BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

# FORTY-SIXTH ANNUAL REPORT
# AND
# STATEMENT OF ACCOUNTS
# 2013

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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. **Formulate and implement a macro-prudential policy** in order to fulfil the tasks of the Bank as the national macro-prudential authority;

v. **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;

vi. **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;

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

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

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

x. **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.**

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**as at 31 March 2014*

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Mr Peter Paul Tabone
*Currency Services & Security*

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*(left to right)*

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*Seated:* Mr Alfred DeMarco (Deputy Governor), Professor Josef Bonnici (Governor & Chairman), Mr Alexander Demarco (Deputy Governor).

**as at 31 March 2014*

## ORGANISATION CHART*

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  - Governors' Office
    *Dr Bernard Gauci*
  - Legal Office
    *Dr Bernadette Muscat*
  - Internal Audit Department
  - Economics and Research Department
    - Economic Analysis
    - Modelling and Research
  - Communications Department
  - EU and International Relations Department
  - Deputy Governor
    Monetary Policy
    *Mr Alfred DeMarco*
  - Deputy Governor
    Financial Stability
    *Mr Alexander Demarco*
- Director General - Financial Policy and Special Projects
  *Mr René G. Saliba*
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    *Mr Oliver Bonello*
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      - Financial Stability Surveillance, Assessment and Data
      - Policy, Crisis Management and Stress Testing
    - Information Systems Department
      - Information Technology
      - Projects and Applications Development
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      - Knowledge Services
  - Market Operations Directorate
    *Mr Raymond Filletti*
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      - Investments
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      - Monetary Operations and Collateral Management
      - Government Securities
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      - Currency Operations
      - Security Control
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    - 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

**as at 31 March 2014*

*Bank Ċentrali ta' Malta*
*Eurosistema*
*Il-Gvernatur*

*Central Bank of Malta*
*Eurosystem*
*The Governor*

28 March 2014

The Hon Professor Edward Scicluna
Minister for Finance
Maison Demandols
South Street
Valletta VLT 1102

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 2013.

Yours sincerely

**Professor Josef Bonnici**

## CONTENTS

## ABBREVIATIONS

| | |
|---|---|
| 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 |
| MFI | monetary financial institution |
| MFSA | Malta Financial Services Authority |
| MGS | Malta Government Stock |
| MRO | main refinancing operation |
| MSE | Malta Stock Exchange |
| NCB | national central bank |
| NFC | non-financial corporation |
| NPISH | non-profit institutions serving households |
| NSO | National Statistics Office |
| RPI | Retail Price Index |
| TARGET | Trans-European Automated Real-time Gross settlement Express Transfer system |
| ULC | unit labour costs |

## GOVERNOR'S STATEMENT

The global economic recovery remains subdued and differentiated across various countries and regions. Supported by such factors, as a continuing accommodative monetary policy and a reduced fiscal drag, the recovery is gradually strengthening in advanced economies. The narrowing spreads on government bonds in those countries most affected by the crisis are a sign that some measure of confidence has been restored.

Despite signs of a moderate recovery, aggregate real gross domestic product (GDP) in the euro area declined by 0.5%, compared with a drop of 0.7% in 2012. On a quarterly basis, GDP grew slightly during the final three quarters of the year on the back of a gradual strengthening in private consumption and investment. The improvement in economic conditions was observed especially in stressed countries, suggesting a bottoming-out of the crisis in the euro area. This positive development is also mirrored in economic sentiment, which has continued on an upward path. In December 2013, the EU economic sentiment indicator reached its long-term average for the first time since July 2011.

Against the still fragile external environment, the Maltese economy continued to outperform the euro area average. Real GDP growth accelerated to 2.4% during 2013, from 0.6% in the previous year. Domestic demand recovered as private consumption increased; however, following six years of growth, net exports dampened economic growth. For 2014, the Central Bank of Malta projects a recovery in gross fixed capital formation and a much less negative contribution of net exports, while GDP growth is forecast to remain broadly stable.

The positive performance in 2013 remained job-rich as employment in Malta was on average 3.1% higher than a year earlier. With the labour supply rising at a faster pace than the number of employed, employment growth was not sufficient to generate a reduction in the unemployment rate which, on a seasonally adjusted basis, edged up to 6.5% from 6.4% in 2012. With the labour supply growing, the number seeking employment continued to rise.

Meanwhile, on the basis of the Harmonised Index of Consumer Prices (HICP), the rate of inflation decelerated in Malta and in the euro area as a whole. With the moderation in prices being more pronounced, the rate of inflation in Malta declined to 1.0% from 3.2% in 2012, mainly because of developments in service prices, more specifically hotel accommodation.

Although inflation in the euro area as a whole has decreased, and stayed below the European Central Bank's (ECB) 2% objective, there is at this stage no sign of deflation, or widespread price declines. A geographical assessment of inflation shows that recent price changes have been positive in all but three countries; thus, negative price changes are not widespread but rather concentrated mainly in the stressed countries. In terms of incidence of inflation across product markets, price declines were observed in only a small proportion of the components of the HICP basket. In addition, there are no signs that low inflation is self-fulfilling as long-term inflation expectations remain well anchored. Therefore, the statistics show no signs of substantial deflation and they also confirm the ongoing correction of imbalances in stressed countries.

Under pressure to address economic imbalances and to implement structural reforms, various countries in the euro area have seen a reduction in nominal wages. Equivalent to the depreciation of the exchange rate, internal devaluation in stressed countries is bound to improve their competitive position. In effect, unit labour costs (ULC) in these countries have decelerated and have now moved closer to those in the better performing countries.

Malta's ULCs have been converging upward to the euro area average. In this context, the improved competitiveness of stressed economies may pose a challenge for the Maltese economy, especially since an export-led recovery in these countries has already started. It is therefore essential for higher wages in Malta to be sustained by gains in productivity. Malta needs to remain nimble and flexible in carving out new niche sectors, which would allow it to continue on the path of successful economic diversification. Towards that end, the quality of human capital needs to meet the changing needs of domestic and export markets, and for that purpose the educational system has to provide the required training and qualification profiles. In addition, the authorities need to continue with programmes that attract foreign investment to Malta. Further efforts to reduce and streamline bureaucracy are warranted, as highlighted in the World Bank's *Doing Business Report* 2014, which has also pointed to the need for improvement in the business environment, including reductions in port handling costs, the facilitation of start-ups and increased efficiency in insolvency procedures.

On the fiscal side, the Bank's forecast (based on current budgetary proposals) indicates the deficit ratio falling below the 3% threshold value to 2.9% in 2013, and then remaining stable in 2014. The debt ratio is expected to increase in 2013 to 71.3% from 70.8% in 2012, and then to rise further to 71.8% in 2014. Concrete measures to rein in the debt ratio below the 60% benchmark are essential, as the room for fiscal manoeuvre is severely constrained.

In addition, the new EU fiscal rules oblige Member States to take corrective measures to bring down the deficit and debt ratios below the respective benchmarks. Prudence and cost awareness in the management of public sector resources are important for putting public finances on a solid and sustainable footing, contributing also to lower borrowing costs and long-term economic growth.

Domestic government bond yields continued to decline during 2013, extending the downward trend observed since the first half of 2011. The accommodative monetary policy measures taken by the ECB, particularly its forward guidance, led to reduced volatility and risk premia across markets. As global debt markets generally stabilised throughout 2013, the spread over the German bund declined in 2013, reversing the widening that occurred in 2012. Demand for local government securities remained strong, and in fact the Government continued to benefit from a positive investor sentiment, keeping the cost of borrowing at a relatively low level when compared with countries with similar credit ratings. Since 2008, the bid-to-cover ratio for government bonds has averaged around 2.0, while that recorded in 2013 was 2.3. Developments in the first months of 2014 indicate that a similar level of participation will be maintained, as the first issue of the year retained a bid-to-cover ratio of 2.3 and the issue was over-subscribed by €72.8 million. Meanwhile, the funding requirement for 2014 is expected to remain at the same level of the previous year at €650 million.

### The banking sector

The Maltese banking sector has been a significant contributor to the resilience of the Maltese economy to external shocks and to its alignment with the economically stronger group of countries in the euro area. Malta continues to host a relatively large financial sector without exposing itself to excessive risk. In terms of the soundness of its banks, Malta ranked 14th place worldwide according to the World Economic Forum. Financial soundness indicators show that the Maltese banking sector compares very well with European averages. The Capital Adequacy Ratio of Maltese banks remains well above the 8% regulatory minimum, while the solvency ratios are, on average, considerably higher than the EU average.

The sector is also characterised by ample liquidity. At 29.4%, the proportion of liquid assets in total assets is almost three times higher than the euro area average. On the funding side, Maltese banks remain characterised by stable inflows with the loan-to-deposit ratio for core domestic banks standing at 66.5%, compared with 106% in the euro area. The low ratio reflects continued reliance on retail deposits sources. Interbank and Eurosystem funding remained both very modest at 0.5% of total liabilities in each case.

On the assets side, while credit to households grew by 4.9%, reflecting a stable mortgage market, aggregate credit growth turned negative in 2013, mainly mirroring the orderly deleveraging of the corporate sector. Meanwhile, interest rates on loans to business remain relatively high as compared with other euro area countries, particularly for small and medium-sized enterprises (SME). This could be due to various market characteristics. In this regard, the eventual establishment of a development bank would provide further access to finance, particularly for SMEs, and may also serve to complement the banks' funding of larger projects.

The Maltese banking sector is profitable, with core domestic banks on average reporting a return on equity of nearly 20%, which is significantly better than the 5% registered for the average of the European Union. At 1.4%, return on assets is also higher than the 0.28% reported for the EU average.

## The Joint Financial Stability Board

During the year the Joint Financial Stability Board (JFSB) addressed a number of issues of a macro and micro-prudential nature. One major outcome discussed by the JFSB related to the amendments to Banking Rule BR/09. These amendments, issued by the Malta Financial Services Authority (MFSA) at the end of 2013, address credit risk measures arising from the assessment of the quality of asset portfolios of credit institutions.

Briefly, the amendments to BR/09 require banks to allocate an amount of capital to a reserve. This allocation is equal to 2.5% of a bank's non-performing loans (NPL), less impairments and interest in suspense as defined in International Financial Reporting Standards. For certain overdue NPLs, the requirement rises to 5% and can be raised further by the MFSA.

Of significance also is that the amendments to BR/09 align the definition of NPLs and forbearance with the newly established European Banking Authority (EBA) draft Technical Standard on Supervisory Reporting on Forbearance and Non-Performing Exposures. The amendments also require credit institutions to recognise incurred losses as early as possible within the context of the International Financial Reporting Standards. To this effect, institutions are required to set up appropriate governance structures, a robust credit risk management framework and reporting systems.

These amendments will strengthen provision practices and are expected to improve the banks' overall coverage ratio. Such measures will also further strengthen the soundness of the Maltese banking system in view of the ECB's ongoing comprehensive assessment, which consists of an Asset Quality Review of the leading banks in euro area countries and a stress-testing exercise that is being undertaken in close coordination with the EBA.

With the augmented responsibilities for the Bank particularly in the area of financial stability, the governance structure at the Bank has been modified. In 2013 the Central Bank of Malta Act was amended to add a Deputy Governor position with particular focus on financial stability. This reflects the increased focus being given by central banks to financial stability as a result of the recent financial crisis and the ECB's role in the Single Supervisory Mechanism. The amendments to the Central Bank of Malta Act also now provide the legal framework for the establishment of the JFSB between the Bank and the MFSA.

## Bank policies and operations

As a member of the Eurosystem and through the Governor's participation in the Governing Council of the ECB, the Bank contributes effectively to the formulation of monetary policy in the euro area. The Bank is also responsible for the implementation of the single monetary policy in Malta as determined by the Governing Council.

During the year the Bank conducted open market operations with eligible banks worth an aggregate of €23.7 billion, compared with €11.2 billion registered in 2012.

The Bank's operations in TARGET2, through which high value transfers are settled, increased further in 2013. However, the value of payment flows decreased significantly to €97.9 billion from €263.8 billion in 2012, as lower interest rates reduced the incentive for counterparties to hold overnight deposits with the Bank.

The relatively high interest rates observed in previous years had reflected heightened market volatility and uncertainty. In the context of the subsequent decline in yields across financial markets, maturing securities were reinvested in lower yielding assets within the set risk parameters, such that interest income declined from €86.1 million in 2012 to €78.4 million in 2013. Still, the Bank reported a positive financial performance, even if the profit level (including provisions), at €66.7 million, was short of the previous year's record of €78.2 million, but well above the average of €47.7 million over the past ten years. Furthermore, the Bank continued to increase its financial buffers by enhancing its provisions by a further €8 million to €18.9 million to cover interest rate and credit risk. The Board of Directors approved the transfer of €8.4 million to reserves and to pass on €50 million to the Government of Malta.

On behalf of the Board of Directors, I would like to thank the Bank's staff for their dedication and hard work, and for contributing so whole-heartedly to this *Annual Report*.

Professor Josef Bonnici

# PART I

# FINANCIAL AND

# ECONOMIC DEVELOPMENTS

# 1. INTERNATIONAL ECONOMIC DEVELOPMENTS AND THE EURO AREA ECONOMY[1]

Developments in the global economy were mixed during 2013. In general, the recovery in advanced economies strengthened during the year. On the other hand, activity slowed down in many large emerging economies on the back of capital market turmoil, political tensions, structural problems and policy tightening. Global inflationary pressures remained contained.

Against a backdrop of weak inflation, central banks in Europe and Japan maintained an accommodative monetary policy stance during the year to aid the nascent recovery. Towards the end of the year, however, the US Federal Reserve began to withdraw part of its monetary stimulus.

In financial markets, stock prices rallied while bond yields rose as the economic outlook in advanced economies improved and the Federal Reserve withdrew part of its stimulus. A drop in risk aversion also contributed to a narrowing of interest rate spreads across the euro area periphery. In commodity markets gold was the main mover, with its price dropping significantly during 2013. Other commodity prices, such as industrial metals and food, also decreased.

In the euro area, gross domestic product (GDP) contracted overall in 2013. Nonetheless, activity began to recover during the second half of the year. Inflationary pressures weakened as the year progressed. Against this background, the European Central Bank (ECB) reduced its key interest rates in both May and November, with the rate on the main refinancing operations (MRO) being cut to 0.25%. The Bank also adopted a forward guidance approach in July, when it announced that it expected its key interest rates to remain at current or lower levels for an extended period of time.

## The international economy

*United States*

The US economy continued to expand in 2013. During the year, real GDP grew by 1.9%, a slower pace than that registered in 2012 as domestic demand slowed (see Table 1.1).

Private consumption grew at a solid pace in 2013, supporting domestic demand as rising equity, property prices and an improving labour market boosted consumer confidence. Nonetheless, the contribution of private spending to growth was lower in 2013 than in 2012. Government spending, on the other hand, fell, weighing on domestic demand on account of widespread federal government spending cuts that had begun in March. Lower public investment also dragged down fixed capital formation during the year, with total investment expanding at a slower pace in 2013 when compared with the previous year. Moreover, although the housing market recovery remained strong, total investment was negatively impacted by rising interest rates in the latter half of the year. This reflected expectations of a less accommodative monetary policy stance on the part of the Federal Reserve. Inventory stocking, meanwhile, added to growth during the year.

**Table 1.1**
**REAL GDP GROWTH IN ADVANCED ECONOMIES**
*Percentage changes over preceding period; seasonally adjusted*

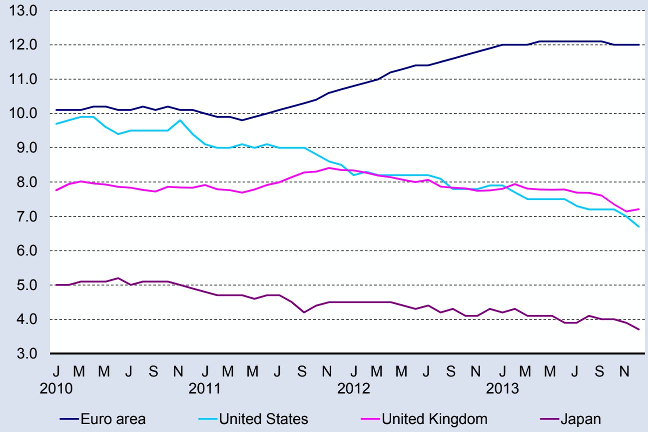
| | 2013 | | | | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | | | |
| United States | 0.3 | 0.6 | 1.0 | 0.8 | 1.8 | 2.8 | 1.9 |
| Euro area | -0.2 | 0.3 | 0.1 | 0.3 | 1.6 | -0.7 | -0.5 |
| United Kingdom | 0.5 | 0.8 | 0.8 | 0.7 | 1.0 | 0.3 | 1.9 |
| Japan | 1.1 | 0.9 | 0.3 | 0.3 | -0.5 | 1.4 | 1.6 |

Source: Eurostat.

[1] The cut-off date for data on GDP in this Chapter is 5 March 2014.

On the external side, net exports contributed slightly positively to GDP growth as export growth remained solid, albeit slower than in 2012. The ongoing shale energy boom had a large impact on the US trade balance during the year, supporting export growth while reducing imports of petroleum.

