratings

13 January: Standard & Poor's lowered the credit ratings of nine euro area Member States, including Malta, in the context of the sovereign debt crisis. Malta's long-term rating was lowered by one notch to A-, while its short-term rating was reduced to A-2. The outlook was revised to negative.

13 February: Moody's Investors Service downgraded Malta's government bond rating to A3 from A2. The outlook remained negative.

4 September: Moody's Investors Service affirmed Malta's A3 government bond rating. The outlook remained negative. In addition, Moody's also affirmed the foreign and local currency debt ratings of Malta Freeport Corporation Limited at A3, given its government-guaranteed entity status.

25 September: Fitch Ratings affirmed Malta's long-term foreign and local currency issuer default ratings at A+. The outlook was stable.

11 December: Fitch Ratings affirmed Malta's rating at A+ with a stable outlook.

PART III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2012

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 2012.

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 2012, 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 2012 are set out on pages A-6 to A-42 and disclose an operating profit of €66.8 million (2011: €52.5 million). The amount payable to the Government of Malta is €52.0 million (2011: €42.0 million).

Board of Directors

The members of the Board of Directors during the year ended 31 December 2012 and up to the date of authorisation for issue of the financial statements were:

Professor Josef Bonnici – Governor
Mr Alfred DeMarco – Deputy Governor
Mr Victor Busuttil
Ms Antoinette Caruana
Ms Philomena Meli (appointed on 23 Jan 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

28 March 2013

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 2012 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-42, which comprise the balance sheet as at 31 December 2012, 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 and by Guideline ECB/2012/29 of 10 December 2012 ("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 is 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 2012 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

28 March 2013

Balance sheet as at 31 December 2012

	Assets	2012 €'000	2011 €'000
A 1	**Gold and gold receivables**	**13,402**	**10,347**
A 2	**Claims on non-euro area residents denominated in foreign currency**	**512,064**	**386,988**
A 2.1	Receivables from the IMF	161,909	161,973
A 2.2	Balances with banks and security investments, external loans and other external assets	350,155	225,015
A 3	**Claims on euro area residents denominated in foreign currency**	**224,156**	**276,681**
A 4	**Claims on non-euro area residents denominated in euro**	**382,689**	**182,251**
A 4.1	Balances with banks, security investments and loans	382,689	182,251
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**	**378,150**	**498,210**
A 5.1	Main refinancing operations	-	141,000
A 5.2	Longer-term refinancing operations	378,150	357,210
A 5.3	Fine-tuning reverse operations	-	-
A 5.4	Structural reverse operations	-	-
A 5.5	Marginal lending facility	-	-
A 5.6	Credits related to margin calls	-	-
A 6	**Other claims on euro area credit institutions denominated in euro**	**405**	**15,207**
A 7	**Securities of euro area residents denominated in euro**	**1,304,549**	**1,367,673**
A 7.1	Securities held for monetary policy purposes	128,015	164,891
A 7.2	Other securities	1,176,534	1,202,782
A 8	**General government debt denominated in euro**	**-**	**-**
A 9	**Intra-Eurosystem claims**	**51,457**	**50,404**
A 9.1	Participating interest in ECB	15,050	13,997
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**	**6,281**	**14,314**
A 11	**Other assets**	**729,930**	**755,538**
A 11.1	Coins of euro area	328	99
A 11.2	Tangible and intangible fixed assets	20,699	19,919
A 11.3	Other financial assets	555,844	596,591
A 11.4	Off-balance sheet instruments revaluation differences	7,316	167
A 11.5	Accruals and prepaid expenses	48,352	45,873
A 11.6	Sundry	97,391	92,889
Total Assets		**3,603,083**	**3,557,613**

* Only an ECB balance sheet item

	Liabilities	2012 €'000	2011 €'000
L 1	**Banknotes in circulation**	**757,451**	**737,561**
L 2	**Liabilities to euro area credit institutions related to monetary policy operations denominated in euro**	**1,474,004**	**1,101,141**
L 2.1	Current accounts (covering the minimum reserve system)	252,574	431,571
L 2.2	Deposit facility	621,430	668,644
L 2.3	Fixed-term deposits	600,000	-
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**	**297,027**	**438,553**
L 5.1	General government	247,294	420,756
L 5.2	Other liabilities	49,733	17,797
L 6	**Liabilities to non-euro area residents denominated in euro**	**84,840**	**86,530**
L 7	**Liabilities to euro area residents denominated in foreign currency**	**151,639**	**122,511**
L 8	**Liabilities to non-euro area residents denominated in foreign currency**	**2**	**-**
L 8.1	Deposits, balances and other liabilities	2	-
L 8.2	Liabilities arising from the credit facility under ERM II	-	-
L 9	**Counterpart of special drawing rights allocated by the IMF**	**111,210**	**113,213**
L 10	**Intra-Eurosystem liabilities**	**290,655**	**557,872**
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	90,692	130,049
L 10.4	Other liabilities within the Eurosystem (net)	199,963	427,823
L 11	**Items in course of settlement**	**-**	**-**
L 12	**Other liabilities**	**53,578**	**61,148**
L 12.1	Off-balance sheet instruments revaluation differences	-	-
L 12.2	Accruals and income collected in advance	40,062	45,559
L 12.3	Sundry	13,516	15,589
L 13	**Provisions**	**11,677**	**847**
L 14	**Revaluation accounts**	**17,756**	**14,430**
L 15	**Capital and reserves**	**301,244**	**281,807**
L 15.1	Capital	20,000	20,000
L 15.2	Reserves	281,244	261,807
L 16	**Profit for the year**	**52,000**	**42,000**
Total Liabilities		**3,603,083**	**3,557,613**