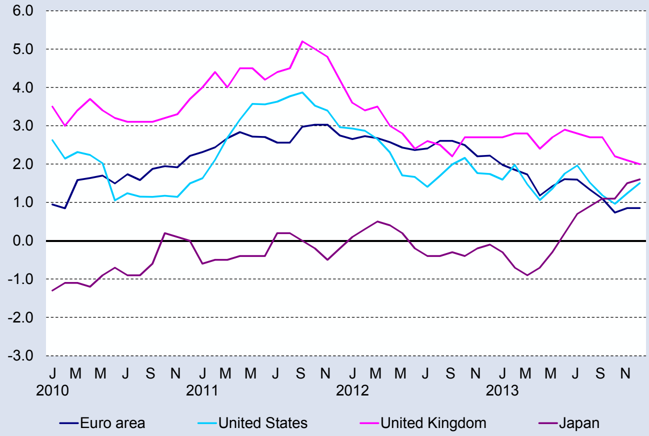
**Chart 1.1**
**UNEMPLOYMENT RATE**
*(percentage of the labour force; monthly data; seasonally adjusted)*




Sources: Eurostat; US Bureau of Labor Statistics; UK Office of National Statisitcs; Japan Statistics Bureau.

Labour market conditions improved substantially during 2013, with the unemployment rate dropping by 1.2 percentage points to 6.7% in December (see Chart 1.1). At this rate, unemployment was 3.3 percentage points below the peak of 10.0% reached in 2009 at the height of the crisis. The decline in the number of unemployed during 2013 partly reflected a rise in employment, particularly in the services industry. However, the labour force participation rate continued to drop, indicating that a number of discouraged workers had left the labour market.

**Chart 1.2**
**CONSUMER PRICE INFLATION**
*(annual percentage changes)*




Sources: Eurostat; US Bureau of Labor Statistics; UK Office of National Statisitcs; Japan Statistics Bureau.

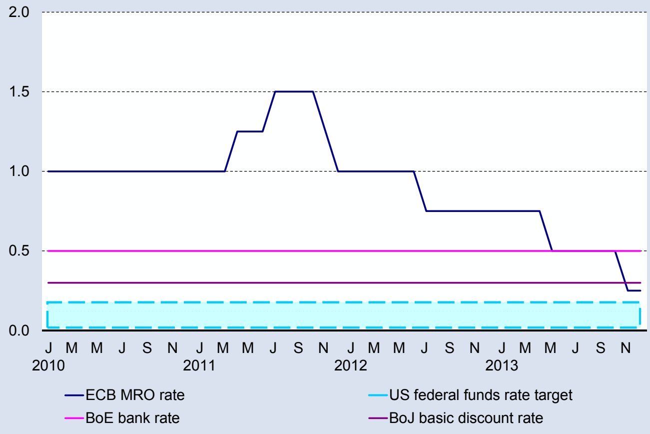
Inflationary pressures in the United States remained modest throughout 2013, with the annual rate of Consumer Price Index (CPI) inflation ending the year at 1.5%, 0.2 percentage point below the end-2012 level (see Chart 1.2). Developments in the overall inflation rate were mainly driven by energy price movements, in particular motor fuel prices, although overall energy price inflation was unchanged from 2012 at 0.5%. Food price inflation, meanwhile, weakened during the year. Excluding food and energy, inflation also dropped by 0.2 point to 1.7% during the 12 months to December 2013. Subdued inflation continued to point towards a degree of slack within the US economy, despite the expansion in activity.

In light of these developments, the Federal Reserve held the federal funds target rate unchanged in a range between 0.00% and 0.25% throughout 2013 (see Chart 1.3).

During 2013 the Federal Reserve continued to implement non-standard monetary policy measures, such as purchasing mortgage-backed securities, reinvesting principal payments from its holdings in agency mortgage-backed securities and rolling over maturing Treasury securities. In January it also started buying additional longer-term Treasury securities, in a further attempt to maintain downward pressure on longer-term interest rates and support mortgage markets. In June, however, the Fed announced its intention to taper its asset purchases, conditional on a continued improvement in economic conditions.

Indeed, in December the Fed moderated the pace of its purchases of mortgage-backed securities and long-term Treasury securities, with total monthly purchases falling by USD 10.0 million to USD 75.0 million. This reflected the Bank's assessment that underlying economic activity and labour market conditions had improved. Concurrently, however, given the weak inflation outlook, the Fed also altered its forward guidance statement, stating that the existing low target range for the federal funds rate would remain in place past the time that the unemployment rate declined below 6.5%, on condition that inflation expectations were well anchored.

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




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

With regard to fiscal policy, an agreement was reached at the start of the year to partly avoid the "fiscal cliff", a considerable fiscal tightening. Nevertheless, federal government spending was hit in March by a series of automatic spending cuts. Moreover, in October the US Government entered a partial, two-week shutdown, which halted all non-essential government services until the debt ceiling was raised. Congress subsequently passed a two-year budget in December, trimming automatic government spending cuts in exchange for savings elsewhere. The government deficit in the United States was estimated to have reached 6.2% of GDP in 2013, down from 9.2% in 2012.[2]

### *United Kingdom*

The UK economy grew by 1.8% during 2013, up from just 0.3% in 2012, the fastest rate since the financial crisis struck in 2008 (see Table 1.1). Private consumption was the main driver of growth during 2013, while the contributions of investment and net exports also improved when compared with the previous year. The robust expansion in output registered throughout the year mainly reflected faster growth in the large services industry and a recovery in the construction industry. The latter resulted from an upturn in the property market. However, manufacturing declined, though the rate of contraction was smaller than in the previous year as industry began to recover as the year wore on.

The labour market situation generally improved throughout 2013, with the unemployment rate in December standing at 7.2%, down from 7.8% at the end of 2012 (see Chart 1.1). The drop in the jobless rate mainly occurred during the second half of the year, coinciding with a pick-up in employment during the same period. However, total pay growth remained weak and below inflation, thereby suggesting a further drop in living standards.

Inflation in the United Kingdom remained relatively high during 2013, though it abated towards the end of the year (see Chart 1.2). In December the annual CPI inflation rate stood at 2.0%, down from 2.7% at the end of the previous year and in line with the Bank of England's inflation target for the first time since November 2009. The deceleration was mainly driven by a slower rise in energy prices and lower contributions from food and education prices toward the end of the year. The latter reflected a base effect following a strong rise in tuition fees a year earlier.

The Bank of England's key monetary policy instruments were left unchanged during 2013, with the official bank rate standing at 0.50% and its stock of asset purchases at GBP 375.0 billion (see Chart 1.3). In March the Bank's remit was amended to add more weight to growth and employment, though the primacy of the price stability objective and the inflation target remained unchanged. In August the Bank provided explicit guidance on the future path of its monetary policy, stating that its official interest rate would not be raised and its stock of asset purchases not reduced at least until the unemployment rate fell to 7.0%. However, this forward guidance would cease to apply if material risks to price stability or financial stability were deemed to have risen.

[2] General government deficit estimates in this Chapter are sourced from the European Commission's Winter 2014 economic forecasts.

In April the Bank, together with the Treasury, announced an extension to the Funding for Lending Scheme. The scheme, launched in July 2012, is aimed at boosting lending to the real economy through the provision of funds at below-market rates to financial corporations. The extension was designed to encourage lending to smaller businesses, as well as to cover financial leasing and factoring corporations. Further changes to the scheme were announced in November to re-focus the incentives towards business lending.

In October the Bank of England announced changes to the way it dealt with lenders in financial difficulty, namely by offering liquidity for longer periods, accepting a wider range of collateral and lowering the cost of using the discount window.

On the fiscal side, in March the UK Government unveiled its budget for 2013, envisaging a gradual drop in the fiscal deficit. Government debt, on the other hand, is expected to peak in 2016-2017. The budget was followed by the Government's Autumn Statement in December, which included a number of fiscal measures, such as a gradual rise in the pension age. The general government deficit ratio was estimated to have widened slightly during 2013, edging up by 0.2 percentage point over 2012 to 6.3% of GDP.

### *Japan*

The Japanese economy continued to recover in 2013, with real GDP growth accelerating slightly to 1.6% in 2013 from 1.4% in the previous year (see Table 1.1). Growth was especially robust during the first two quarters. Government spending was the main driver of growth, reflecting strong fiscal stimulus measures. Private consumption growth was also solid, as increases in asset prices and fiscal stimulus measures boosted confidence. Higher demand prior to the announced increase in the national sales tax in 2014 also supported consumer spending. On the other hand, growth in private investment slowed during 2013, as a strong upturn in the property sector was offset by a contraction in business investment, suggesting that recent stimulus measures were still not having the desired effect on firms' capital expenditure.

On the external side, net exports continued to contribute negatively to growth for the third year in a row, despite a strong start to 2013. Exports were boosted at the start of the year by a weakening of the yen. However, this positive momentum was offset later on owing to a slowdown in emerging market trading partners. Import growth, however, remained solid throughout the year.

The economic recovery was also felt in the labour market, with the unemployment rate declining gradually over the year (see Chart 1.1). In December the jobless rate stood at 3.7% from 4.3% 12 months prior, as the number of people in employment rose. Around half of the gain in employment was registered in the manufacturing sector.

Price pressures picked up during 2013, with the overall annual inflation rate standing at 1.6% in December, its highest level since 2008. In contrast, inflation had ended 2012 in negative territory (see Chart 1.2). Faster price growth mainly reflected developments in prices of imported items, such as energy and food, on account of the weakening of the yen in the wake of the Bank of Japan's accommodative policy measures. Moreover, core inflation, which excludes food and energy prices, broke its four-year deflationary trend during the year. While the yen's diminished purchasing power on international markets played a role, the recent economic recovery could also have played a part by allowing sellers to raise prices.

With regard to monetary policy, in January the Bank of Japan changed its price stability goal of 1.0% inflation to 2.0% in terms of the annual consumer price inflation rate, committing itself to pursue monetary easing to achieve this target as early as possible.

In April the Bank introduced a new monetary policy strategy, changing the main target for money market operations from the uncollateralised overnight call rate to the monetary base, which was projected to significantly increase by end-2014. The Bank's holdings of Japanese government bonds were also set to expand and the average maturity of the portfolio was expected to lengthen. Moreover, the Bank also decided to raise its purchases of other assets, such as exchange traded funds. At the same time, the previous asset purchase programme was terminated. In mid-2013 the Bank announced a number of measures to address the rise in financial market volatility, which had been observed at the time.

On the fiscal front, Japan's new Government unveiled a stimulus package at the start of the year, which was followed by the approval of a record-high budget in May. In October the fiscal authorities announced that, as from April 2014, they would raise the national sales tax to shore up the country's finances. Another stimulus package was also launched to mitigate the adverse impact of the tax increase on the economy. Fiscal stimulus showed up in a slight widening of the general government deficit to an estimated 9.0% of GDP in 2013.

### *Emerging economies*

Economic activity in major emerging economies slowed down during 2013. GDP growth in China rose by 7.7%, marginally down from 7.8% in the previous year. The slowdown was mainly a result of attempts by the authorities to re-orient the economy away from investment and exports towards private consumption by tightening credit standards, and by opening up the financial system to market forces. Meanwhile, demand for exports during the year was weighed down by weaker growth in other emerging economies and by a strong currency.

Economic growth also weakened in other major emerging economies, such as Russia and Brazil. Activity during 2013 was dampened by capacity constraints and weaker foreign demand. Other factors included falling prices for commodity exports, political unrest in some countries and capital outflows. The latter reflected expectations of monetary policy tapering in the United States and the resulting increase in interest rates in key advanced economies.

Meanwhile, inflationary pressures in most emerging economies remained strong during 2013, as import prices were pushed up by weakening currencies.

## International financial markets

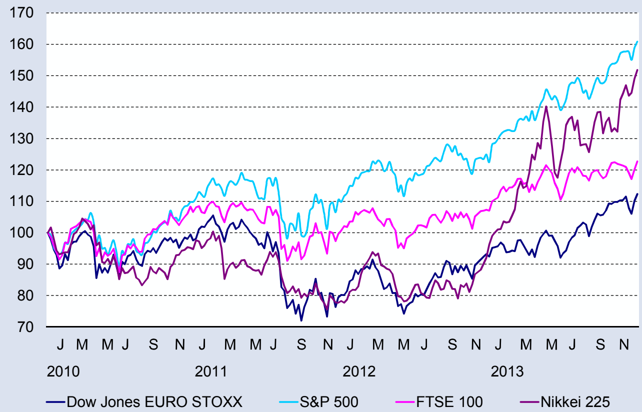
### *Equities*

Equity prices in advanced economies rose substantially over the course of 2013, extending the rally that began in 2012 (see Chart 1.4). Share prices in the United States (S&P500) and in the euro area (Dow Jones EUROSTOXX) rose by 29.6% and 20.5%, respectively. In the United Kingdom, equities included in the FTSE100 Index gained 14.4% in value while share prices in Japan, as measured by the Nikkei 225, surged by 56.7%.

Developments in equity markets were positive at the start of the year, reflecting increased optimism over improving economic conditions in advanced economies, the fiscal cliff deal that was reached in the United States and continued liquidity injections by central banks around the globe. In particular, the low interest rate environment at the time boosted investor demand for higher-yielding assets, such as shares.

Investors' risk appetite was dampened somewhat during the second quarter. This reflected policy uncertainty in the United States and Europe, including the impact of the bail-out of Cyprus, and worries over the economic outlook in China. The increase in risk aversion was compounded by expectations of a reduction in monetary policy stimulus in the United States and the resulting drop in market liquidity.

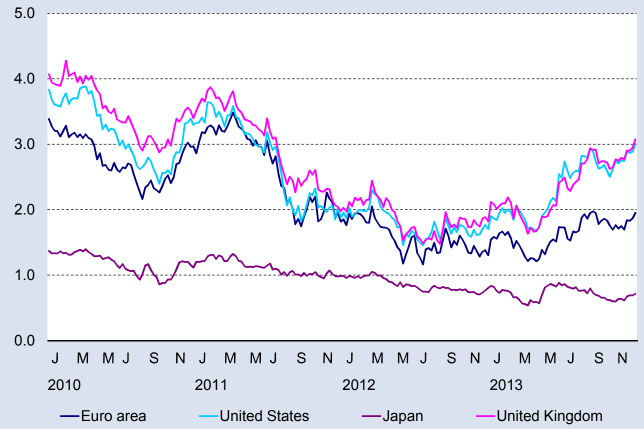
**Chart 1.4**
**STOCK PRICE INDICES**
*(end of week index; Jan. 2010=100)*




Source: Reuters.

The rally in equity prices gathered pace again in the second half of the year, reflecting further signs of stronger economic growth in advanced economies, the resolution of the fiscal deadlock in the United States and continued accommodative policies and forward guidance statements by central banks, which largely offset the impact of slower quantitative easing by the Federal Reserve.

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



Source: Reuters.

*Government bond yields*

Ten-year sovereign bond yields in most advanced economies rose strongly during 2013, reflecting an overall drop in demand for assets with a safe-haven status (see Chart 1.5). Yields on American and British sovereign debt both stood at 3.0% at the end of 2013, after a rise of 125 and 119 basis points, respectively. Similarly, ten-year yields on German bonds, traditionally used as a benchmark yield in the euro area, gained 64 basis points to end the year at 1.9%.

The surge in yields mainly occurred during the second and third quarters of the year, triggered by increased uncertainty over the Federal Reserve's asset purchase programme and signs of an economic recovery in advanced economies. These factors offset temporary episodes of increased risk aversion during the year, such as a rise in uncertainty in Europe and in the United States at the end of the first quarter, fears over the war in Syria during the summer, and the fiscal impasse in the United States in October.

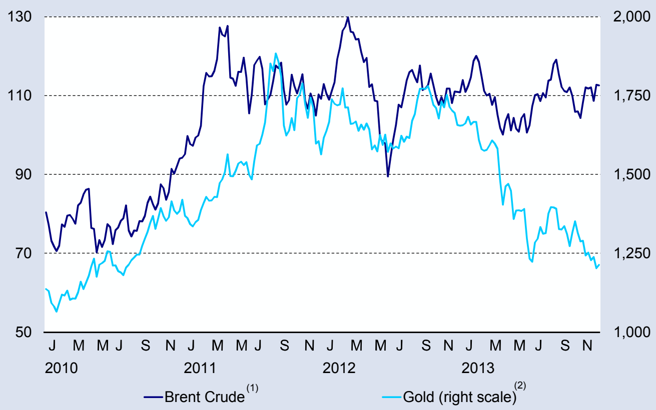
In contrast, ten-year government bond yields in Japan dropped by an overall 7 basis points during 2013, ending the year at 0.7%. The main driver was the increase in government bond purchases by the Bank of Japan during the year, which offset upward pressures on yields stemming from a rise in domestic inflation expectations.

## Commodities

*Oil*

The price of Brent crude oil stood at USD 110.5 per barrel at the end of 2013, 1.0% lower than its value 12 months earlier (see Chart 1.6). Improved market sentiment pushed up oil prices at the start of 2013, buoyed by a more favourable outlook in advanced economies. Upward pressures were compounded by rising tensions in North Africa and the Middle East. These early gains were reversed during the spring, reflecting increased political uncertainty in Europe and concerns about tighter monetary policy in the United States.

**Chart 1.6**
**OIL AND GOLD PRICES**
*(end of week)*



(1) US dollars per barrel; (2) US dollars per troy ounce.
Source: Reuters.

A large cut in Libyan exports and the possibility of military action in Syria supported oil prices during the summer, though this increase was dampened once more during the fourth quarter on account of renewed political uncertainty in the United States and a reduction in tensions over Iran's nuclear programme.

### *Gold*

The price of gold extended the downward trend that had started in mid-2012. It dropped sharply during 2013, falling by 28.0% to end the year at USD 1,204.9 per troy ounce (see Chart 1.6). The main factors driving this drop were low inflationary pressures together with an overall reduction in risk aversion, as the economic recovery strengthened in advanced economies. These developments lowered the demand for gold both as a safe-haven asset as well as an inflation hedge. Furthermore, investors appeared to have switched into more attractive assets, such as equities.

In April rumours that central banks in stressed European nations might sell their gold reserves to raise funds sparked a sell-off in gold. Prices dropped further in June as the US Federal Reserve announced its intention to slow down its rate of monetary easing, thereby reducing inflation expectations and strengthening the dollar. Developments during the summer, including the war in Syria and strong physical demand from Asia, temporarily supported the gold price. However, demand dropped once more toward the end of the year, in part reflecting the resolution of the fiscal impasse in the United States.

### *Metals*

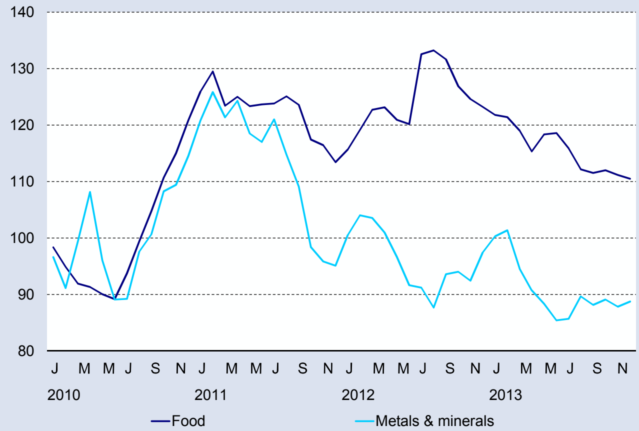
Prices of metals dropped during 2013, with the World Bank's Metals and Minerals Index falling by 8.9% (see Chart 1.7). Following a robust start to the year on account of a strengthening growth outlook in major economies, metal prices decreased strongly during the second quarter on the back of renewed concerns about the Chinese economy, the world's largest consumer of commodities. Political uncertainty in Europe and expectations of Federal Reserve policy tapering also contributed to the decline. Towards the end of the year, prices generally stabilised, supported by renewed optimism over the recovery in advanced economies and by cuts in Indonesian commodity exports.

The drop in the Metals and Minerals Index throughout the year was broad-based, with prices of copper, aluminium and nickel, among others, all declining. Iron ore was the only major index component to gain in value during the period, owing to high demand and tight supply.

### *Food*

Food prices generally dropped throughout 2013, with the World Bank's Food Index shedding 10.3% of its value (see Chart 1.7). The falling price of grains was the main driver of the overall decrease, reflecting an abundant increase in output over the year on account of favourable weather conditions in supplier countries. Edible oil prices also dropped during 2013. Meanwhile, dairy prices surged during the year, as adverse weather conditions in Australia and New Zealand led to a cut in output.

**Chart 1.7**
**COMMODITY PRICES**
*(monthly indices; 2005 = 100)*




Source: World Bank.

## Economic and financial developments in the euro area

### *Gross domestic product*

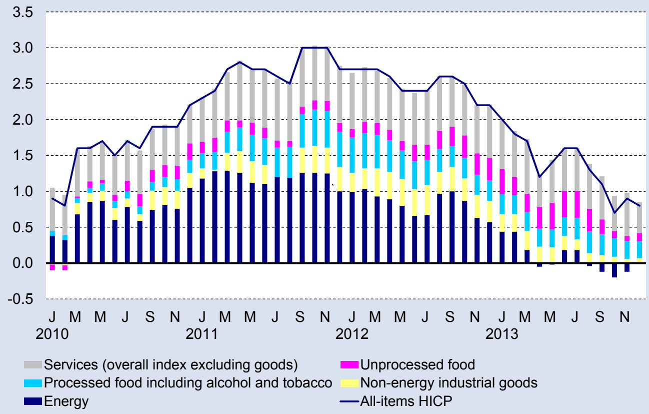
The euro area economy contracted during 2013, with real GDP declining by 0.5% (see Table 1.2), following a 0.7% drop in 2012. In 2013 GDP growth was impacted by a decrease in domestic demand, with all components bar government spending falling. The contribution of net exports, meanwhile, remained positive, though lower than in 2012 as export growth slowed.

Nonetheless, the annual growth rate of GDP masks a fragile economic recovery that started during the year. On a quarterly basis, GDP grew slightly during the final three quarters of the year on the back of a gradual strengthening in private consumption and investment. The improvement in economic conditions was especially observed in stressed countries, suggesting a bottoming-out of the crisis in the euro area.

### *Inflation*

Inflation weakened considerably during 2013, with the annual rate of Harmonised Index of Consumer Price (HICP) inflation decelerating throughout the year (see Chart 1.8). As a result, in December the rate stood at 0.8%, as against 2.2% at the end of 2012. The drop in price pressures was broad-based. In particular, energy prices exerted a considerable drag on inflation during the year. Price weakness also stemmed from the non-energy industrial goods, services and unprocessed

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




Source: Eurostat.

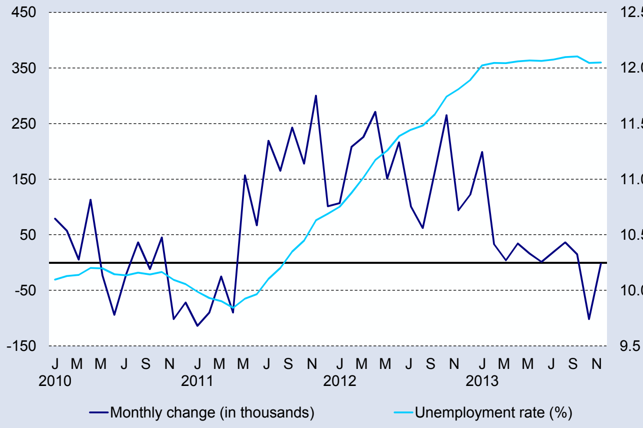
**Table 1.2**
**REAL GDP GROWTH IN THE EURO AREA**
*Seasonally adjusted*

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| | | *Annual percentage changes* | |
| Private consumption | 0.3 | -1.4 | -0.7 |
| Government consumption | -0.1 | -0.5 | 0.2 |
| Gross fixed capital formation | 1.6 | -4.1 | -3.0 |
| **Domestic demand** | **0.7** | **-2.2** | **-1.0** |
| Exports | 6.5 | 2.5 | 1.3 |
| Imports | 4.5 | -0.9 | 0.1 |
| **GDP** | **1.6** | **-0.7** | **-0.5** |
| | | *Percentage point contributions* | |
| Private consumption | 0.2 | -0.8 | -0.4 |
| Government consumption | 0.0 | -0.1 | 0.0 |
| Gross fixed capital formation | 0.3 | -0.8 | -0.5 |
| Changes in inventories | 0.3 | -0.5 | -0.1 |
| **Domestic demand** | **0.7** | **-2.2** | **-1.0** |
| **Net exports** | **0.9** | **1.5** | **0.5** |
| **GDP** | **1.6** | **-0.7** | **-0.5** |

Source: Eurostat.

food components. These developments reflected a residual high degree of slack within the economy in an environment of subdued demand. Moreover, the recent rebalancing in stressed economies may have reduced wage and price growth. Lower global commodity prices, as discussed earlier, as well as a strengthening of the exchange rate, also contributed to the easing in price pressures.

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



Source: Eurostat.

## *Labour market*

Labour market conditions remained weak during 2013, though a slight improvement was observed toward the end of the year (see Chart 1.9). The unemployment rate peaked at a record high of 12.1% in April from 11.9% at the end of 2012, in line with the contraction in economic activity during the period. The jobless rate stabilised during the second and third quarters, before declining marginally to 12.0% in the final three months of the year.

Encouragingly, the average absolute increase in the number of unemployed during 2013 was much smaller than that registered in 2012. Indeed, the jobless number dropped during the final quarter of the year, suggesting that the effects of the incipient economic recovery were beginning to be felt in the labour market. Cross-country divergences remained, however, with a low unemployment rate in Germany contrasting with elevated levels in Greece and Spain.

## *Monetary policy*

The Governing Council of the ECB lowered key interest rates on two occasions during 2013, in May and in November (see Chart 1.3). In each case, the interest rate on the MROs was cut by 25 basis points to end the year at a historical low of 0.25%. Meanwhile, the rate on the marginal lending facility was reduced by 50 basis points in May and by 25 basis points in November to end 2013 at 0.75%. The deposit facility rate was left unchanged at 0.00%. The policy rates' corridor narrowed during the year and became asymmetric around the MRO. Rates were cut against a backdrop of economic weakness and subdued monetary and loan dynamics, as well as low underlying price pressures over the medium term.

In July the ECB introduced forward guidance, announcing that it expected key interest rates to remain at existing or lower levels for an extended period of time. This reflected mainly the subdued medium-term outlook for inflation and the weak state of the euro area economy. The Governing Council reaffirmed this forward guidance following the November rate cuts.

The Eurosystem also continued to implement non-standard monetary policy measures. In November the ECB decided to continue conducting its MROs as fixed rate tender procedures with full allotment at least until July 2015. This procedure would also remain in use for the Eurosystem's special-term refinancing operations until the end of the second quarter of 2015.

In July the ECB adjusted its collateral eligibility rules for Eurosystem monetary operations. Meanwhile, in September the ECB and the Bank of England agreed to extend their liquidity swap arrangement up to September 2014. In October a bilateral currency swap arrangement was signed with the People's Bank of China. Furthermore, the ECB announced that existing temporary bilateral liquidity swap arrangements with five major central banks were being converted to standing arrangements.

**Table 1.3**
**EURO AREA MONETARY AGGREGATES**
*Annual percentage changes*

| | 2012 | 2013 | | | |
|---|---|---|---|---|---|
| | Dec. | Mar. | June | Sep. | Dec. |
| **M1** | **6.4** | **7.1** | **7.5** | **6.6** | **5.7** |
| Currency in circulation | 2.3 | 1.9 | 2.1 | 3.1 | 5.3 |
| Overnight deposits | 7.3 | 8.1 | 8.7 | 7.3 | 5.8 |
| **M2-M1 (Other short-term deposits)** | **2.1** | **0.5** | **0.1** | **0.1** | **-1.7** |
| Deposits with an agreed maturity of up to two years | -2.0 | -5.3 | -5.6 | -4.9 | -6.1 |
| Deposits redeemable at notice of up to three months | 5.8 | 5.9 | 5.4 | 4.5 | 2.1 |
| **M2** | **4.5** | **4.1** | **4.3** | **3.8** | **2.5** |
| **M3** | **3.5** | **2.5** | **2.4** | **2.0** | **1.0** |

Source: ECB.

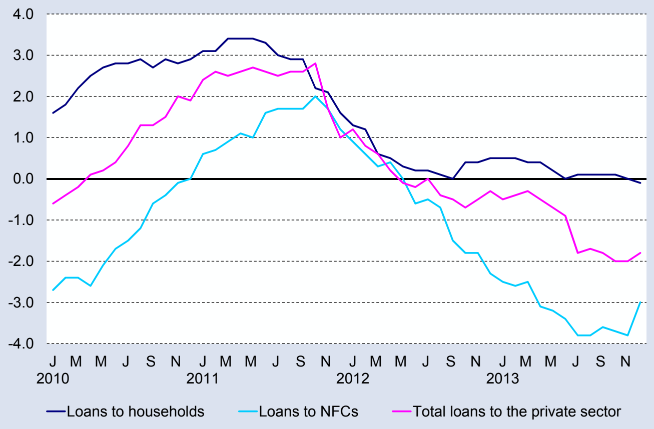
## *Money and credit*

Monetary conditions within the euro area were subdued during 2013, with monetary growth decelerating throughout the year (see Table 1.3). In December the annual growth rate of M3, a measure of broad money, stood at 1.0%, down from 3.5% in December 2012. This slowdown was mostly driven by the illiquid money categories, more specifically marketable instruments and time deposits. Annual growth in M1, a measure of the most liquid forms of money, was robust throughout the year, though it too declined, standing at 5.7% in December. This relatively strong demand for liquidity points to lingering risk aversion in European financial markets, as well as to the small opportunity cost of holding narrow money in an environment of low interest rates.

With regard to counterparts of M3, total credit in the euro area continued to decline, despite the accommodative monetary policy stance. This reflected a persistent drop in private sector credit. The net external assets of euro area monetary financing institutions (MFI), on the other hand, generally rose during the year, reflecting the increased interest of international investors in euro area assets as a result of the easing in financial market tensions since the summer of 2012.

Loans, which account for most of private sector credit, declined throughout the year, with the rate of contraction becoming larger over the course of the year (see Chart 1.10). In December their annual rate of change stood at -1.8% from -0.3% 12 months previously. These developments mainly reflected a strong drop in loans to non-financial corporations (NFC). The annual growth rate of loans to households was generally positive but subdued in 2013, as a moderate expansion in loans for house purchases offset declines in consumer loans and in other lending.

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



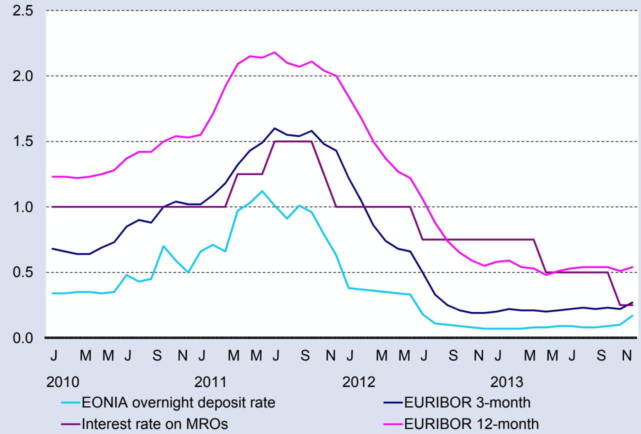

Source: ECB.

The drop in credit flows reflected weak demand dynamics owing to the fragile economic recovery, uncertainty and deleveraging on the part of households and firms. In addition, some larger firms may have bypassed the banking system by issuing debt securities. Supply factors too had a negative impact. Such factors included high credit risk in some euro area economies, a tightening in capital requirements for euro area banks and banks' desire to improve their balance sheet positions ahead of the ECB's Asset Quality Review, which began in November.

### *Money market rates*

In the money markets, the three-month EURIBOR, along with the 12-month EURIBOR and the EONIA overnight deposit rate, were broadly stable at low levels during 2013, albeit increasing marginally at the end of the year. These low levels reflected the accommodative monetary policy stance of the ECB, as well as the introduction of forward guidance in July. Nonetheless, rates failed to follow the ECB's key interest rates downward, with excess liquidity levels declining as banks repaid funds raised from long-term refinancing operations ahead of the ECB's Asset Quality Review, referred to earlier. With money market rates generally stable, the ECB's rate cuts in May and November led to a narrower spread between the ECB's MRO rate and the three-month EURIBOR during 2013 (see Chart 1.11). In December the spread stood at zero, from 56 basis points 12 months before.

**Chart 1.11**
**KEY INTEREST RATES**
*(percentages per annum; monthly averages)*

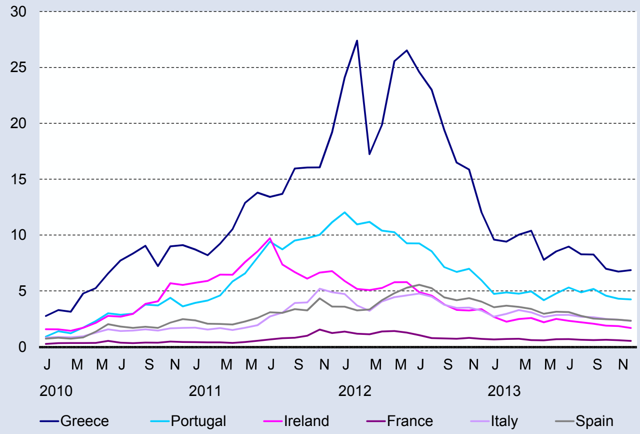



Source: Central Bank of Malta.

### *Government bond spreads*

Within the euro area, spreads between yields on ten-year German bonds and those issued by other sovereigns narrowed further during 2013 (see Chart 1.12). While partly caused by the rise in German yields referred to earlier, these developments also reflected falling bond yields in several stressed economies during the year. The latter occurred on the back of the easing of euro area financial market tensions following the announcement of the ECB's Outright Monetary Transactions programme in the summer of 2012. In addition, the improved economic outlook in some of these countries led to a rise in capital inflows. These factors helped offset temporary spikes in yields owing to several episodes of political uncertainty in these countries during the year.

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




Source: ECB.