* Only an ECB balance sheet item

Profit and Loss account for the year ended 31 December 2012

		2012 €'000	2011 €'000
1.1	Interest income	86,093	92,203
1.2	Interest expense	(11,291)	(23,524)
1	**Net interest income**	**74,802**	**68,679**
2.1	Realised gains / (losses) arising from financial operations	16,289	7,474
2.2	Write-downs on financial assets and positions	(4,095)	(8,386)
2.3	Transfer (to) / from provisions for foreign exchange rate, interest rate, credit and gold price risks	(11,400)	-
2	**Net result of financial operations, write-downs and risk provisions**	**794**	**(912)**
3.1	Fees and commissions income	95	95
3.2	Fees and commissions expense	(622)	(588)
3	**Net income / (expense) from fees and commissions**	**(527)**	**(493)**
4	**Income from equity shares and participating interests**	**588**	**744**
5	**Net result of pooling of monetary income**	**1,353**	**(4,826)**
6	**Other income**	**4,852**	**3,982**
	Total net income	**81,862**	**67,174**
7	**Staff costs**	**(9,605)**	**(9,423)**
8	**Administrative expenses**	**(4,863)**	**(4,449)**
9	**Depreciation of tangible and intangible fixed assets**	**(562)**	**(639)**
10	**Banknote production services**	**-**	**(196)**
11	**Other expenses**	**(5)**	**(3)**
	Profit for the year	**66,827**	**52,464**
	Transfer to reserves for risks and contingencies	**(14,827)**	**(10,464)**
	Payable to the Government of Malta in terms of article 22(2) of the Central Bank of Malta Act (Cap. 204)	**52,000**	**42,000**

The financial statements on pages A-6 to A-42 were approved for issue by the Board of Directors on 28 March 2013 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 2012

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 Bank is required under article 21(5) of the Central Bank of Malta Act (Cap. 204) (the Act) to prepare its financial statements in accordance with the provisions established by the Governing Council of the European Central Bank (ECB) under Article 26.4 of the Statute of the European System of Central Banks and of the European Central Bank (the Statute). These provisions are outlined in the Guideline ECB/2010/20 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 2012 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.

[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 and by Guideline ECB/2012/29 of 10 December 2012 OJ L356, 22.12.2012. p.94.

(c) Recording of transactions

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

All 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 SDRs, 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. 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

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) which are valued at amortised cost subject to a Eurosystem impairment framework and Outright Monetary Transactions (OMTs) which will be valued at market prices.

(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 2012, mid-market prices at 31 December 2012 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, Special Drawing Rights (SDR) and other claims 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 the last working day of the year. 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) 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

Demonetised Maltese lira currency notes shall, until ten years following the expiration of the period mentioned in the notice of demonetisation, be redeemable by the Bank on demand for euro at the conversion rate of the Maltese lira for the euro of 0.4293 as established by Council Regulation (EC) No 1134/2007 of 10 July 2007 and without charge.

In accordance with article 62 (3) of the Central Bank of Malta Act (Cap. 204), after the expiration of one year following the end of the period established in the notice, any unpresented demonetised Maltese lira currency notes cease to be included in the Bank’s currency liabilities. The value of such notes, after deducting therefrom the value of any notes which are subsequently redeemed, shall be apportioned to the profits of the Bank over the remaining period until the expiration of the ten-year period.

(m) Tangible and intangible fixed assets

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 by the Bank in accordance with Guideline ECB/2010/20 as amended by Guideline ECB/2012/29.[3] Taking into due consideration the nature of its activities, the Bank may establish a provision for foreign exchange rate, interest rate, credit and gold price risks and for other purposes on its balance sheet. The Bank shall decide on the size and use of the provision on the basis of a reasoned estimate of its risk exposure.

(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 2012 was 0.0632% (2011: 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. The Bank's share during the financial year ended 31 December 2012 was 0.0903% (2011: 0.0903%).

5 Change to the capital key

In 2011 and 2012 there were no changes to the capital key. On 1 July 2013, a change of the ECB's capital key will occur as a result of the accession of Croatia.

6 Banknotes in circulation

The ECB and the seventeen participating NCBs, which together comprise the Eurosystem, issue euro banknotes.[4] The total value of euro banknotes in circulation is allocated to the Eurosystem central banks on the last working day of each month in accordance with the banknote allocation key.[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 (2011: 0.0830%) 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

[3] Guideline of the ECB of 10 December 2012 amending Guideline ECB/2010/20 on the legal framework for accounting and financial reporting in the ESCB (2012/833/EU) OJ L356/94 22.12.2012.

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

[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.

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 ECB profit distribution

The Governing Council of the ECB has decided that the seigniorage income of the ECB, which arises from the 8% share of euro banknotes allocated to the ECB, and the ECB's income arising from the SMP and OMT shall be due in full to the NCBs in the same financial year it accrues. Unless otherwise decided by the Governing Council, the ECB shall distribute this income in January of the following year in the form of an interim distribution of profit.[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. In general, before the end of the year, the Governing Council decides whether all or part of the ECB's income arising from SMP securities and OMTs, 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 OMTs 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-ESCB balances

Intra-Eurosystem balances result from cross-border payments in the EU that are settled in central bank money in euro. These transactions are for the most part initiated by private entities. They are primarily settled in the Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET2) and give rise to bilateral balances in the TARGET2 accounts of EU central banks. These bilateral balances are netted out and then assigned to the ECB on a daily basis, leaving each NCB with a single net bilateral position vis-à-vis the ECB only. Intra-Eurosystem balances of the Bank vis-à-vis the ECB arising from TARGET2, as well as other intra-Eurosystem balances denominated in euro (e.g. interim profit distributions to NCBs and

[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.

monetary income results), are presented on the balance sheet as a single net asset or liability position and disclosed under A9.5 ‘Other claims within the Eurosystem (net)’ or L10.4 ‘Other liabilities within the Eurosystem (net)’. Intra-ESCB balances versus non-euro area NCBs not arising from TARGET2 are disclosed either under A4 ‘Claims on non-euro area residents denominated in euro’ or L6 ‘Liabilities to non-euro area residents denominated in euro’.

Intra-Eurosystem claims arising from the Bank’s participating interest in the ECB are reported under A9.1 ‘Participating interest in ECB’.

Intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are reported as a single net claim or liability under A9.5 or L10.4 as appropriate, see ‘Banknotes in circulation’ in note 6 above.

Intra-Eurosystem balances arising from the transfer of foreign reserve assets to the ECB by NCBs joining the Eurosystem are denominated in euro and reported under A9.2 ‘Claims equivalent to the transfer of foreign reserves’.

Notes to the balance sheet

Assets

A 1 Gold and gold receivables

The Bank's gold balances consist of correspondent accounts with foreign banks, holdings with counterparties and numismatic coins. On 31 December 2012, gold was revalued at €1,261.179 (2011: €1,216.864) per fine ounce. The resultant unrealised valuation gains of €519,859 (2011: €993,288) are disclosed under liability item L14 'Revaluation accounts'.

	€'000	Fine troy ounces
Balance as at 31 December 2011	10,347	8,503
Net transactions during the year	3,528	2,123
Decrease in revaluation on 31 December 2012	(473)	
Balance as at 31 December 2012	**13,402**	**10,626**

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:

	2012	2011	Change
	€'000	€'000	€'000
US dollar	**303,262**	205,134	98,128
Great Britain pound	**42,586**	1,266	41,320
Special Drawing Rights	**161,909**	161,973	(64)
Other	**4,307**	18,615	(14,308)
Total	**512,064**	386,988	125,076

A 2.1 Receivables from the IMF

	2012	2011	Change
	€'000	€'000	€'000
Reserve Tranche Position	**38,647**	37,612	1,035
SDR holdings	**106,126**	107,629	(1,503)
IMF Borrowing Agreement	**17,136**	16,732	404
Total	**161,909**	161,973	(64)

(a) IMF quota

Malta's membership subscription to the IMF amounts to SDR102 million (2011: SDR102 million). The Bank's financial position relating to this subscription at 31 December 2012 is reflected in the balance sheet as follows:

(i) Reserve Tranche Position included in the above table is equivalent to SDR33,153,437 (2011: SDR31,694,400). 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 SDR1,459,037 due to net purchases under the IMF Financial Transaction Plan less administrative expenditure.

(ii) Currency Subscription included within asset sub-item A11.6 'Sundry assets' is stated at €80,229,715 (2011: €83,420,465) 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 €80,229,715 or SDR68,846,563 (2011: €83,420,465 or SDR70,305,600).

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. As of 14 December 2012, 145 members having 77.1 per cent of Fund quotas have consented to their proposed quota increases under the 14th General Review of Quotas, thus exceeding the required threshold. However, until the required number of acceptances to the reforms to the IMF Executive Board is achieved, the proposed quota increase will not become effective.

Malta's quota will increase by SDR66.3million 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 the 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. During 2012, there were no sales under this agreement (2011: SDR5,300,000). However, an early repayment of SDR300,000 was received from the outstanding drawings under the Bilateral Borrowing Agreement. Malta's SDR holdings as at end of 2012, including interest received thereon, stood at SDR91,040,916 (2011: SDR90,695,608).

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 €120,000,000 as part of a commitment made by the EU in 2009 to support the IMF's lending capacity. The total term of this interest-bearing agreement shall not exceed four years. As at 31 December 2012, the amount utilised under this facility stood at €17,135,783 (SDR14,700,000).

In January 2013, the IMF and the Bank signed a new bilateral borrowing agreement whereby the Bank has agreed to lend to the Fund an SDR denominated amount up to €260,000,000. The total term of this interest bearing agreement will not exceed four years.

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.

	2012	2011	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**218,015**	177,578	40,437
Held-to-maturity debt securities	**50,434**	-	50,434
Fixed-term deposits with banks	**41,662**	38,624	3,038
Current accounts and overnight deposits with banks	**39,381**	8,094	31,287
Other	**663**	719	(56)
Total	**350,155**	225,015	125,140

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:

	2012	2011	Change
	€'000	€'000	€'000
US dollar	**211,493**	234,265	(22,772)
Great Britain pound	**6,763**	42,416	(35,653)
Other	**5,900**	-	5,900
Total	**224,156**	276,681	(52,525)

This item also includes a claim arising from reverse operations with Eurosystem counterparties amounting to €75,792,027 (2011: nil) in connection with the regular US dollar liquidity-providing operations with maturities of approximately one week and three months. The US dollars are provided by the Federal Reserve to the ECB by means of a temporary swap line with the aim of offering US dollar liquidity to euro area counterparties. The ECB simultaneously enters into back-to-back swap transactions with euro area NCBs, which use these funds to conduct liquidity-providing operations with Eurosystem counterparties. These take the form of repurchase transactions against eligible collateral and carried out as fixed rate tender procedures with full allotment.

During 2012, the aggregate US dollar liquidity-providing operations with the Bank amounted to USD783,000,000 (2011: nil) consisting of USD412,000,000 and USD371,000,000 in the three-month and one-week tenor respectively. Outstanding amount of USD liquidity providing operations at the end of the year amounted to USD100,000,000 (2011: nil).

	2012	2011	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**98,537**	100,224	(1,687)
Fixed-term deposits with banks	**49,777**	176,393	(126,616)
Current accounts and overnight deposits with banks	**50**	64	(14)
US dollar liquidity-providing operations	**75,792**	-	75,792
Total	**224,156**	276,681	(52,525)

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.

	2012	2011	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**167,491**	106,443	61,048
Held-to-maturity debt securities	**214,399**	75,535	138,864
Current accounts and overnight deposits	**799**	273	526
Total	**382,689**	182,251	200,438

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 €1,126,019 million (2011: €863,568 million) of which the Bank holds €378,150,000, (2011: €498,210,000). 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.

Losses can only materialise if both the counterparty fails and the recovery of funds received from the resolution of the collateral provided by the counterparty is not sufficient. It should be noted that for specific collateral which can be accepted by NCBs at their own discretion, risk sharing has been excluded by the Governing Council of the ECB.

A 5.1 Main refinancing operations

Main refinancing operations (MROs) are regular liquidity-providing reverse transactions carried out by the Eurosystem NCBs with a weekly frequency and generally a maturity of one week, normally by means of standard tenders. Since October 2008, these operations were conducted as fixed rate tender procedures. These operations play a key role in achieving the aims of steering interest rate, managing market liquidity and signalling the monetary policy stance.

All counterparties that fulfil the general eligibility criteria may submit bids within a specified timeframe. Participation in MROs requires the availability of eligible collateral.

During 2012, 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 €6,185,000,000 (2011: €16,519,800,000,). There were no outstanding operations at the end of the year (2011: €141,000,000).

The following table highlights the changes in the MRO rate during 2011 and 2012 as decided by the Governing Council:

With effect from:	Changes in basis points (bps)	Effective rate (%)
1 January 2011		1.00
13 April 2011	+25 bps	1.25
13 July 2011	+25 bps	1.50
09 November 2011	-25 bps	1.25
14 December 2011	-25 bps	1.00
11 July 2012	**-25 bps**	**0.75**

A 5.2 Longer-term refinancing operations

These operations aim to provide counterparties with additional longer-term refinancing. In 2012, as well as in 2011, operations were conducted with maturities equal to the reserve maintenance period and with maturities of three, six, twelve and thirty-six months. These operations were conducted at fixed rate with allotment of the total amount bid.