### *Euro exchange rate*

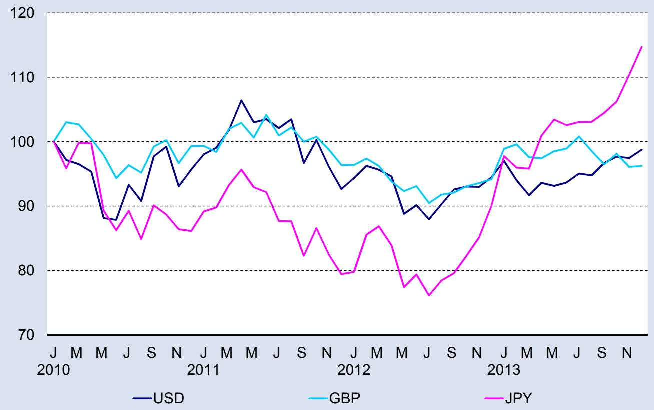
The euro generally appreciated throughout 2013, with the nominal effective exchange rate gaining 4.9% following a slight decline in 2012 (see Chart 1.13). This strengthening generally reflected the improved economic outlook in several euro area economies and tight liquidity conditions in money markets. The euro was also buoyed by receding concern about the redenomination risk that had influenced foreign exchange markets in 2012. These factors offset the downward impact of continued accommodative monetary policy measures by the ECB.

**Chart 1.13**
**EURO NOMINAL EFFECTIVE EXCHANGE RATE**
*(index of daily effective exchange rate; Q1 1999=100)*


Source: ECB.

On a bilateral basis, the euro strengthened against both the US dollar and the Japanese yen during 2013 (see Chart 1.14). The former weakened against the common currency amid lingering uncertainty over the Federal Reserve's monetary stimulus policies, as well as political tensions over the fiscal sequester in March and the government shutdown in October. Meanwhile, the Japanese yen depreciated strongly against the euro throughout the year, reflecting the strong stimulus measures taken by the fiscal and monetary authorities in Japan.

**Chart 1.14**
**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.

Against the pound sterling, the euro appreciated overall during 2013, though the gain was strongest at the start of the year. As the year wore on, the common currency gradually depreciated against the pound, mainly reflecting the relatively strong economic performance in the United Kingdom and increased expectations that the Bank of England would tighten its monetary policy relatively soon.

## 2. MONETARY AND FINANCIAL DEVELOPMENTS

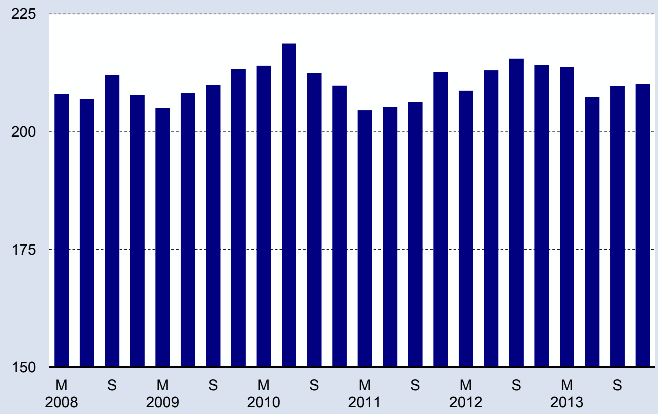
The total assets of core domestic banks in Malta declined slightly during 2013. Deposits remained the main source of funding, with balances belonging to residents of Malta growing more rapidly when compared with the previous year. Similarly, credit granted to residents picked up, as higher credit to general government offset lower borrowing by the corporate sector.

Domestic primary money market yields fell during 2013, mirroring reductions in key policy rates. Meanwhile, yields on five-year and ten-year Maltese government bonds fell, whereas those on the corresponding euro area government securities rose. Consequently, spreads over euro area benchmarks for both five-year and ten-year government securities narrowed over the year. The Malta Stock Exchange (MSE) share index rose strongly during most of 2013.

### Core domestic banks' total assets

The total assets belonging to the domestically relevant banking system dipped from 214% of gross domestic product (GDP) at end-December 2012 to 210% at end-December 2013 (see Chart 2.1).[1,2]

Chart 2.1
**TOTAL ASSETS/LIABILITIES OF CORE DOMESTIC BANKS**
*(% of GDP; GDP data are four-quarter moving sums)*



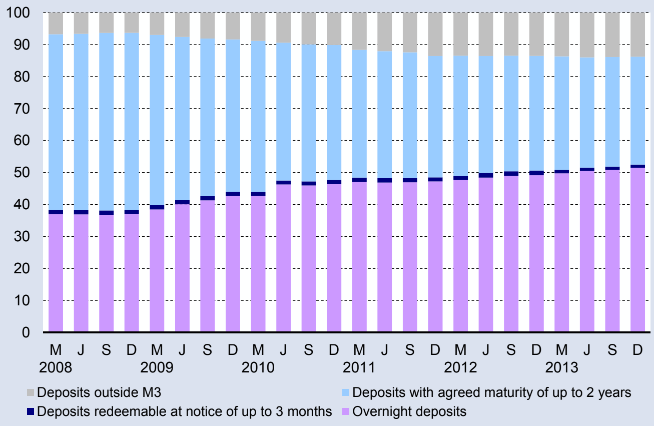

Sources: Central Bank of Malta; NSO.

### Residents' deposits

During 2013 the rate of growth of total residents' deposits gained considerable momentum. Overall, annual growth in total residents' deposits accelerated during 2013, rising to 9.1% in December from 5.6% a year earlier.

As in previous years, during 2013 deposits belonging to Maltese residents and held with resident credit institutions were composed mostly of overnight deposits and time deposits with agreed maturity of up to two years (see Chart 2.2). While the former's share in total deposits continued to strengthen during 2013, the latter again lost ground.

Chart 2.2
**DISTRIBUTION OF TOTAL RESIDENTS' DEPOSITS[(1)]**
*(percentage points)*




[(1)] Deposits outside M3 exclude deposits belonging to central government.
Source: Central Bank of Malta.

Overnight deposits continued to expand rapidly, rising by 14.3% in 2013 up from 10.0% in 2012 (see Table 2.1). As in previous years, balances belonging to households and non-financial corporations (NFC) were the main factor driving growth in such deposits. Households' overnight balances grew by 12.0% during the period reviewed,

[1] The domestically relevant banks, or "core" domestic banks, are APS Bank Ltd, Banif Bank (Malta) plc, Bank of Valletta plc, HSBC Bank Malta plc, and Lombard Bank Malta plc.
[2] GDP statistics are sourced from NSO *News Release* 047/2014 issued on 11 March 2014.

**Table 2.1**
**DEPOSITS OF MALTESE RESIDENTS**
*Annual percentage changes; EUR millions*

| | 2011 Dec. | 2012 Dec. | 2013 Dec. | 2013 Amount outstanding | 2013 Absolute change |
|---|---|---|---|---|---|
| **Overnight deposits** | **8.7** | **10.0** | **14.3** | **5,771.0** | **723.3** |
| *of which* | | | | | |
| Households | 6.1 | 10.2 | 12.0 | 3,610.0 | 388.2 |
| Non-financial corporations | 15.2 | 5.5 | 22.0 | 1,814.5 | 327.2 |
| **Deposits redeemable at notice up to 3 months** | **-0.8** | **23.8** | **-25.5** | **113.0** | **-38.7** |
| *of which* | | | | | |
| Households | 0.3 | -5.3 | -2.1 | 96.0 | -2.1 |
| Non-financial corporations | 2.2 | 187.0 | -70.3 | 15.8 | -37.3 |
| **Deposits with agreed maturity up to 2 years** | **-4.0** | **-0.3** | **2.7** | **3,782.5** | **99.5** |
| *of which* | | | | | |
| Households | -7.9 | 1.2 | 2.2 | 3,057.0 | 65.7 |
| Non-financial corporations | 7.7 | -5.2 | -5.6 | 405.3 | -24.2 |
| **Deposits with agreed maturity above 2 years** | **42.9** | **5.5** | **11.0** | **1,544.5** | **152.7** |
| *of which* | | | | | |
| Households | 45.1 | 5.0 | 10.2 | 1,459.2 | 135.5 |
| Non-financial corporations | -0.4 | 18.3 | 21.6 | 65.7 | 11.7 |
| **Total residents' deposits[1]** | **6.6** | **5.6** | **9.1** | **11,211.0** | **936.9** |

[1] Total residents' deposits exclude deposits belonging to Central Government.

Source: Central Bank of Malta.

up from 10.2% a year earlier. This persistently strong preference of households for liquid monetary assets may stem from the reduced opportunity cost of investing in such assets, given the low interest rates on alternative deposits in recent years. Meanwhile, the annual growth rate of overnight NFC deposits reached double-digit levels, rising to 22.0% in 2013 from 5.5% in 2012, as firms too appear to be building up liquid balances.

At the same time, the annual growth rate of deposits with an agreed maturity of up to two years turned positive, with these deposits expanding by 2.7% during 2013 following a contraction of 0.3% in 2012. Increases in deposits held by households and insurance companies offset a reduction in balances belonging to NFCs.

In contrast, deposits redeemable at notice up to three months contracted at double-digit rates during the year, following a strong increase in 2012. The fall was driven predominantly by lower balances belonging to private NFCs. In absolute terms, these deposits are relatively small when compared with other types of deposits and movements are generally quite volatile.

Deposits with maturities above two years, which are excluded from broad money (M3), have steadily gained popularity in recent years, with their share in total deposits rising from 7.0% in January 2008 to 13.8% in December 2013 (see Chart 2.2). These longer-term deposits have been popular with households in search of higher returns on their investments. Numerous schemes launched by banks during the past few years have augmented the shift towards such deposits, which went up by 11.0% in 2013 following a 5.5% rise in the previous year.

### Interest rates on residents' deposits

The weighted average interest rate paid by monetary financial institutions (MFI) on all deposits belonging to households and NFCs resident in Malta edged down marginally to 1.41% in December 2013 from 1.42% one

**Table 2.2**
**INTEREST RATES ON OUTSTANDING DEPOSITS BELONGING TO RESIDENTS OF MALTA**(1)

*Percentages per annum; weighted average rates as at end of period*

| | 2011 Dec. | 2012 Dec. | 2013 Dec. |
|---|---|---|---|
| **Total deposits belonging to households and non-financial corporations** | **1.41** | **1.42** | **1.41** |
| **Overnight deposits** | | | |
| Households | 0.31 | 0.32 | 0.35 |
| Non-financial corporations | 0.30 | 0.28 | 0.30 |
| **Time deposits with agreed maturity up to 2 years** | | | |
| Households | 2.05 | 2.07 | 2.07 |
| Non-financial corporations | 2.00 | 1.99 | 1.91 |
| **Time deposits with agreed maturity over 2 years** | | | |
| Households | 3.21 | 3.42 | 3.55 |
| Non-financial corporations | 3.13 | 3.06 | 3.12 |

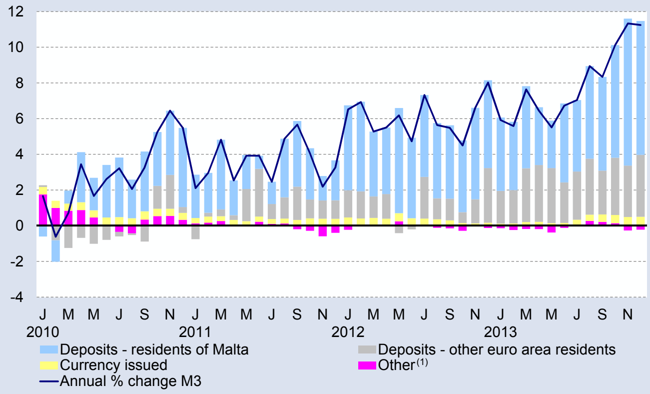
(1) Annualised agreed rates on euro-denominated deposits.
Source: Central Bank of Malta.

year previously (see Table 2.2).[3] Rates received by households on overnight deposits rose by 3 basis points to 0.35%, while those earned by NFCs edged up by 2 points to 0.30%. In contrast, rates on time deposits with an agreed maturity of up to two years remained unchanged for households but dropped moderately to 1.91% for NFCs. Meanwhile, there was a rise in rates offered on time deposits with an agreed maturity above two years.

## Contribution to euro area M3

Deposits belonging to residents of Malta were the main driving force behind growth in the contribution of Maltese MFIs to euro area M3. The latter extended its recent upward trend, rising by 11.2% during 2013 from 8.0% in 2012. Deposits held by euro area residents also played a significant role, whereas the contributions from currency issuance and other monetary liabilities were small (see Chart 2.3).[4]

**Chart 2.3**
**CONTRIBUTIONS OF RESIDENT MFIs TO EURO AREA MONETARY AGGREGATES**
*(percentage points; annual percentage change)*




(1) The "other" category consists of loans granted to resident MFIs, repurchase agreements, money market fund shares/units and debt securities with a maturity of up to and including two years issued by MFIs.
Source: Central Bank of Malta.

## Credit to residents

Credit to Maltese residents has been growing at a slower rate since mid-2009 after the onset of the global financial crisis. During 2013, however, credit to residents grew at a faster

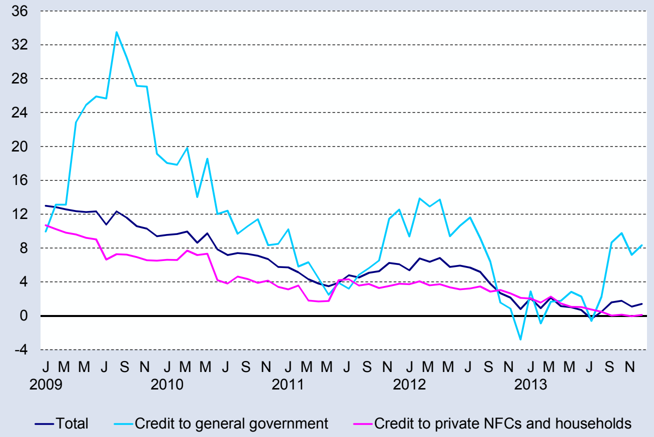
[3] Data on interest rates on outstanding amounts shown in Table 2.2 cover MFI euro-denominated deposits belonging to households and NFCs resident in Malta. The household sector also includes Non-Profit Institutions Serving Households (NPISH). NFCs include all enterprises except banks, insurance companies and other financial institutions. Hence, these statistics do not cover all economic sectors.

[4] The 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 having terms to maturity of up to two years, as well as other monetary liabilities of Maltese MFIs towards euro area residents. Monetary statistics cover all MFIs resident in Malta.

pace, rising by 1.4% following 0.8% growth in 2012 (see Chart 2.4). Faster growth in credit to general government offset a small fall in credit granted to the remaining sectors. Credit growth in Malta continues to exceed the corresponding rate in the euro area.

Credit granted to general government increased during 2013, as banks expanded their Treasury bill and Malta Government Stock (MGS) portfolios, particularly towards the end of the year. Consequently, the annual growth rate of credit to the general government accelerated to 8.3% in December from -2.8% a year earlier.

**Chart 2.4**
**CREDIT TO RESIDENTS OF MALTA**
*(annual percentage changes)*




Source: Central Bank of Malta.

During the year reviewed, credit to residents other than general government contracted by 0.4% following a 1.8% increase during 2012. The decline reflected slower growth in credit to private households and NFCs, as shown in Chart 2.4, and especially a drop in loans granted to private NFCs. At the same time, loans to non-bank financial intermediaries also declined.

### *Bank lending to private NFCs*

Bank lending to private NFCs declined at a much faster pace during 2013, falling by 4.9% after a drop of 0.7% in 2012 (see Table 2.3). Apart from subdued domestic private investment, this could also be an indication of continuing tightness in credit standards.

The reduction in loans to private sector NFCs was broad-based, but stemmed mainly from reduced borrowing by firms in the construction and wholesale & retail trade sectors. Indeed, for the first time since the onset of the financial crisis, loans to private NFCs in Malta during the second half of 2013 contracted at a faster annual pace than in the euro area as a whole.