The aggregate LTROs carried out during 2012 amounted to €586,300,000 (2011: €2,252,810,000),[10] while outstanding LTROs at the end of the year amounted to €378,150,000 (2011: €357,210,000).

A 5.3 Fine-tuning reverse operations

Fine-tuning reverse operations aim to regulate the market liquidity situation and steer interest rates, particularly to smooth the effects on interest rates caused by unexpected market fluctuations. Owing to their nature, they are executed on an ad-hoc basis.

During 2012, the ECB conducted one liquidity-providing fine-tuning reverse operation. There was no participation by domestic counterparties in this operation (2011: €1,000,000). There were no outstanding liquidity-providing reverse operations at end of the year (2011: nil).

A 5.4 Structural reverse operations

These are reverse open-market transactions through standard tenders to enable the Eurosystem to adjust its structural liquidity position vis-à-vis the financial sector. No structural operations were conducted by the ECB during 2012 (2011: nil).

A 5.5 Marginal lending facility

Marginal lending facilities may be used by counterparties to obtain overnight liquidity from NCBs at a pre-specified interest rate against eligible assets.

During 2012, the aggregate volume of such transactions with the Bank amounted to €37,239,871 (2011: €662,000,000). There were no outstanding balances as at 31 December 2012 (2011: nil).

[10] This amount includes the move from the twelve-month to the thirty-six-month LTRO.

The following table highlights the changes in the marginal lending facility rate during 2011 and 2012 as decided by the Governing Council:

With effect from:	Changes in basis points (bps)	Effective rate (%)
1 January 2011		1.75
13 April 2011	+25 bps	2.00
13 July 2011	+25 bps	2.25
09 November 2011	-25 bps	2.00
14 December 2011	-25 bps	1.75
11 July 2012	**-25 bps**	**1.50**

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.

	2012	2011	Change
	€'000	€'000	€'000
Fixed-term deposits	**-**	15,000	(15,000)
Current accounts and overnight deposits	**405**	207	198
Total	**405**	15,207	(14,802)

A 7 Securities of euro area residents denominated in euro

This item consists of securities held for monetary policy purposes as well as other securities.

A 7.1 Securities held for monetary policy purposes

This sub item contains securities acquired by the Bank within the scope of the covered bond purchase programmes (CBPPs),[11] SMP[12] as well as OMTs.[13] The Bank decided to participate in the SMP and the OMT, however no OMTs were carried out as at balance sheet date.

Under the SMP, established in May 2010, the ECB and the NCBs were able to purchase euro area public and private debt securities in order to address the malfunctioning of certain segments of the euro area debt securities markets and to restore the proper functioning of the monetary policy transmission mechanism.

[11] 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), OJ L 297, 16.11.2011, p. 70.

[12] ECB Decision of 14 May 2010 establishing a SMP (ECB/2010/5), OJ L 124, 20.5.2010, p. 8.

[13] On 6 September 2012, the Governing Council of the ECB decided on a number of technical features regarding the Eurosystem outright transactions in secondary sovereign bond markets that aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy, which will be known as OMTs.

The total Eurosystem NCBs' holding of SMP securities amounts to €192,608 million (2011: €194,199 million), of which the Bank holds €128,014,753 (2011: €164,890,840). The net decrease of €36,876,087 was mainly due to redemptions in 2012. 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.

Part of the Bank's holdings under the SMP comprises debt securities issued by the Hellenic Republic. 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, and were not included on the list of eligible securities that were subject to restructuring in the context of the private sector involvement (PSI) initiative. Consequently, the Bank did not incur any realised losses on its holdings of Greek government bonds.

Securities purchased under the SMP are classified as held-to-maturity and are valued 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 estimated recoverable amounts as at the year-end.

In the context of the impairment test conducted as at the end of 2012 on securities purchased under the SMP, the Governing Council identified two impairment indicators in particular, relating to the holdings of Greek government bonds, which occurred in the course of 2012. The first was the restructuring in March 2012 of part of the debt issued by the Hellenic Republic in the context of the PSI initiative and the second was the debt buy-back operation carried out by the Greek government in December 2012. The Governing Council considered that the occurrence of these impairment indicators did not warrant an impairment of the SMP holdings since, on the basis of the information available as at 31 December 2012, there was no evidence of changes in the estimated future cash flows. No impairment losses were therefore recorded at the year-end on the Bank's holdings of Greek government bonds under the SMP. Furthermore, no impairment losses were recorded in respect of the other securities purchased under the SMP.

The Governing Council assesses on a regular basis the financial risks associated with the securities held under the SMP and the two covered bond purchase programmes.

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.

	2012	2011	Change
	€'000	€'000	€'000
Marketable debt securities other than those held-to-maturity	**386,077**	403,869	(17,792)
Held-to-maturity debt securities	**790,457**	798,913	(8,456)
Total	**1,176,534**	1,202,782	(26,248)

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

Pursuant to Article 28 of the Statute, the NCBs are the sole subscribers to the capital of the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the ESCB Statute and which are subject to adjustment every five years.

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 third 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 are as follows:

	Subscribed capital since 29 December 2010	Paid-up capital until 26 December 2012	Paid-up capital since 27 December 2012
Nationale Bank van België/ Banque Nationale de Belgique	261,010,385	220,583,718	261,010,385
Deutsche Bundesbank	2,037,777,027	1,722,155,361	2,037,777,027
Eesti Pank	19,261,568	16,278,234	19,261,568
Central Bank of Ireland	119,518,566	101,006,900	119,518,566
Bank of Greece	211,436,059	178,687,726	211,436,059
Banco de España	893,564,576	755,164,576	893,564,576
Banque de France	1,530,293,900	1,293,273,900	1,530,293,900
Banca d’Italia	1,344,715,688	1,136,439,021	1,344,715,688
Central Bank of Cyprus	14,731,333	12,449,666	14,731,333
Banque centrale du Luxembourg	18,798,860	15,887,193	18,798,860
Central Bank of Malta	6,800,732	5,747,399	6,800,732
De Nederlandsche Bank	429,156,339	362,686,339	429,156,339
Oesterreichische Nationalbank	208,939,588	176,577,921	208,939,588
Banco de Portugal	188,354,459	159,181,126	188,354,459
Banka Slovenije	35,381,025	29,901,025	35,381,025
Národná banka Slovenska	74,614,364	63,057,697	74,614,364
Suomen Pankki – Finlands Bank	134,927,820	114,029,487	134,927,820
Subtotal for euro area NCBs	**7,529,282,289**	**6,363,107,289**	**7,529,282,289**
Българска народна банка (Bulgarian National Bank)	93,467,027	3,505,013	3,505,013
Česká národní banka	155,728,161	5,839,806	5,839,806
Danmarks Nationalbank	159,634,278	5,986,285	5,986,285
Latvijas Banka	30,527,971	1,144,800	1,144,800
Lietuvos bankas	45,797,337	1,717,400	1,717,400
Magyar Nemzeti Bank	149,099,600	5,591,235	5,591,235
Narodowy Bank Polski	526,776,978	19,754,137	19,754,137
Banca Naţională a României	265,196,278	9,944,860	9,944,860
Sveriges Riksbank	242,997,052	9,112,389	9,112,389
Bank of England	1,562,145,431	58,580,454	58,580,454
Subtotal for non-euro area NCBs	**3,231,370,113**	**121,176,379**	**121,176,379**
Total	**10,760,652,402**	**6,484,283,668**	**7,650,458,668**

In 2012, 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 NCBs 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 2012, the Bank had no claims in this respect (2011: nil) but had a liability which is presented in liability sub-item L10.3 'Net liabilities related to the allocation of euro banknotes within the Eurosystem'.

A 9.5 Other claims within the Eurosystem (net)

As at 31 December 2012, the Bank's claims were netted off from liability sub-item L10.4 'Other liabilities within the Eurosystem (net)' (2011: nil).

A 10 Items in course of settlement

These assets comprise transactions which are not yet settled as at the end of the financial year.

A 11 Other assets

A 11.1 Coins of euro area

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

A 11.2 Tangible and intangible fixed assets

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

	Land and buildings	Computer equipment and other assets	Total
	€'000	€'000	€'000
Cost			
As at 31 December 2011	23,052	4,496	27,548
Additions	533	809	1,342
As at 31 December 2012	**23,585**	**5,305**	**28,890**
Accumulated depreciation			
As at 31 December 2011	3,839	3,790	7,629
Charge for the year	202	360	562
As at 31 December 2012	**4,041**	**4,150**	**8,191**
Net book value			
As at 31 December 2011	19,213	706	19,919
As at 31 December 2012	**19,544**	**1,155**	**20,699**

The table above includes an amount of €632,557 (2011: €248,173) 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 2012, 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.

In November 2012, the Bank's Board of Directors approved the investment by the Bank in a fixed income investment programme to be managed by external asset managers in the form of contractual funds. The investment will be recognised at net asset value on the Bank's balance sheet. The programme was first funded in January 2013.

	2012	2011	Change
	€'000	€'000	€'000
Malta Government stocks	**302,252**	341,432	(39,180)
Malta Government Treasury bills	**-**	2,472	(2,472)
Held-to-maturity debt securities	**253,592**	252,687	905
Total	**555,844**	596,591	(40,747)

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. However, as at year-end the Bank's holdings included €481,555 Floating Rate 6 Month Euribor MGS 2015 (V). 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, mainly foreign exchange swap transactions outstanding as at 31 December 2012. At year end, these unrealised gains amounted to €7,315,545 (2011: €167,016).

A 11.5 Accruals and prepaid expenses

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

	2012	2011	Change
	€'000	€'000	€'000
Accrued interest income	**48,289**	45,839	2,450
Prepaid expenditure	**63**	34	29
Total	**48,352**	45,873	2,479

Accrued interest income at 31 December 2012, includes an amount of €706,967 (2011: €1,458,078) attributable to interest on intra-Eurosystem claims.

A 11.6 Sundry

Sundry assets mainly consist of IMF Currency Subscription and an amount of €4,000,000 transferred to the Malta Government out of the profits earned in 2012 at the end of the reporting year.

	2012	2011	Change
	€'000	€'000	€'000
IMF Currency Subscription (see note A2.1)	**80,230**	83,420	(3,190)
Other	**17,161**	9,469	7,692
Total	**97,391**	92,889	4,502

Liabilities

L 1 Banknotes in circulation

This item consists of the Bank's share of the total euro banknotes in circulation (see note 6 'Banknotes in circulation' in the general notes to the financial statements).

During 2012, the total value of banknotes in circulation within the Eurosystem increased by 2.7% from €888,628 million to €912,592 million. According to the banknote allocation key, the Bank had euro banknotes in circulation worth €757,451,360 at the end of the year compared with €737,561,240 at the end of 2011.

The value of the euro banknotes actually issued by the Bank in 2012 decreased by 2.2% from €867,610,170 to €848,143,705. As this is more than the allocated amount, the difference of €90,692,345 (compared to €130,048,930 in 2011) is shown under liability sub-item L10.3 'Net liabilities related to the allocation of euro banknotes within the Eurosystem'.

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

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

	2012	2011	Change
	€'000	€'000	€'000
Current accounts (covering the minimum reserve system)	**252,574**	431,571	(178,997)
Deposit facility	**621,430**	668,644	(47,214)
Fixed term deposits	**600,000**	-	600,000
Deposits related to margin calls	**-**	926	(926)
Total	**1,474,004**	1,101,141	372,863

L 2.1 Current accounts (covering the minimum reserve system)

These accounts include deposits by the credit institutions which are utilised to meet the minimum reserve requirement and settlement of payments. The main criterion for including these deposits within this sub-item is that the respective credit institutions must appear in the list of institutions which are subject to the minimum reserve regulations of the Eurosystem. Minimum reserve requirements have to be met on average over the reserve maintenance period in accordance with the schedule published by the ECB. Since 1 January 1999, the minimum reserve balances have been remunerated at the prevailing marginal interest rate for the main refinancing operations of the Eurosystem.

L 2.2 Deposit facility

The deposit facility refers to overnight deposits placed by eligible counterparties that access the Eurosystem liquidity absorbing standing facility at pre-specified rates. During 2012, the aggregate volume of such transactions with the Bank amounted to €156,788,107,913 (2011: €81,806,263,623). The outstanding balance as at year-end amounted to €621,430,495 (2011: €668,644,312).