Lending to small and medium-sized enterprises (SME), which are normally more dependent on bank financing than larger firms, declined by 3.1% following an increase of 5.6% in 2012. Still, SMEs fared somewhat better than larger NFCs during the year, with lending to SMEs contracting at a smaller annual

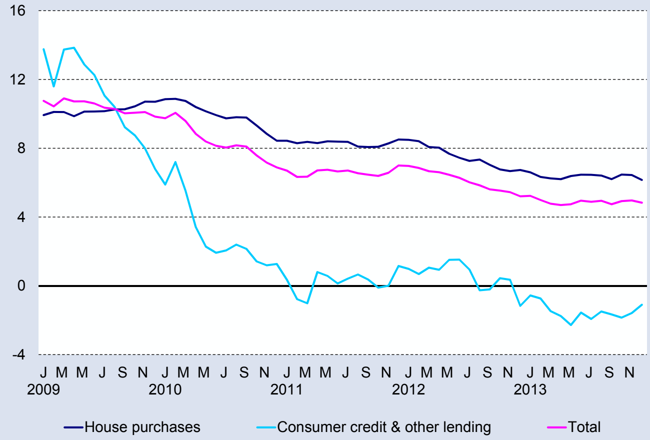
**Table 2.3**
**SECTORAL CONTRIBUTIONS TO GROWTH IN LOANS TO PRIVATE NFCs**
*Percentage points; annual percentage changes*

| | All private NFCs | | SMEs | |
|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 |
| | Dec. | Dec. | Dec. | Dec. |
| Accommodation and food service activities | 0.2 | -0.2 | 0.1 | 0.3 |
| Construction | -1.8 | -3.4 | -0.1 | -4.5 |
| Manufacturing | 0.7 | -0.3 | 0.5 | 1.1 |
| Real estate activities | 0.1 | 0.6 | 3.1 | -0.6 |
| Transportation and storage | -0.4 | -0.4 | 0.0 | -0.9 |
| Wholesale and retail trade | -0.5 | -1.2 | 0.3 | -1.5 |
| Other | 0.9 | 0.1 | 1.7 | 3.0 |
| **Total** | **-0.7** | **-4.9** | **5.6** | **-3.1** |

Source: Central Bank of Malta.

pace than credit to larger borrowers. Declines in borrowing were most evident in construction and in the wholesale & retail trade. Loans to SMEs, which have been facilitated by targeted EU loan guarantee programmes, comprised more than three-fourths of those granted to all private NFCs resident in Malta during 2013.[5]

Chart 2.5
LOANS TO HOUSEHOLDS
*(annual percentage changes)*




Source: Central Bank of Malta.

### *Bank lending to households*

Bank lending to households, which is the other major component of credit to the private sector, grew at a slower pace during 2013, with the annual growth rate falling to 4.8% from 5.2% in 2012 (see Chart 2.5). Growth in lending for house purchases dipped by 0.5 percentage point to 6.2% during the year. In contrast, consumer loans – which include the use of credit cards and overdraft facilities, together with certain other types of lending – contracted further, albeit at a slightly slower pace, falling by 1.1% during 2013 as opposed to a drop of 1.2% in 2012. In comparison, growth in lending to households within the euro area was flat during the year to December 2013.

## Interest rates on loans to Maltese residents

The weighted average interest rate charged by MFIs on outstanding loans to resident households and NFCs fell further during 2013, ending the year at 4.26% from 4.32% in December 2012. Rates paid by households on mortgages fell by 5 basis points to 3.35%, while rates charged to households on consumer credit & other lending dropped by 4 points to 5.55% (see Table 2.4).[6] Rates on loans to NFCs edged down by a mere basis point to 4.72%. These modest declines in bank lending rates, at a time of substantial reductions in official interest rates, indicate that the pass-through remains incomplete.

**Table 2.4**
**MFI INTEREST RATES ON OUTSTANDING LOANS TO MALTESE RESIDENTS[(1)]**
*Percentages per annum; weighted average rates as at end of period*

| | 2011 Dec. | 2012 Dec. | 2013 Dec. |
|---|---|---|---|
| **Total loans to households and non-financial corporations** | **4.44** | **4.32** | **4.26** |
| Households and NPISH | | | |
| Lending for house purchases | 3.43 | 3.40 | 3.35 |
| Consumer credit and other lending[(2)] | 5.66 | 5.59 | 5.55 |
| Non-financial corporations[(2)] | 4.85 | 4.73 | 4.72 |

(1) Annualised agreed rates on euro-denominated loans to households and NFCs.
(2) Includes bank overdrafts.
Source: Central Bank of Malta.

5 SMEs are those companies which employ fewer than 250 employees and have a turnover not exceeding €50 million and/or an annual balance sheet total not exceeding €43 million.

6 Data on interest rates on outstanding amounts shown in Table 2.4 cover MFI euro-denominated loans granted to households and NFCs resident in Malta. These statistics do not cover all sectors of the economy.

### Credit standards

Credit market conditions continued to be monitored by the Bank Lending Survey (BLS) throughout 2013.[7] Survey results revealed that, after having been tightened in 2012, credit standards applied on lending to enterprises and households remained unchanged during 2013. Banks also reported that demand for loans by firms remained unchanged during most of the year, with slight declines being recorded during the second quarter. With regard to households, demand for home purchase loans increased slightly during three of the quarters surveyed. In contrast, demand for loans for consumption purposes remained unchanged during 2013, with the exception of the first quarter, when one of the four respondent banks recorded a slight decline.

### Credit granted to euro area residents outside Malta

Credit granted by resident MFIs to residents of euro area countries except Malta continued to decline, falling by €1.3 billion, or 28.7% in 2013, a stronger drop than the 10.8% fall recorded during 2012. This reflected reduced lending to non-bank financial intermediaries and private NFCs. Additionally, lower resident bank holdings of securities issued by financial vehicle corporations residing in other euro area countries contributed. Internationally-oriented banks accounted for most of the drop.

### Net claims on non-residents of the euro area

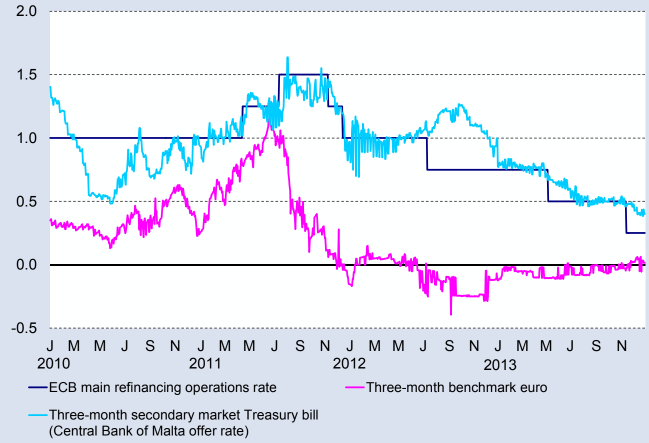
During 2013 resident MFIs' net claims on non-residents of the euro area contracted by €536.1 million, or 5.3% (see Table 2.5). This followed an increase of €2.3 billion in 2012.

Gross claims on non-residents of the euro area fell by 3.6% over the year, as reduced lending to private NFCs and non-bank financial intermediaries was only partly offset by higher deposits held by resident banks with non-euro area credit institutions. At the same time, liabilities contracted by 2.6%, as a drop in foreign loans taken up by resident banks, along with a reduction in time deposits held with them, outweighed an increase in repurchase agreements.

### The money market

During 2013 the European Central Bank cut the interest rate on its main refinancing operations (MRO) twice, in May and November, by a total of 50 basis points. As a result, the MRO rate was lowered to 0.25% by the end of the year (see Chart 2.6). The

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




Sources: Central Bank of Malta; ECB; Reuters.

**Table 2.5**
**NET CLAIMS ON NON-RESIDENTS OF THE EURO AREA**
*EUR millions; changes on a year earlier*

| | 2012 Dec. | 2013 Dec. | Amount | % |
|---|---|---|---|---|
| **Net claims on non-residents of the euro area[(1)]** | **10,103.2** | **9,567.1** | **-536.1** | **-5.3** |
| Claims on non-residents of the euro area | 32,576.8 | 31,390.4 | -1,186.4 | -3.6 |
| Liabilities to non-residents of the euro area | 22,473.6 | 21,898.5 | -575.1 | -2.6 |

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.

primary market yield on Maltese three-month Treasury bills mirrored the movements in the MRO rate and declined for most of the year. The yield ended 2013 at 0.39%, 47 basis points lower than a year earlier.

Money market activity in Malta was dominated by trading in Treasury bills. During 2013 €1.1 billion worth of Treasury bills were issued by the Government, €276.6 million more than in the previous year. Three-month bills accounted for more than half of the amount issued, while the remainder mainly consisted of six-month bills. Resident banks continued to participate actively in the primary market and bought more than 85% of the total, the highest proportion in recent years, with money market funds buying most of the remainder.

Despite the increase in primary market activity during the year, turnover in the secondary market for Treasury bills amounted to €9.3 million, significantly less than the €38.5 million in the previous year. All transactions involved the Central Bank of Malta in its capacity as market-maker.

Secondary market yields on domestic three-month bills followed developments in the primary market and declined steadily during the year. The yield ended December at 0.40%, 60 basis points lower than at end-2012 (see Chart 2.6). On the other hand, the three-month benchmark euro area yield rose by 14 basis points on the previous year and returned to positive territory.[8] Consequently, the spread between the two narrowed by 74 basis points to 39 basis points by the end of 2013.

## The capital market

### *The bond market*

Net issues of long-term debt securities on the domestic primary market during 2013 amounted to €209.8 million, down from €348.5 million in the previous year (see Table 2.6).

**Table 2.6**
**ISSUES OF LONG-TERM DEBT SECURITIES[(1)]**
*EUR millions [(2)]*

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| **Government** | | | |
| Total issues[(3)] | 727.7 | 792.4 | 777.1 |
| Redemptions[(4)] | 288.1 | 495.8 | 520.1 |
| Net issues | 439.6 | 296.6 | 257.0 |
| **Corporate sector** | | | |
| Total issues | 60.4 | 80.0 | 58.0 |
| Redemptions[(5)] | 4.4 | 28.1 | 105.2 |
| Net issues | 56.0 | 51.9 | -47.2 |
| **Total net issues** | **495.6** | **348.5** | **209.8** |

(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) Amounts denominated in foreign currency are converted to euro according to the exchange rate prevailing on the day of transactions.
(3) Data exclude MGS that were issued directly to the Foundation for Church Schools. These amounted to €3.3 million in 2011, €1.3 million in 2012 and €2.4 million in 2013. Data include the creation of MGS as part of the MGS Switch Auction Programme. These include €158.1 million 4.30% MGS 2016 (IV) in 2011 and €20.2 million 3.75% MGS 2017 (IV) and €121.4 million 3.85% MGS 2018 (V) in 2012. For 2013 data include €83.7 million 3.20% MGS 2019 (V) and €64.0 million 3.35% MGS 2020.
(4) Redemptions include debt securities bought back by the issuer but exclude the redemption of MGS that were issued directly to the Foundation for Church Schools. Data include the cancellation of €159.9 million 5.7% MGS 2012 (III) issue, €146.5 million 3.6% MGS 2013 (IV) and €150.0 million 5.1% MGS 2014 (III) for 2011,2012 and 2013, respectively, as part of the MGS Switch Auction Programme.
(5) Redemptions include debt securities bought back by the issuer.
Sources: Central Bank of Malta; MSE; Treasury.

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

On a net basis, issues of long-term government debt decreased by €39.6 million to €257.0 million. This reflected a combination of reduced gross issues and a rise in redemptions. Total gross issues of long-term government debt, including debt issued for the purpose of converting bonds maturing in 2014 into longer-dated securities, amounted to €777.1 million, €15.3 million less than in the previous year.

New government bond issues took place in March, June, September, November and December. These had terms to maturity varying between five years and 19 years and were mostly oversubscribed. Retail investors, mainly resident households and nominees, bought just over half the amount issued at a fixed price. The remainder was auctioned, primarily to resident credit institutions and collective investment schemes.

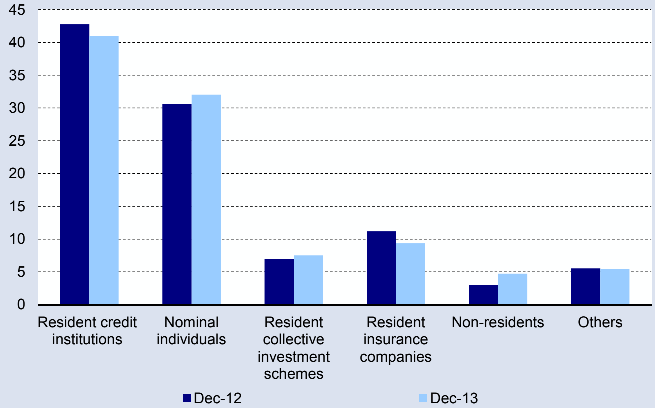
In December the Government concluded a three-year MGS switch auction programme that had been launched in 2011, aimed at lengthening and smoothing the interest payments and redemptions of existing MGS. Around one-third of the MGS maturing in 2014 was converted into an €83.7 million MGS issue maturing in 2019, and a further €64.0 million MGS issue maturing in 2020. Once again, the programme attracted strong demand from investors.

The share of outstanding MGS held by individuals increased during the year. This may partly reflect the relatively low rates of interest on banks deposits and lack of alternative domestic capital market investments. On the other hand, the share held by resident credit institutions declined in 2013 (see Chart 2.7).

Following increased activity in the primary market, turnover in the secondary government bond market grew by 20%, reaching €679.0 million in 2013. The Central Bank of Malta, acting as market-maker, accounted for more than four-fifths of the value traded.

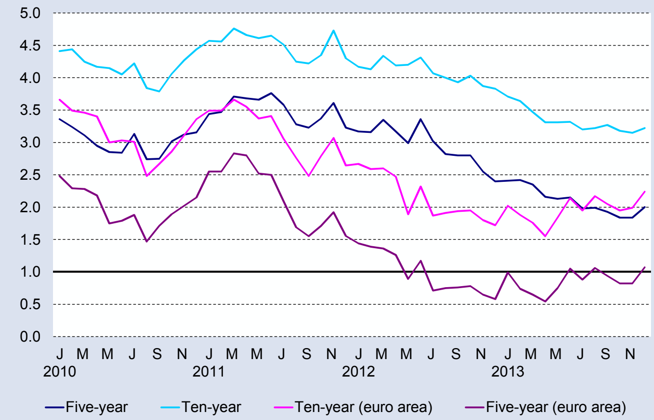
Movements in domestic government bond yields broadly mirrored developments in benchmark euro area yields in the first quarter of 2013.[9] Subsequently, however, benchmark euro area yields started to rise, whereas domestic yields continued on their downward path, extending the decline seen since 2011 (see Chart 2.8). Therefore, spreads on domestic government bonds tightened, in the context of a general narrowing of spreads across the euro area.

**Chart 2.7**
**OUTSTANDING MGS BY INVESTOR BASE[(1)]**
*(percentages)*




(1) Incorporates both fixed-rate and floating-rate MGS.
Sources: Central Bank of Malta; MSE.

**Chart 2.8**
**GOVERNMENT BOND YIELDS**
*(percentages per annum; end of month)*




Sources: Central Bank of Malta; ECB.

9 Benchmark euro area yields are based on AAA-rated central government bonds.

During 2013 the yield on five-year domestic government securities fell by 40 basis points to 2.00%. On the other hand, the corresponding benchmark euro area government bond yield rose by 49 basis points and closed the year at 1.07%. As a result, the spread on five-year debt narrowed by 89 basis points to 0.93% from end-2012 to end-2013.

Ten-year domestic government bond yields fell by 61 basis points during 2013, reaching 3.22% in December. Conversely, the benchmark ten-year yield in the euro area rose by 52 basis points, ending the year at 2.24%. Consequently, the ten-year sovereign spread narrowed by 113 basis points to 0.98%, the lowest level since mid-2010.

Turning to the corporate sector, the value of corporate debt securities issued on the primary market amounted to €58.0 million, the lowest level since 2006. Four new issues took place following the change in listing policies that came into effect on 5 March 2013.[10] All were well received by the public and were oversubscribed.

Following weak issuance on the primary market, activity in the secondary market for corporate bonds fell by €13.6 million, or around 30% to €33.4 million. Around 70% of the trading was concentrated in around 15 bonds, mostly issued by the banking and construction sectors.

### *The equity market*

During 2013 one new firm was listed on the MSE after an initial public offering on the equity market. Tignè Mall plc was listed following the issuance of 56.4 million ordinary shares with a nominal value of €0.50 each offered through an initial public offering in May.

In the secondary equity market, turnover surged to €53.1 million during 2013, almost 60% higher than the previous year, and the highest amount since 2007. In line with trends abroad and in view of the relatively low-yielding bank deposits and fixed income securities, investors' preferences may have continued to shift towards equities. Higher turnover mirrored a rise in the number of shares traded, as well as a general increase in share prices.

The MSE Index, which had reached a trough at the beginning of 2012, continued to recover during 2013. The majority of the companies listed on the MSE saw a higher share price during the year with 12 firms, notably in the IT sector, registering double-digit growth. Consequently, the MSE Index rose strongly during most of 2013 and closed the year at 3,685.8, 14.8% higher than at end-2012 (see Chart 2.9).

**Chart 2.9**
**MALTA STOCK EXCHANGE SHARE INDEX**
*(end of month)*


Source: MSE.

[10] The new listing policies, revised by Malta Financial Services Authority, eased the requirements for firms to set up a sinking fund, notably when the bond is secured by easily realisable assets.

## 3. OUTPUT, EMPLOYMENT AND PRICES[1]

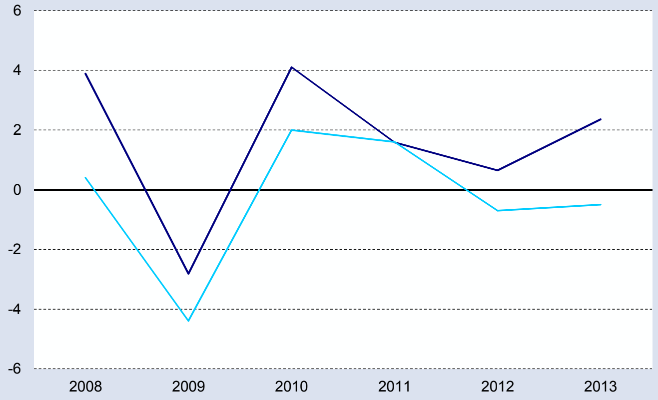
The Maltese economy grew at a faster pace in 2013, compared with the previous year. Domestic demand recovered and was the main driver behind economic growth as private consumption increased and changes in inventories turned positive. Conversely, net exports dampened economic growth, following six years of positive contributions.