The following table highlights the changes in the interest rate on the overnight deposit facility during 2011 and 2012 as decided by the Governing Council of the ECB:

With effect from:	Changes in basis points (bps)	Effective rate (%)
1 January 2011		0.25
13 April 2011	+25 bps	0.50
13 July 2011	+25 bps	0.75
9 November 2011	-25 bps	0.50
14 December 2011	-25 bps	0.25
11 July 2012	**-25 bps**	**0.00**

L 2.3 Fixed-term deposits

These deposits are fine-tuning liquidity-absorbing operations for a fixed-term at variable rate tender. The ECB did not conduct fine-tuning operations at the end of the maintenance period, which generally used to be absorption operations with an overnight tenor (2011: €1,578 million).

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 €3,791,294,230 (2011: €138,214,360). The outstanding balance as at the year-end amounted to €600,000,000 (2011: nil).

L 2.4 Fine-tuning reverse operations

Fine-tuning liquidity-absorbing reverse operations are executed on an ad hoc basis with the purpose to offset high liquidity imbalances. 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 2012 (2011: nil).

L 2.5 Deposits related to margin calls

These deposits refer to cash received from counterparties in those instances where the market value of the collateral pledged has fallen below an established trigger point implying a shortfall of collateral to cover the outstanding monetary policy operations. Deposits related to margin calls were used by counterparties during 2012, on those instances where their respective pool of collateral fell below the mentioned trigger level. However, no margin calls were outstanding as at end of the year (2011: €926,000).

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.

	2012	2011	Change
	€'000	€'000	€'000
Current accounts	**146,078**	271,704	(125,626)
Sinking fund accounts	**101,216**	149,052	(47,836)
Total	**247,294**	420,756	(173,462)

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.

	2012	2011	Change
	€'000	€'000	€'000
IMF current accounts (see note A2.1)	**80,230**	83,420	(3,190)
Others	**4,610**	3,110	1,500
Total	**84,840**	86,530	(1,690)

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.

	2012	2011	Change
	€'000	€'000	€'000
Government of Malta current accounts	**81,328**	105,657	(24,329)
Government of Malta sinking fund accounts	**796**	3,745	(2,949)
Other current accounts and fixed-term deposits	**69,515**	13,109	56,406
Total	**151,639**	122,511	29,128

L 8 Liabilities to non-euro area residents denominated in foreign currency

This item includes deposits, balances and other liabilities denominated in foreign currency.

L 9 Counterpart of special drawing rights allocated by the IMF

This item represents the counterpart of special drawing rights allocated by the IMF to Malta (see note A2.1(b) ‘Receivables from the IMF’ above).

L 10 Intra-Eurosystem liabilities

This item represents the Bank’s liabilities to the ECB and to the other Eurosystem NCBs.

L 10.3 Net liabilities related to the allocation of euro banknotes within the Eurosystem

This sub-item consists of the liability of the Bank vis-à-vis the Eurosystem relating to the excess of euro banknotes issued by the Bank over and above the amount allocated to the Bank by the ECB in accordance with the banknote allocation key (see note L1 ‘Banknotes in circulation’ above). The decrease in comparison to 2011 (€39,356,585) is due to the decrease in banknotes put into circulation by the Bank in 2012 (which represents a decrease of 2.2%) as compared to the rise in banknotes in circulation in the Eurosystem as a whole (increase of 2.7% compared to 2011). The remuneration of this liability is calculated at the prevailing marginal rate for the Eurosystem MRO rate (refer to note 6 ‘Banknotes in circulation’ in the general notes to the financial statements).

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 Eurosystem MRO rate. 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 ECB profit distribution.

	2012	2011	Change
	€’000	€’000	€’000
TARGET2 balance	**201,265**	422,463	(221,198)
Net result from pooling of monetary income	**(783)**	5,949	(6,732)
ECB profit distribution	**(519)**	(589)	70
Total	**199,963**	427,823	(227,860)

With respect to 2012, the Governing Council decided that an amount of €1,166 million (2011: €1,166 million) should be retained by the ECB from the its income derived from banknotes in circulation and the SMP (see note 7 ‘ECB profit distribution’ in the general notes to the financial statements).

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 foreign exchange swap transactions outstanding as at 31 December 2012. At year-end, there were no unrealised losses (2011: 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 (see note 3(l) 'Demonetised Maltese lira currency notes' in the general notes to the financial statements).

	2012	2011	Change
	€'000	€'000	€'000
Accrued interest payable	**868**	1,109	(241)
Deferred income in respect of demonetised			
Maltese Lira currency notes	**38,636**	43,676	(5,040)
Other	**558**	774	(216)
Total	**40,062**	45,559	(5,497)

L 12.3 Sundry

Sundry liabilities include unrealised revaluation gains attributable to Malta Government stocks held as part of an earmarked portfolio amounting to €8,671,278 (2011: €5,166,436). These liabilities also comprise realised losses attributable to off-balance sheet positions, principally foreign exchange swap transactions 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.

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 occurred. In accordance with the general accounting principle of prudence, the Governing Council has decided to reduce the provision from a total amount of €949 million as at 31 December 2011 to an amount of €310 million as at 31 December 2012 to reflect the increase in the price of the collateral received by the Eurosystem and payments by the debtor. The Bank's share in this provision amounts to €276,644 (2011: €846,888).

The respective adjustments are reflected in the NCBs' profit and loss accounts. In the case of the Bank, the resulting income amounted to €570,244 (2011: €1,122,639) (see note 5 'Net result of pooling of monetary income' to the profit and loss account).

Also included under this item is a provision of €10,900,000 approved by the Board in accordance with the amendment to the Guideline which came into force on 31 December 2012 to cover interest rate and credit risks. The calculations have been carried on the Modified Duration (MD) of the marketable securities other than those held to maturity for a given neutral level of interest rate exposure applied by the Bank, assuming that the risk free yield curve will shift upwards in a parallel fashion of one basis point. The amount provided also includes the Expected Value (EV) which was calculated for a projected holding period on the Bank's whole portfolio of marketable securities categorised into rating classes on which migration rates are applied to establish the likely position each portfolio would be like in the projected period.

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.

	2012	2011	Change
	€'000	€'000	€'000
Gold	**520**	993	(473)
Foreign currency positions	**15**	329	(314)
Securities	**17,221**	13,108	4,113
Total	**17,756**	14,430	3,326

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 2011	20,000	75,505	140,466	45,836
Net issuance of euro coins				4,610
Transfer from profits for the year			14,827	
Balance as at 31 December 2012	**20,000**	**75,505**	**155,293**	**50,446**

L 15.1 Capital

In terms of article 19(1) of the Central Bank of Malta Act (Cap. 204), the Bank shall have an authorised capital of €20,000,000. This is fully paid up and is held exclusively by the Government of Malta.

L 15.2 Reserves

(a) General reserve fund

In terms of article 19(2) of the Central Bank of Malta Act (Cap. 204), the Bank shall also maintain a general reserve fund which shall be of not less than €20,000,000 and which shall be available for any purpose as may be determined by the Board of Directors. Whenever amounts are drawn from the general reserve fund, these shall be replaced as may be decided by the Board.

(b) Reserves for risks and contingencies

Reserves for risks and contingencies are maintained in terms of article 22(1) of the Central Bank of Malta Act (Cap. 204) to cover the broad range of risks to which the Bank is exposed. The major risks in this regard arise from potential movements in market values of the Bank's holdings of domestic and foreign securities and other investments, losses which could arise from support of the financial system in the Bank's role as a lender of last resort and other non-insured losses.

(c) Capital contribution

This reserve represents the capital contribution made by the Government of Malta to the Bank in respect of the agency agreement between the Bank and the Government relating to the issuance of euro coins. The Bank shall act as agent of the Government and shall retain full responsibility for procurement, storage and issuance of euro coins. This reserve represents seigniorage revenue arising from the issue of euro coins. In terms of the agency agreement, the Government has agreed not to withdraw such revenue and retain these amounts in a reserve account held at the Bank. Allocation of revenue to the reserve account shall be deemed as a capital contribution to the Bank by the Government.

Notes to the profit and loss account

1 Net interest income

This item represents the net result of interest income and interest expense.

1.1 Interest income

Interest income includes income on foreign reserve assets and euro-denominated portfolios, as well as interest income on intra-Eurosystem claims and monetary policy instruments.

	2012	2011	Change
	€'000	€'000	€'000
Marketable debt securities			
- In euro	**65,935**	58,258	7,677
- In foreign currency	**4,015**	4,124	(109)
Fixed-term deposits			
- In euro	**16**	285	(269)
- In foreign currency	**930**	1,682	(752)
Current accounts and overnight deposits			
- In euro	**-**	3	(3)
- In foreign currency	**20**	5	15
IMF	**45**	160	(115)
Monetary policy operations			
- Main refinancing operations	**1,077**	4,037	(2,960)
- Longer-term refinancing operations	**218**	130	88
- Floating rate longer-term refinancing operations	**3,792**	7,525	(3,733)
- Fine-tuning reverse operations	**-**	1	(1)
- Marginal lending facility	**2**	46	(44)
- Securities Markets Programme	**9,886**	10,630	(744)
Intra-Eurosystem claims			
- Claims arising from the transfer of foreign reserves	**277**	392	(115)
- Net claims related to the allocation of banknotes within the Eurosystem	**813**	2,454	(1,641)
- TARGET2 balances	**17**	-	17
Forward foreign exchange contracts	**(1,038)**	2,353	(3,391)
Other interest income	**88**	118	(30)
Total	**86,093**	92,203	(6,110)

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.

	2012	2011	Change
	€'000	€'000	€'000
Government accounts			
- In euro	**1,566**	2,976	(1,410)
- In foreign currency	**270**	322	(52)
Other customer accounts			
- In euro	**131**	169	(38)
- In foreign currency	**117**	27	90
Monetary policy operations			
- Minimum reserves	**2,144**	5,711	(3,567)
- Overnight deposits	**859**	2,008	(1,149)
- Fixed-term deposits	**12**	80	(68)
- Deposits related to margin calls	**10**	21	(11)
Intra-Eurosystem liabilities			
- TARGET2 balances	**6,028**	12,113	(6,085)
Other interest expense	**154**	97	57
Total	**11,291**	23,524	(12,233)

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.

	2012	2011	Change
	€'000	€'000	€'000
Net gains / (losses) on disposal of financial instruments	**15,326**	5,895	9,431
Net gains / (losses) on foreign currency positions	**963**	1,579	(616)
Total	**16,289**	7,474	8,815

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.

	2012	2011	Change
	€'000	€'000	€'000
Write-downs on debt securities	**4,045**	8,381	(4,336)
Write-downs on foreign currency positions	**50**	5	45
Total	**4,095**	8,386	(4,291)

2.3 Transfer to/from provisions for foreign exchange rate, interest rate, credit and gold price risk

This sub-item consists of movements in provisions (see note L13 'Provisions' in the notes to the balance sheet).

3 Net income / (expense) from fees and commissions

Fees and commissions receivable mainly arise from banking services provided by the Bank. Fees and commissions payable include correspondent account charges, handling fees on cheques drawn on the Bank and TARGET2 connection and participation fees.

4 Income from equity shares and participating interests

During 2012 the Bank received €68,769 (2011: €154,697) representing its relative share of the ECB's distributable remaining profits for 2011 in proportion to the Bank's subscribed capital key (see note 4 'Capital key' in the general notes to the financial statements).

In 2012 the ECB's income on the SMP and on euro banknotes in circulation amounting in total to €1,741 million was partially retained by the ECB in accordance with a decision of the Governing Council dated 10 January 2013 in order to fund the increase of €1,166 million in the ECB provision for foreign exchange rate, interest rate, credit and gold price risks to its maximum allowable level. From the balance of €575 million distributed to the NCBs, the Bank received €519,025 (2011: €588,911) 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 amounting to €163 million 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.

5 Net result of pooling of monetary income

This item contains the net result of pooling of monetary income for 2012 amounting to an income of €783,184 as against an expense of €5,948,645 in 2011; 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 €570,244 (2011: €1,122,639) (see note L13 'Provisions' in the notes to the balance sheet). The net income shown in this item amounted to €1,353,428 as against a net expenditure amounting to €4,826,006 in 2011.

The amount of each Eurosystem NCB's monetary income is determined by measuring the actual annual income that is derived from the earmarkable assets held against the liability base. The liability base consists mainly of the following items: banknotes in circulation; liabilities to credit institutions related to monetary policy operations denominated in euro; net intra-Eurosystem liabilities resulting from TARGET2 transactions; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is to be deducted from the monetary income to be pooled.

The earmarkable assets consist mainly of the following items: lending to euro area credit institutions related to monetary policy operations denominated in euro; securities held for monetary policy purposes; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET2 transactions; net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem; and a limited amount of each NCB's gold holdings in proportion to each NCB's capital key. Gold is considered to generate no income.

Where the value of an NCB's earmarkable assets exceeds or falls short of the value of the liability base, the difference shall be offset by applying to the value of the difference the latest applicable marginal rate for the Eurosystem main refinancing operations.