In terms of gross value added (GVA), services continued to provide the major contribution to growth in nominal terms. In absolute terms, the largest increases over 2012 were recorded in sectors comprising mining & utilities, public administration & defence, and professional & scientific activities.

### Gross domestic product

Real gross domestic product (GDP) growth accelerated to 2.4% during 2013, from 0.6% in the previous year and 1.6% in 2011. Output grew in every quarter of the year on an annual basis, with the fastest growth registered in the second quarter. Subsequently, growth moderated, reaching 2.2% in the final quarter.

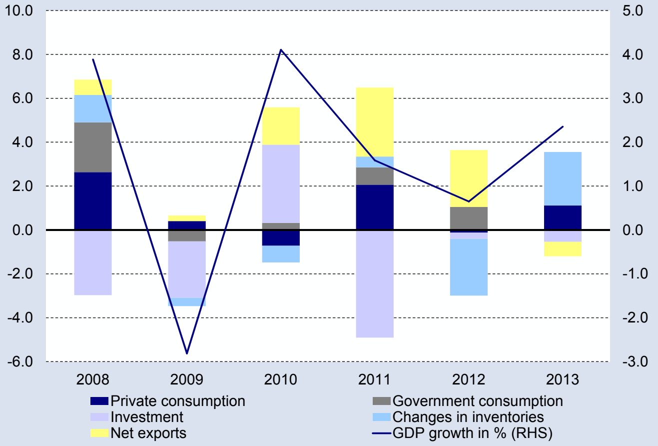
**Chart 3.1**
**REAL GDP GROWTH**
*(annual percentage change)*




Sources: NSO; Eurostat.

Developments in the Maltese economy generally followed a similar path to those in the euro area up to 2011. In the last two years, however, GDP growth rates diverged, with economic expansion in Malta contrasting with falling real GDP in the euro area (see Chart 3.1).

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




Source: NSO.

Domestic demand recovered in 2013, boosting economic growth by 3.0 percentage points. This was due to higher private consumption and positive changes in the inventories item (which also includes a statistical discrepancy), and which outweighed falls in investment and government consumption (see Chart 3.2 and Table 3.1).[2] In contrast, although they remained positive for the third consecutive year, net exports fell during 2013. Consequently, their share of GDP declined to 3.8% from 4.6% in 2012. The drop in net exports lowered real GDP growth by 0.7 percentage point.

[1] The cut-off date for data on GDP-related variables included in this Chapter, including unit labour costs, is 11 March 2014.

[2] The figure for inventories also includes acquisitions less disposals of valuables, as well as statistical discrepancies. The National Statistics Office (NSO) estimates GDP using the production approach. The expenditure approach is then reconciled with the production approach, with any resulting statistical discrepancies being allocated to changes in inventories.

**Table 3.1**
**GROSS DOMESTIC PRODUCT AT CONSTANT PRICES**

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| | | | *Annual percentage changes* | | |
| Private final consumption expenditure | 0.6 | -1.1 | 3.3 | -0.2 | 1.8 |
| Government final consumption expenditure | -2.7 | 1.7 | 4.2 | 5.4 | -0.2 |
| Gross fixed capital formation | -14.2 | 22.2 | -26.1 | -2.0 | -3.8 |
| Changes in inventories (% of GDP) | 1.3 | 0.6 | 1.0 | -1.5 | 0.9 |
| **Domestic demand** | **-3.0** | **2.3** | **-1.5** | **-2.0** | **3.2** |
| Exports of goods & services | -8.4 | 15.7 | 4.8 | 8.6 | -5.6 |
| Imports of goods & services | -8.4 | 13.3 | 1.6 | 6.2 | -5.2 |
| **Gross domestic product** | **-2.8** | **4.1** | **1.6** | **0.6** | **2.4** |
| | | | *Percentage point contributions* | | |
| Private final consumption expenditure | 0.4 | -0.7 | 2.1 | -0.1 | 1.1 |
| Government final consumption expenditure | -0.5 | 0.3 | 0.8 | 1.0 | 0.0 |
| Gross fixed capital formation | -2.6 | 3.6 | -4.9 | -0.3 | -0.5 |
| Changes in inventories | -0.4 | -0.8 | 0.5 | -2.6 | 2.4 |
| **Domestic demand** | **-3.1** | **2.4** | **-1.6** | **-1.9** | **3.0** |
| Exports of goods & services | -7.9 | 13.8 | 4.7 | 8.7 | -6.1 |
| Imports of goods & services | 8.1 | -12.1 | -1.6 | -6.1 | 5.5 |
| **Net exports** | **0.3** | **1.7** | **3.1** | **2.6** | **-0.7** |
| **Gross domestic product** | **-2.8** | **4.1** | **1.6** | **0.6** | **2.4** |

Source: NSO.

### *Domestic demand*

Private consumption recovered strongly following a drop of 0.2% in 2012, rising by 1.8% in the year under review and pushing GDP growth by 1.1 percentage points. On an annual basis, private consumption increased throughout the year. Consumption growth was supported by higher employee compensation and by an increase in real disposable income, which, according to the Central Bank of Malta's estimates, rose by 3.8%.

Economic uncertainty in 2012, especially owing to the sovereign debt crisis in the euro area, may have led to a postponement of consumption into the year under review. During 2013 consumption was supported by higher spending on transport, as evidenced by data on new vehicle registrations, which showed a rise. Expenditure on motor vehicles was, in fact, boosted by incentives, which came into effect in the second quarter of 2013, related to the purchase of motor vehicles.

Government real consumption decreased by 0.2% after accelerating by 5.4% in 2012. Its negative effect on real GDP growth was minimal. In nominal terms government consumption increased, driven by growth in employee compensation. This was partly offset by lower intermediate consumption and higher sales of output, which are netted from government consumption in the national accounts.

Gross fixed capital formation (GFCF) continued to decline in 2013. It dropped by 3.8% following a decrease of 2.0% in 2012. The drop in GFCF lowered real GDP growth by half a percentage point. Despite continued investment on large projects, such as the Valletta City Gate, investment spending in real terms fell in the construction sector mainly owing to negative developments in non-residential construction. Investment spending on transport equipment also contracted. On the other hand, investment in machinery increased under the impact of major infrastructural projects, while the category comprising IT-related products also rose.

In nominal terms, investment rose slightly. Available information shows that private sector investment spending increased, primarily on machinery and IT-related products, while falling on construction and transport equipment. Government investment declined, reflecting lower expenditure on all major categories, except machinery.

Changes in inventories, which are influenced by the statistical discrepancy, turned positive during 2013. They were equivalent to 0.9% of GDP as against -1.5% in 2012. As a result, changes in inventories boosted real GDP growth by 2.4 percentage points. Unfortunately, it is difficult to interpret the economic significance of this item since the statistical discrepancy is not separated from changes in inventories.

### *Net exports*

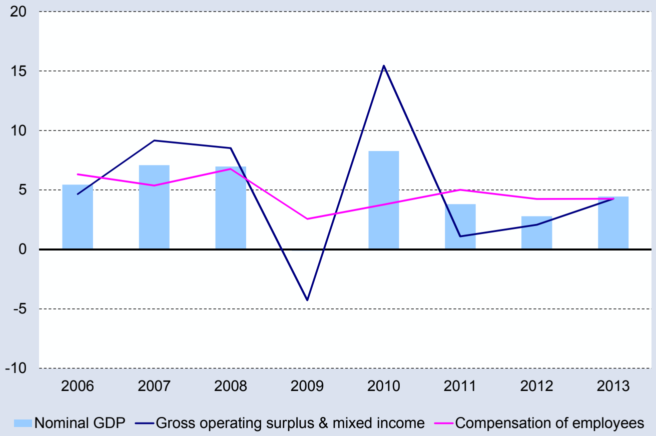
Exports of goods and services fell by 5.6% in 2013 after having risen by 8.6% in 2012. The decline in exports in absolute terms was mostly due to goods, which were 8.6% lower in 2013 following very strong growth in the previous year. Export of services also decreased, albeit at a decelerating pace, shedding 0.4%. Movements in nominal exports mirrored those in real exports. Customs data show that exports of goods decreased across all categories, except food and chemicals. The largest declines in absolute terms, compared with 2012, were in re-exports of oil and exports of machinery & transport equipment, which include semiconductors.

The subdued performance of exports and investment had a stronger impact on imports of goods and services than the recovery in private consumption. Imports declined by 5.2% in real terms during 2013, following growth of 6.2% in the previous year. Imports of goods accounted for most of this decline, falling by 7.0%, while imports of services decreased by 2.2%. In contrast, both had risen during 2012. In nominal terms, imports of both goods and services were lower in 2013 compared with the previous year. Customs data indicate that imports of goods declined across all major commodity groups, except machinery & transport equipment, reflecting the purchase of capital equipment for major projects. On the other hand, the biggest drop in imports was in petroleum products, in line with lower re-exports of fuels and efficiency gains in the domestic production of energy.

### *Nominal GDP*

Nominal GDP growth accelerated to 4.4% in 2013 from 2.8% in the previous year. Based on the income approach, growth in compensation of employees was resilient, accelerating slightly from 4.2% in 2012 to 4.3% in the year under review. The rise in compensation was broad-based. The highest gains in absolute terms were in sectors comprising public administration & defence and professional & scientific activities. In contrast, employee compensation in the construction sector fell, in line with the ongoing reduction in employment in this industry. Gross operating surplus & mixed income growth more than doubled during the year, increasing by 4.3% compared with 2.1% in 2012 (see Chart 3.3).[3] In sectorial terms, the largest rise in absolute terms was registered by the sectors encompassing utilities, transport and professional & scientific activities. Conversely, gross operating surplus fell mainly in the manufacturing and wholesale & retail sectors.

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




Source: NSO.

On the output side, GVA grew by 4.3%, up from 3.1% in 2012. GVA contributed 3.8 percentage points to

[3] Mixed income is the remuneration for the work carried out by the owner (or members of his family) of an unincorporated enterprise. It cannot be distinguished from the entrepreneurial profit of the owner.

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

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| Agriculture, forestry & fishing | 0.2 | 0.1 | 0.0 | 0.1 | 0.0 |
| Mining & quarrying; utilities | 0.8 | -0.1 | -1.0 | -0.8 | 1.1 |
| Manufacturing | -2.3 | 1.0 | 0.5 | 0.0 | -0.8 |
| Construction | 0.0 | 0.4 | -0.1 | -0.1 | -0.1 |
| Services | 0.6 | 6.4 | 3.3 | 3.5 | 3.5 |
| *of which:* | | | | | |
| Wholesale & retail trade; repair of motor vehicles; transportation; accomodation & related activities | -1.1 | 1.0 | 0.4 | 1.0 | 0.6 |
| Information & communication | 0.0 | 0.8 | 0.6 | 0.4 | 0.4 |
| Financial & insurance activities | 1.5 | 1.3 | 0.8 | 0.5 | 0.2 |
| Real estate activities | 0.3 | 0.2 | 0.1 | 0.0 | 0.1 |
| Professional, scientific, administrative & related activities | -0.2 | 1.1 | 0.6 | 0.4 | 1.2 |
| Public administration & defence; education; health & related activities | 0.9 | 0.9 | 0.8 | 0.9 | 0.9 |
| Arts, entertainment; household repair & related services | -0.8 | 1.0 | 0.0 | 0.3 | 0.1 |
| **Gross value added** | **-0.7** | **7.8** | **2.7** | **2.7** | **3.8** |
| **Net taxation on products** | **0.6** | **0.5** | **1.1** | **0.1** | **0.7** |
| **Annual nominal GDP growth (%)** | **-0.1** | **8.3** | **3.8** | **2.8** | **4.4** |

Source: NSO.

nominal GDP growth with the remaining 0.7 percentage point attributable to net taxation on products (see Table 3.2).[4]

Services continued to be the main driver behind growth, adding 3.5 percentage points to nominal GDP. In particular, the sectors comprising public administration & defence and professional & scientific activities recorded the largest increases in GVA in absolute terms. As a result, these two sectors in aggregate boosted nominal GDP growth by 2.1 percentage points.

The wholesale & retail, transport and accommodation sectors also made a significant contribution of 0.6 of a percentage point to nominal GDP growth. More specifically, the transport and accommodation sub-sectors pushed up GVA in this sector, reflecting the continued strong performance of the tourism industry, whereas wholesale and retail GVA was lower. Information & communication added a further 0.4 percentage point to GDP growth. Meanwhile, real estate activities and financial & insurance sectors made more moderate contributions of 0.1 and 0.2 of a percentage point, respectively, towards nominal GDP growth.

Turning to direct production, GVA in manufacturing declined by 7.1%, reducing nominal GDP growth by 0.8 percentage point. The construction sector also continued to contribute negatively to economic growth, with GVA in this sector declining for the third consecutive year.

In contrast, GVA in the mining & utilities sector increased substantially during the year under review following large drops in the previous three years. This sector added 1.1 percentage points to nominal GDP growth following more efficient energy production, which also led to lower imports of oil.

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

## Industrial production[5]

Industrial production contracted by 4.2% during 2013, after growing by 6.4% in the previous year (see Table 3.3). Production in manufacturing, which accounts for most of industrial output, decreased by 4.7% after having expanded by 6.7% in 2012. The output of the energy sector also declined in 2013, contracting by 2.0% after having increased by 4.4% in the previous year. Lower energy output is consistent with the general decline in manufacturing activity. On the other hand, production in the mining & quarrying sector continued to grow during 2013, albeit at a slower pace than in 2012.

The overall drop in manufacturing output mainly reflected developments in the production of computer, electronic & optical products, pharmaceuticals and textiles. In the first two sectors, the drop in output reversed most of the gains registered in 2012. In contrast, production of food, wearing apparel and rubber & plastic products picked up, while output in the beverages sector continued to grow, though at a slower pace than in previous years.

In line with the fall in production, data on manufacturing sales point to a contraction in turnover of 2.6% during 2013, following a rise of 6.3% in the previous year.[6] On the basis of these data, exports and domestic sales contracted by 3.1% and 8.3%, respectively.

**Table 3.3**
**INDUSTRIAL PRODUCTION**
*Percentages; annual average percentage changes*

| | Shares | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **Industrial production** | **100.0** | **-0.1** | **6.4** | **-4.2** |
| | | | | |
| **Manufacturing** | **91.4** | **-0.6** | **6.7** | **-4.7** |
| *Of which:* | | | | |
| Computer, electronic & optical products | 18.5 | 1.4 | 12.5 | -10.6 |
| Food products | 10.2 | -0.6 | 4.2 | 11.4 |
| Wearing apparel | 6.5 | 41.7 | 2.4 | 4.6 |
| Rubber & plastic products | 6.2 | 4.7 | -11.8 | 3.3 |
| Basic pharmaceutical products & pharmaceutical preparations | 5.5 | -17.6 | 31.8 | -26.7 |
| Textiles | 5.2 | 2.3 | -7.0 | -22.6 |
| Repair & installation of machinery and equipment | 5.0 | 0.1 | -0.6 | -3.5 |
| Beverages | 4.6 | 6.6 | 4.7 | 1.5 |
| | | | | |
| **Energy** | **8.0** | **2.7** | **4.4** | **-2.0** |
| Electricity, gas, steam & air conditioning supply | 7.4 | 2.6 | 4.6 | -2.3 |
| Water collection, treatment and supply | 0.6 | 3.1 | 4.0 | -1.1 |
| | | | | |
| **Mining and quarrying** | **0.6** | **-1.9** | **26.5** | **2.3** |

Sources: NSO; Eurostat.

[5] Industrial production data are based on samples 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 sectorial coverage between the two measures also differs, since industrial production data also capture the output of the energy sector, as well as mining & quarrying.

[6] Data on industrial sales are taken from Eurostat.

## BOX 1: A NEW MEASURE OF HOUSEHOLD DISPOSABLE INCOME FOR MALTA[1]

Household disposable income is the income available to households for consumption or saving. In other words, it is the income households receive from all sources – such as income deriving from employment, be it in the form of compensation received by employees or income from self-employment; net investment income, that is interest payments and dividends deriving from financial assets, less interest paid; cash payments received through social transfers; and income coming from the rental of property – less the total taxation households pay on the different sources of income. This includes taxes on employment income, such as income taxes paid by households and national insurance contributions paid by employees and the self-employed, taxation on investment income and taxes on rental income.

Disposable income is a key macroeconomic variable, particularly within the context of the Keynesian absolute income hypothesis, which asserts that private consumption is a function of disposable income.[2,3] Economic theory, therefore, suggests that disposable income can explain consumption behaviour, a claim that has been supported by several empirical studies.[4,5] Moreover, a reliable measure of disposable income is central to accurately gauging the household saving rate.[6] The latter has important macroeconomic implications, particularly for the funding of investment spending, which, in turn, is a critical driver of long-term growth. The saving rate also sheds light on how well equipped households are to deal with economic shocks, such as adverse labour market conditions, and their ability to provide themselves with pensions and healthcare rather than depending on the state.