The monetary income pooled by the Eurosystem is allocated among NCBs in relation to the subscribed capital key. The net result arising from the calculation of monetary income is a receipt (as opposed to a payment in 2011) by the Bank which is the difference between the net monetary income pooled amounting to €20,436,935 (2011: €20,153,207) and the amount redistributed of €21,140,102 (2011: €14,168,090). An income of €80,016, being an adjustment for previous years' payments, was received (2011: €36,472).

6 Other income

Other income includes an amount of €3,000,000, relating to the balance of unredeemed Maltese lira fifth series currency notes, which as at 31 December 2012 amounted to the equivalent of €44,636,177 (2011: €46,675,865). These currency notes will still be exchangeable at the Bank until 31 January 2018. The value of unredeemed currency notes, after deducting therefrom the amount of currency notes which are expected to be redeemed until that date, is apportioned as income in the profit and loss account over the remaining period until 31 January 2018. This accounting treatment is in accordance with the provisions of article 62(3) of the Central Bank of Malta Act (Cap. 204) (see note 3(l) 'Demonetised Maltese lira currency notes' in the general notes to the financial statements). This item also includes income from numismatic issues of coins.

7 Staff costs

Staff costs include salaries and other ancillary costs.

	2012	2011	Change
	€'000	€'000	€'000
Staff salaries	**7,856**	7,773	83
Other staff costs	**902**	852	50
Training, welfare and other related expenditure	**847**	798	49
Total	**9,605**	9,423	182

The full-time equivalent average number of staff employed by the bank during the year was as follows:

	2012	2011	Change
	Number	Number	Number
Governors	**2**	2	-
Director General	**1**	1	-
Divisional Directors	**5**	4	1
Heads and executives	**97**	85	12
Supervisory and clerical staff	**164**	174	(10)
Non-clerical staff	**35**	34	1
Total	**304**	300	4

8 Administrative expenses

This item consists of operating expenditure incurred by the Bank.

	2012	2011	Change
	€'000	€'000	€'000
Market information and communication expenses	**710**	582	128
Other administrative expenditure	**4,153**	3,867	286
Total	**4,863**	4,449	414

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 €76,000 (2011: €74,000).

Compensation to the members of the Board of Directors for the financial year under review amounted to €159,807 (2011: €179,966). 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 foreign exchange swap transactions with notional amounts of €434,398,194 (2011: €376,250,000) involving the forward deals of euro against the forward purchase or sale of other currencies and SDR43,000,000 (2011: nil) in a forward deal of SDR against euro.

(b) Contingent liabilities and commitments

	2012	2011	Change
	€'000	€'000	€'000
Contingent liabilities			
Guarantees and letters of credit	**599**	2,063	(1,464)
Financial commitments			
Repayment of foreign loans on behalf of the Government	**89**	1,447	(1,358)
Total	**688**	3,510	(2,822)

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 €6,862,000. (2011: €9,200,000).

(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.

(d) Market maker in Malta Government securities and Treasury bills

The Bank acts as market maker in Malta Government securities and Treasury bills and ensures their liquidity in the secondary market by being ready to trade in such securities on the initiative of the market (see note A11.3 'Other financial assets' to the balance sheet). Income earned by the Bank from these assets amounting to €12,311,396 (2011: €11,641,456) is included in note 1.1 'Interest income' to the profit and loss account.

(e) Demonetised Maltese lira currency notes

Maltese lira currency notes were replaced by euro banknotes when Malta became part of the euro area on 1 January 2008. Consequently, Maltese lira currency notes remained legal tender until 31 January 2008 but will continue to be redeemed at the conversion rate of the Maltese lira for the euro of 0.4293 and without charge until 31 January 2018.

During 2012, demonetised Maltese lira currency notes presented for redemption amounted to €2,039,688 (2011: €3,218,435). At 31 December 2012, the value of unpresented demonetised currency notes amounted to €44,636,177 (2011: €46,675,865).

(f) Investment securities pledged as collateral

As at 31 December 2012, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of US$95,000,000 or approximately €72,000,000 (2011: USD45,000,000 or approximately €35,000,000). No amounts were borrowed under these facilities at the balance sheet dates.

(g) Assets held in custody

As at 31 December 2012, assets held in custody by the Bank in terms of the Insurance Business Act (Cap. 403) amounted to €31,455,062 (2011: €33,056,173).

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

In 2003, the Bank was appointed investment manager in respect of funds belonging to the Investor and Depositor Compensation Schemes. The Bank manages these funds on a discretionary basis in accordance with the investment parameters set by the Management Committees of the respective Schemes. As at 31 December 2012, the Investor and Depositor Compensation Schemes had deposits of €48,925 (2011: €175,007) and €694,710 (2011: €477,532) respectively, with the Bank.

(i) Statement of the Bank's investments

The statement of the Bank's investments is disclosed in accordance with the requirements of article 21(2)(b) of the Central Bank of Malta Act (Cap. 204).

The exposure country is the country of location of the institution or entity with which the Bank's placements and other financial assets are held. The exposure country in respect of assets held with branches of international banks and financial institutions is usually deemed to be the country of location of the parent. In case of subsidiaries of banks and financial institutions, the exposure country is generally determined on the basis of the location of the subsidiary undertaking.

	EUR €'000	GBP €'000	USD €'000	Other €'000	Total €'000
Cash and balances with banks					**41,626**
Gold balances					**13,402**
Placements with banks by exposure country:					
Belgium	-	-	-	5,900	**5,900**
Denmark	-	29,408	-	-	**29,408**
France	-	6,739	37,138	-	**43,877**
Other countries	-	12,254	-	-	**12,254**
	-	**48,401**	**37,138**	**5,900**	**91,439**
Securities by issuer category:					
Government	1,228,840	-	131,506	-	**1,360,346**
Monetary financial institutions	781,835	-	157,181	-	**939,016**
Non-financial institutions	48,227	-	2,472	-	**50,699**
Other financial institutions	168,494	-	73,447	-	**241,941**
Supranational	14,887	-	2,380	-	**17,267**
	2,242,283	**-**	**366,986**	**-**	**2,609,269**
Claims on the International Monetary Fund					**161,909**
Participating interest in the European Central Bank					**15,050**
Transfer of Foreign Reserves to the European Central Bank					**36,407**
Other Foreign Currency Assets					**443**
Total Investments					**2,969,545**