### Existing measures of household disposable income for Malta: a stocktake

Despite its importance, official data on disposable income in Malta with the desired frequency, span and timeliness are unavailable. While the Maltese national accounts do provide data on disposable income up to 1999, thereafter readings for this series are not publicly available.[7] One source for data on disposable income is the Survey on Income and Living Conditions (SILC) published by Malta's NSO. However, this survey is only conducted on an annual basis and is available with a considerable lag. Moreover, the survey is rather recent and data are only available over the 2005-2010 period. Another source is the Household Budgetary Survey (HBS), also issued by

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2 In this article, "household disposable income" and "disposable income" are used interchangeably, as are the terms "household saving rate" and "saving rate".

3 See Keynes, J. M., *The General Theory of Employment, Interest, and Money*, London, Macmillan, 1936.

4 See, for example, Fagan, G. and Morgan, J., "An Overview of the Structural Econometric Models of Euro-Area Central Banks", in Fagan, G. and Morgan, J. (eds.), *Econometric Models of the Euro-Area Central Banks*, Edward Elgar, 2005, pp. 1-49.

5 Other important developments in this field were the life-cycle hypothesis developed by Modigliani and Brumberg and the permanent income hypothesis put forward by Friedman, which suggest that economic agents do not base consumption decisions solely on current income, but rather on expected lifetime resources. See Modigliani, F. and Brumberg, R., "Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data", in Kurihara, K. (ed.), *Post-Keynesian Economics*, New Brunswick, New Jersey, Rutgers University Press, 1954, pp. 388-436, and Friedman, M., *A Theory of the Consumption Function*, Princeton, New Jersey, Princeton University Press, 1957. In fact, empirical studies show that both current income and expected lifetime resources explain private consumption. Again, see Fagan, G. and Morgan, J., "An Overview of the Structural Econometric Models of Euro-Area Central Banks", in Fagan, G. and Morgan, J. (eds.), *Econometric Models of the Euro-Area Central Banks*, Edward Elgar, 2005, pp. 1-49.

6 The household saving rate is household saving expressed as a percentage of household disposable income, where household saving is calculated by deducting private consumption from household disposable income. Saving rates may be measured on a gross or on a net basis. Net saving rates are calculated by subtracting depreciation from saving and from disposable income. The saving rates presented here are all gross saving rates and thus do not take the effect of depreciation into account.

7 A discussion of the saving rate in Malta between 1970 and the late 1990s can be found in Grech, A. G., "The Private and Public Saving Gaps in Malta and their Impact on the Current Account", *Quarterly Review*, 33(1), Central Bank of Malta, 2000, pp. 51-61.

the NSO, which, however, only provides readings for 2000 and 2008, and is also published with a significant lag.

The absence of the necessary disposable income statistics narrows the range of research that can be conducted on the domestic economy. This article proposes a new measure of disposable income for Malta to promote further work in this regard and to broaden the research questions that can be tackled. Indeed, the development of this measure stemmed from the need to construct a consumption function that explains domestic private consumption behaviour within the broader context of building a new macro-econometric model of the Maltese economy.[8] The rest of this article sheds light on the methodology behind this measure and analyses the new data on disposable income and the saving rate that emerge.

### The anatomy of the new measure of household disposable income for Malta

The new measure of disposable income is defined as:

$$ypd = yempnet + selfempinc - taxempinc + socbenc + invinc + imprents$$

where: *ypd* = household disposable income

*yempnet* = compensation of employees net of national insurance contributions paid by employers and imputed government national insurance contributions in respect of its own employees.

*selfempinc* = income of the self-employed

*taxempinc* = taxes on employment income

*socbenc* = social benefits received in cash

*invinc* = investment income

*imprents* = imputed rents

Households, therefore, are assumed to receive three distinct types of income: income from employment, which can take the form of compensation received by employees or income from self-employment, social security cash payments, and income earned from financial assets.[9] Households pay one type of taxation, namely taxes on employment income.

The frequency of the measure is quarterly. It spans from 2000Q1 to 2013Q3 and can be updated regularly as new data become available. It draws from a multitude of data sources and is constructed using data that are largely publicly available. Whenever quarterly data were unavailable, data of a different frequency were converted into quarterly observations. For all data, the latest vintage was used which, in the case of national accounts data, was the 2013Q3 vintage. We now turn to discuss how the individual components of the measure of disposable income were constructed.[10,11,12]

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8 See Grech, O., Micallef, B., Rapa, N., Grech, A. G. and Gatt, W., "A Structural Macro-Econometric Model of the Maltese Economy", *Working Paper* No. 02/2013, Central Bank of Malta.

9 Another item on the receivable side is imputed rents. Although not strictly a form of income, imputed rents should feature as part of disposable income, nonetheless, as shall be explained further on.

10 The methodology employed generally observes international statistical conventions, for example as laid out in European Commission, International Monetary Fund, Organisation for Economic Co-operation and Development, United Nations and World Bank, in *System of National Accounts 2008*, New York, 2009.

11 All data used and presented are in nominal terms.

12 Throughout, whenever values are converted into euro, all conversions are based on the historical exchange rate rather than the constant conversion rate of €1 = Lm0.4293 used for reporting purposes, since the former captures more accurately what the Maltese lira was worth in euro terms during the period prior to euro adoption.

*Net compensation of employees* – Compensation received by employees is a major source of income for households. The National Accounts provide data for total compensation of employees, which consists of gross wages and salaries payable by employers to employees, as well as total employers' national insurance contributions. Since the latter do not constitute disposable income received by households, they must be deducted from the total figure for compensation of employees when measuring disposable income. Total employers' national insurance contributions consist of actual and imputed contributions. Annual data on actual employers' national insurance contributions were taken from tax revenue releases published by the NSO and converted to quarterly data using government cash data. Imputed employers' national insurance contributions represent the current accruing cost of future pension obligations to current government employees.[13] Quarterly data for this variable were obtained from the NSO's Quarterly Accounts for General Government.

Gross wages and salaries also include national insurance contributions and income taxes paid by employees, which should also be removed since they do not represent disposable income. These taxes, however, are captured under the taxes on employment income component of the disposable income measure and are thus deducted at a later stage. Therefore, the net compensation of employees category refers to income received by employees net of actual and imputed national insurance contributions paid by employers, but not of national insurance contributions and income taxes paid by employees.

*Income of the self-employed* – Employment provides households with another important source of income, that coming from self-employment. The only data on the income of the self-employed available to the author were survey data, the most comprehensive of which are collected under the SILC. Although these data only cover a span of six years, they were used to produce an estimate of income from self-employment over the entire 2000Q1-2013Q3 period. This was done by using the six annual observations on the income of the self-employed to estimate its share in GDP. This was found to be slightly above 7.0%, on average. This ratio was then applied to the quarterly series of GDP to extract an estimate of income from self-employment in each quarter. This source of income was tied to GDP because the income the self-employed receive is likely to be closely linked to national income and to exhibit a pattern that mirrors the business cycle. During an economic upturn, there is a heightened demand for goods and services, and therefore the income of the self-employed is expected to increase. The opposite holds true during a downturn. The income of the self-employed is estimated on a gross basis and therefore national insurance contributions and income taxes paid by the self-employed have to be deducted, but this is done through the taxes on employment income component to which we now turn.

*Taxes on employment income* – The income households earn from employment, namely compensation of employees and income from self-employment, is measured on a gross basis and thus includes both national insurance contributions and income taxes paid by households. These taxes have to be deducted since they do not form part of disposable income. There are three types of taxation that households pay on employment income: national insurance contributions paid by employees, national insurance contributions paid by the self-employed, and income taxes paid by both employees and the self-employed. Tax revenue releases published by the NSO were the source of annual data on all three forms of taxation, which were then converted to a quarterly frequency using government cash data.

*Social benefits received in cash* – Disposable income also depends on social security cash payments received by households. These represent cash transfers, such as pensions and unemployment benefits from Government to eligible households. Social benefits received in kind, such as free medicines, are excluded from disposable income since they do not affect the income available to

[13] For further details see, *Government Finance Statistics Guide*, ECB, Frankfurt am Main, March 2010.

households for consumption or saving. The source of quarterly data on social security cash payments is the NSO's Quarterly Accounts of General Government.[14]

*Investment income* – Another source of income for households is net inflows deriving from financial assets. These consist of interest payments and dividends earned on investment assets, such as deposits, bonds and stocks after deducting the interest paid by households.[15] Investment income may be locally-earned or foreign-earned. The same applies for interest paid. At an aggregate level, data on net investment income earned by households are not available. Therefore, to construct this component of disposable income, a disaggregated approach had to be adopted.

One of the major sources of investment income for Maltese households is net interest receivable from domestic banks, that is, interest received on deposits held with domestic banks less the interest paid on loans from these same banks. Interest earned on deposits was obtained by multiplying the stock of deposits held by resident households by the weighted average deposit rate on household deposits. From this inflow, the interest paid on loans was deducted. Similarly, this was calculated by multiplying the stock of loans to resident households, distinguishing between mortgages and consumer and other credit, by the respective weighted average lending rate applicable to households.[16] The Central Bank of Malta is the source of all these data.

Another important source of investment income for domestic households is interest received on bonds issued by the Maltese Government. To calculate the coupon payments households receive from these bonds, detailed data on the stock of Malta Government Stocks (MGS) were used. The data list on a quarterly basis the stock of all individual MGS still outstanding, and, for each of these individual bonds, the coupon rate and the dates when the coupon payments are payable. The stock of MGS, however, captures the total stock issued, rather than the portion held by households. Data revealing the share of each individual bond held by households are not available. However, aggregate data showing the share of the total outstanding stock held by households on a quarterly basis are available. Therefore, for each quarter, the stock of each outstanding individual bond was multiplied by this aggregate share to arrive at an estimate of the portion of that particular bond issue held by households.[17] To find the coupon payments received by households in a particular quarter, the estimates of the stocks held by households in the previous quarter were used since the coupon payments received in a given quarter depend on the stock of bonds held at the end of the previous quarter. The estimate of the stock held by households of those individual bonds paying a coupon in the following quarter was multiplied by that bond's coupon rate and then halved, since MGS pay semi-annual coupons.[18] These individual coupon payments were then added to find the total coupon payments received by households in the following quarter. For example, to obtain the coupon payments received in 2000Q1, bonds held by households as at 1999Q4 and making a coupon payment in 2000Q1 were considered. Again, all the required data are collected by the Central Bank of Malta.[19]

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[14] The Quarterly Accounts of General Government releases provide data on total social security payments, without distinguishing between those paid in cash and those given in kind. This split was kindly provided separately by the NSO.

[15] Note that capital gains or losses do not form part of disposable income.

[16] Publicly available data on the weighted average deposit rate on household deposits and the weighted average lending rates applicable to households are only available as from 2008Q1. These data were extended backwards to 2000Q1 using similar series.

[17] Data on aggregate shares only go back to 2003Q4. For the period covering 1999Q4 to 2003Q3, the shares taken are the author's own estimates based on trends in the data.

[18] Since 2009Q4, the Government has also been issuing floating rate bonds that have a variable coupon rate equal to the six-month EURIBOR in effect a few days before the coupon date, plus a spread. The details of these bonds were obtained from their prospectus issued in the *Government Gazette*.

[19] Households also receive interest on domestic Treasury bills. This, however, is excluded from the measure on the basis of its insignificance. For example, as at the end of December 2012, households accounted for less than 1.0% of the total outstanding stock of domestic Treasury bills.

Net interest receivable from domestic banks and interest earned on Maltese government bonds are not the only sources of locally-earned investment income. Households also earn income from domestic corporate bonds and shares. Moreover, they receive foreign-earned investment income. However, the statistics required to calculate the income deriving from these other sources are unavailable. Therefore, in the absence of these data, households are assumed to have two sources of investment income: net interest on deposits and loans, and coupon payments received from bonds issued by the Government of Malta.[20] Although this estimate does not capture all sources of investment income, the two sources considered are likely to account for a significant proportion of overall investment income.

*Imputed rents* – The final component in the new measure of disposable income is imputed rents. Imputed rents represent an estimate of the value of housing services households derive from owner-occupied housing. Put differently, they are an estimate of rent households would have paid had they rented the property they occupy. Although imputed rents are not strictly a form of income received by households, they still form part of disposable income. One may recall that disposable income is the income available to households for consumption or saving. On the consumption side, imputed values for rents are included although they do not represent actual expenditure by households. These imputed values on the consumption side must be matched on the income side. There must be some "inflow" to fund this "outlay", which is why imputed rents feature as part of disposable income.[21] Annual data on imputed rents were obtained from Eurostat and then converted to a quarterly frequency using National Accounts data on output by the Real Estate Activities sector provided by the NSO.

This new approach to constructing disposable income produces a raw series that implies unreasonably low saving rates. In large part, this is likely to be due to under-reported incomes and also as a result of sources of income that are absent from this measure due to data unavailability, such as certain forms of investment income and rental income. With this in mind, disposable income was calibrated to produce a saving rate of 6.4% in 2000, a result that emerges from the HBS for that year, and the calibrating factor was applied to the entire series.[22] This raises the entire profile of disposable income, and hence the saving rate series, uniformly, with the dynamics of the original series remaining intact. This article, therefore, does not seek to shed light on the level of disposable income or the level of the saving rate, since these are conditional on the choice of calibration. Instead, it discusses the *growth* in disposable income and *changes* in the saving rate, since these are not sensitive to calibration.

### Assessing the new data on household disposable income and the household saving rate

Chart 1 shows the composition of the new measure by displaying the share of the individual components in disposable income for each of the years between 2000 and 2012.[23] The shares suggest that the most important source of income for households is net compensation of employees, which accounts for 69.8% of disposable income, on average. Other major sources of income are social security cash payments and income from self-employment, which represent, on average, 21.1% and 12.1% of disposable income, respectively. With an average share of 14.9%, taxes on employment income also have an important bearing on disposable income. The component with the lowest relative importance is investment income, which has a rather low average share of 2.9%. In relative terms, the shares of net compensation of employees, income from self-employment and imputed rents are rather stable over time, while the shares of taxes on employment income and social security cash payments rose

[20] Due to data unavailability, investment income is not measured net of taxation.

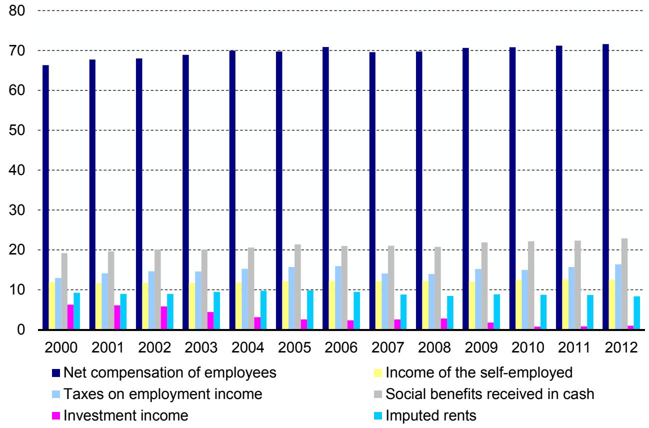
[21] In other words, "if imputed values are added to housing consumption, there must be a resource inflow to 'finance' the additional consumption. This is achieved by adding imputed net rentals on the income side", as explained in Eurostat, "The Distributional Impact of Imputed Rent in EU-SILC", *Methodologies and Working Papers*, Luxembourg, 2010, p. 9.

[22] Although other calibration options were available, we chose to calibrate using the results of the HBS for 2000 because it produced, in our view, the most plausible saving rates.

[23] For brevity, annual figures are presented throughout. Quarterly data are available from the author on request.

notably. Investment income witnessed the most substantial change in share, which fell from 6.3% in 2000 to 1.0% in 2012, largely as a result of the international decline in interest rates. On average, close to 90.0% of the series for disposable income is based on official data, as opposed to estimated data.[24]

**Chart 1**
**COMPOSITION OF HOUSEHOLD DISPOSABLE INCOME**
*(percentage shares of total*)*




* Shares do not add up to 100% because taxes on employment income enter with a negative sign.
Source: Author's calculations.

Table 1 presents the annual growth rates of nominal disposable income, along with a decomposition of the growth rates by contribution of the individual components of disposable income.[25] It also shows nominal private consumption growth and the saving rate. Disposable income grew by 3.4% annually, on average, over the period covering 2000 to 2012, with much of this growth being driven by net compensation of employees. It is possible to distinguish between four distinct periods in the evolution of disposable income growth over this span. As can be seen from Chart 2, between 2002 and 2005 disposable income grew moderately, before growing strongly over the 2006-2008 period. This pick-up in growth was largely brought about by developments in net compensation of employees and investment income. In 2009, as a result of the global financial crisis, disposable income growth slowed considerably, again mirroring developments in net compensation of

**Table 1**
**HOUSEHOLD DISPOSABLE INCOME GROWTH AND CONTRIBUTIONS TO GROWTH, PRIVATE CONSUMPTION GROWTH AND THE HOUSEHOLD SAVING RATE**
*Per cent; percentage points*

| | Household disposable income | Net compensation of employees | Income of the self-employed | Taxes on employment income | Social benefits received in cash | Investment income | Imputed rents | Private consumption | Household saving rate |
|---|---|---|---|---|---|---|---|---|---|
| | % | p.p. | p.p. | p.p. | p.p. | p.p. | p.p. | % | % |
| 2000 | | | | | | | | | 6.4 |
| 2001 | 5.1 | 4.9 | 0.3 | -1.9 | 1.4 | 0.2 | 0.2 | 2.8 | 8.4 |
| 2002 | 2.5 | 1.9 | 0.4 | -0.9 | 1.0 | -0.2 | 0.2 | 0.3 | 10.3 |
| 2003 | -0.1 | 0.8 | 0.0 | 0.1 | 0.0 | -1.4 | 0.5 | 1.1 | 9.2 |
| 2004 | 0.0 | 1.1 | 0.1 | -0.6 | 0.5 | -1.3 | 0.3 | 2.9 | 6.6 |
| 2005 | 2.5 | 1.5 | 0.7 | -0.9 | 1.3 | -0.5 | 0.3 | 4.2 | 5.0 |
| 2006 | 5.1 | 4.8 | 0.7 | -1.0 | 0.7 | -0.1 | 0.1 | 6.2 | 4.1 |
| 2007 | 7.7 | 4.1 | 0.9 | 0.7 | 1.7 | 0.4 | 0.0 | 2.9 | 8.4 |
| 2008 | 6.4 | 4.6 | 0.8 | -0.8 | 1.0 | 0.5 | 0.2 | 7.5 | 7.4 |
| 2009 | 1.4 | 1.9 | 0.0 | -1.4 | 1.4 | -1.0 | 0.5 | 3.3 | 5.6 |
| 2010 | 3.4 | 2.6 | 0.9 | -0.3 | 1.0 | -1.0 | 0.2 | 2.8 | 6.2 |
| 2011 | 3.0 | 2.5 | 0.5 | -1.2 | 0.9 | 0.1 | 0.2 | 4.2 | 5.0 |
| 2012 | 3.6 | 3.0 | 0.4 | -1.3 | 1.4 | 0.2 | 0.0 | 1.5 | 7.0 |

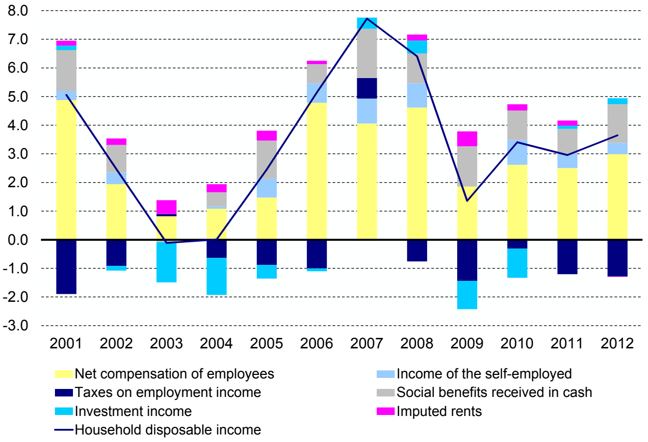
Sources: Author's calculations; NSO.

[24] This figure is based on data weighted by value.
[25] All series used in this study are in euro terms. Since all conversions from Maltese lira to euro are based on the historical exchange rate rather than the constant conversion rate, growth in disposable income partly reflects movements in the exchange rate. This, however, is only the case between 2001 and 2005, because in May 2005 Malta joined ERM 2 and there were no changes in the Maltese lira against the euro until 1 January 2008, when Malta left ERM 2 and adopted the euro.

employees and investment income, but also in taxes on employment income. Over the final period, covering the years 2010-2012, disposable income growth rose and then stabilised at a rate of around 3.3%, on average. All components except social benefits received in cash and imputed rents contributed significantly to this increase in growth.[26]

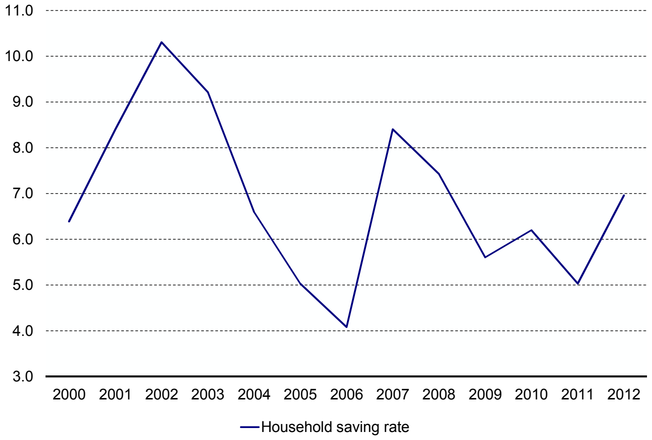
Chart 3 depicts the evolution of the saving rate between 2000 and 2012. Again, the series is characterised by four distinct periods. The first, spanning 2000 to 2002, witnessed an increase in the saving rate as disposable income growth outpaced consumption growth. Between 2003 and 2006, the saving rate declined, first owing to a drop in disposable income that was compounded by an increase in consumption, and then because the rise in disposable income fell short of consumption growth. In 2007 the saving rate rose considerably, mirroring stronger disposable income growth and weaker growth in consumption. The final period, covering 2008 to 2012, is marked by a relatively moderate decline in the saving rate, reflecting the fact that over this period consumption grew at a slightly faster rate than disposable income.[27]

**Chart 2**
**CONTRIBUTIONS TO HOUSEHOLD DISPOSABLE INCOME GROWTH**
*(percentage change; percentage points)*




Source: Author's calculations.

**Chart 3**
**HOUSEHOLD SAVING RATE**
*(per cent)*




Source: Author's calculations.

## Conclusion

This article presented a new measure of household disposable income for Malta, which widens the range of research that can be conducted on the domestic economy. The measure, however, carries some limitations and therefore researchers should use the data with caution. In particular, while the series is likely to capture the dynamics of disposable income, and hence the saving rate, reasonably well, it should not be used to gauge the level of these variables. In light of this, a useful avenue of research would be to pursue this work further and improve on this measure of disposable income, a key macroeconomic variable which has important economic and social implications.

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26 An earlier, but broadly similar, version of the new measure of disposable income was found to explain domestic private consumption behaviour remarkably well, as documented in Grech, O., Micallef, B., Rapa, N., Grech, A. G. and Gatt, W., "A Structural Macro-Econometric Model of the Maltese Economy", *Working Paper* No. 02/2013, Central Bank of Malta.

27 The degree of volatility in the saving rate is comparable with that exhibited by data for other countries.

## Tourism

For the fourth consecutive year the tourism sector continued to perform strongly during 2013, with tourist arrivals, nights stayed and expenditure all higher than the previous year's levels. Tourist numbers grew by 9.6% and approached 1.6 million, while nights stayed and expenditure went up by 8.7% and 8.6%, respectively.

This performance compares favourably with developments in other markets. In 2013, according to the United Nations World Tourism Organisation, the global industry recorded an average growth in arrivals of 5.0%, while the Southern/Mediterranean Europe region went up by 6.1%.[7]

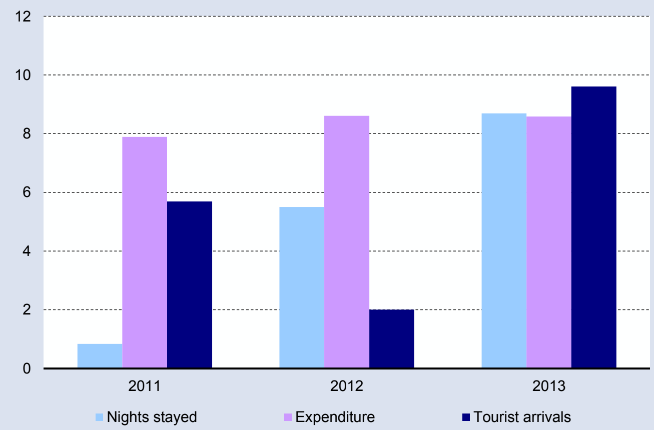
Growth in tourist arrivals in 2013 was significantly higher than the increases recorded in both 2011 and 2012 (see Chart 3.4). Growth was evident across all months of the year, except February.[8] Significant additions were recorded not only in the summer months but also in May, October and November. The number of non-package tourists increased by 11.1% and accounted for slightly more than half the total arrivals, while the number of tourists on package holidays went up by 8.0%. Almost a third of the tourists were repeat visitors, an increase of 10.1% over 2012.

During 2013 the United Kingdom remained Malta's most important source market, accounting for nearly 30.0% of the year's total arrivals. Although the number of UK visitors rose by over 13,000, or 3.0%, the largest increase in tourist arrivals emanated from Italy, which is Malta's second largest source market. The latter accounted for around 15.0% of total arrivals, with the increase in the number of visitors exceeding 30,000, or 15.6%, over the previous year. At the same time, arrivals from Germany, France and Scandinavia, also rose notably. This may reflect the introduction of additional routes to regions in these countries, some by low-cost carriers, during the course of the year. Particular buoyancy was also recorded by smaller markets, such as Libya and Russia, while the combined number of visitors from other markets also increased considerably. Conversely, for the second year running, arrivals from Spain dropped, possibly reflecting weak economic conditions in that country (see Table 3.4).

Malta International Airport data on passenger movements confirm the continued expansion in tourism activity. Malta's airport saw the number of incoming visitors - including both residents and non-residents – surmounting for the first time the four-million passenger threshold, a rise of 10.5% over 2012. This was partly spurred by a 10.2% increase in seat capacity, reflecting the opening of new routes and additional flights to highly frequented destinations. In fact, aircraft flights went up by 9.1% during 2013.

Total nights stayed by tourists during 2013 rose by 8.7% on a year earlier. Nevertheless, as nights stayed increased less rapidly than tourist arrivals, the average length of stay dipped marginally to 8.1 nights. Three-quarters of nights stayed were spent in collective accommodation, including hotels, aparthotels, guesthouses, hostels and tourist villages. The remainder were spent in private accommodation, which includes self-catering apartments,

**Chart 3.4**
**TOURISM INDICATORS**
*(annual percentage changes)*




Source: NSO.

[7] See United Nations World Tourism Organisation, *World Tourism Barometer* January 2014.
[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*

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| **Tourist departures**[(1)] | **1,415.0** | **1,443.4** | **1,582.2** |
| United Kingdom | 438.8 | 441.3 | 454.7 |
| Italy | 201.8 | 202.2 | 233.8 |
| Germany | 134.3 | 137.5 | 147.1 |
| France | 103.6 | 107.9 | 116.5 |
| Scandinavia[(2)] | 93.8 | 97.4 | 105.1 |
| Spain | 63.1 | 60.2 | 53.3 |
| Netherlands | 38.9 | 39.2 | 41.5 |
| Russia | 24.2 | 31.6 | 40.0 |
| Libya | 6.3 | 17.2 | 34.6 |
| Others | 310.3 | 309.0 | 355.6 |
| Cruise passengers | **493.2** | **555.7** | **424.6** |

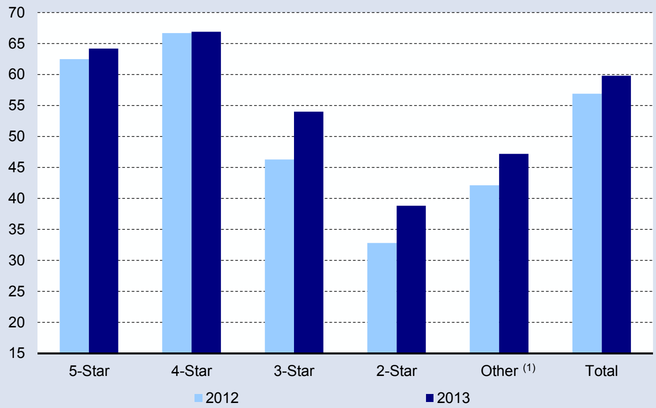
(1) Includes departures by air and by sea. Cruise passengers are shown separately.
(2) Scandinavia includes Denmark, Finland, Norway and Sweden.
Source: NSO.

farmhouses and private residences. When compared with 2012, nights stayed in collective and private accommodation rose by 7.2% and 11.9%, respectively.

Growth in tourist arrivals and nights stayed was accompanied by an increase in tourist expenditure, which rose by 8.6% over the year (see Chart 3.4).[9] Higher tourism spending was spread across all categories of incoming tourists, in particular the non-package holiday category, which climbed by 10.9%. The latter was driven by a rise of 16.0% spending on accommodation and a 6.8% increase on travel fares. Meanwhile, spending on package holidays rose by 6.3%, while the "other" component of tourist expenditure went up by 8.9%.

Based on surveys carried out by the hotel industry during the first nine months of 2013, hotels registered an increase of 1.2% in occupancy, with all three main hotel categories reporting improvements in gross operating profit levels per available room.[10] Meanwhile, higher average achieved room rates were registered in the five and three-star hotel categories, whereas a marginal decline was recorded in the four-star category.

**Chart 3.5**
**AVERAGE OCCUPANCY RATES**
*(per cent)*



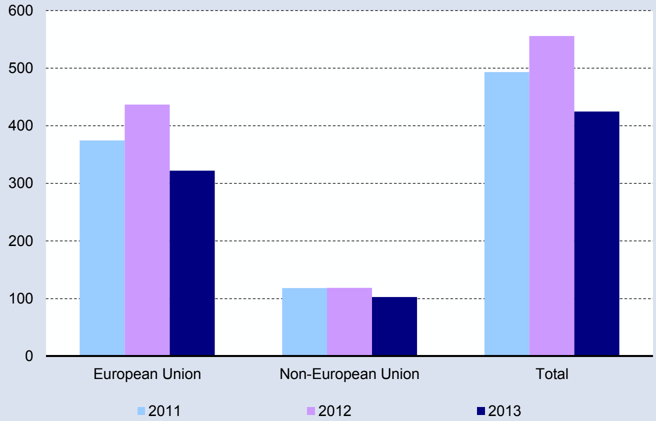

(1) Includes guesthouses, hostels & holiday complexes.
Source: NSO.

NSO data for the full year also corroborate these positive developments, with the total average occupancy rate in collective accommodation establishments climbing to 59.8% from 56.9% in 2012 (see Chart 3.5). Although during 2013 all accommodation categories recorded higher occupancy rates, the improvement was mainly driven by the three and two-star hotels. Nonetheless, at 64.2% and 66.9%, occupancy rates

[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.
[10] See BOV-MHRA surveys.

in five and four-star hotels remained the highest, up by 1.7 percentage point and 0.2 point, respectively, on their 2012 levels.

Chart 3.6
CRUISE PASSENGERS
*(thousands)*




Source: NSO.

During the year under review, the number of cruise liner calls dropped to 286, down by 36 from a year earlier, mainly because one cruise line operator scaled back its visits to Malta. As a result, the number of foreign passengers fell by 131,114, or 23.6%, when compared with 2012 (see Chart 3.6). Cruise passengers coming from the European Union contracted by over a quarter, whereas visitors from non-EU countries fell by 13.5%. The largest declines were recorded from the German, Italian, Spanish and French markets. Conversely, substantial increases were recorded in cruise passengers from the United Kingdom, the United States and Australia.

## Construction

Construction activity continued to decline during 2013, as nominal output dropped by 3.3% after having contracted by 2.5% in the previous year. With intermediate consumption, which includes the purchases of materials for the industry, falling by 4.2%, the GVA of the sector declined by 1.6%, the same rate as that recorded in 2012. Reflecting these developments, the sector's share in nominal GDP stood at 3.6% compared with 3.8% 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 2.1% in 2013, marginally lower than the 2.3% decrease in 2012. Moreover, the profit element declined by 0.8%, extending the trend seen in recent years.

In the first nine months of 2013, total employment in construction fell by 8.8%, or 1,067 jobs compared with the corresponding period of 2012 (see Table 3.5). Much of this decline took place within the public sector, which saw a reclassification of employees from the construction sector to public administration in August 2013.[11] Within the private sector, 280 jobs were lost, equivalent to a drop of 3.3%. The industry's share in the total gainfully occupied population also declined, falling to 7.1% compared with 8.0% in the previous year.

**Table 3.5**
**CONSTRUCTION ACTIVITY INDICATORS**[(1)]

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| **Gross value added (EUR millions)** | **265.8** | **261.6** | **257.5** |
| Share of gross value added in GDP (%) | 4.0 | 3.8 | 3.6 |
| **Total employment** | **12,216** | **12,190** | **11,123** |
| Private employment | 8,631 | 8,723 | 8,443 |
| Share in total gainfully occupied population (%) | 8.2 | 8.0 | 7.1 |

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

11 See NSO *News Release* 007/2014.

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

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| Apartments | 3,736 | 3,276 | 2,489 | 2,062 |
| Maisonettes | 375 | 401 | 298 | 350 |
| Terraced houses | 227 | 191 | 202 | 209 |
| Other | 106 | 87 | 75 | 84 |
| **Total** | **4,444** | **3,955** | **3,064** | **2,705** |

Source: Malta Environment & Planning Authority.

The drop in activity in the construction industry was also evidenced by developments in GFCF. The construction component in GFCF decreased by 5.4% in nominal terms during 2013, compared with a 4.0% increase in the previous year. This drop emanated primarily from the private sector, although related expenditure by the Government also declined.

Outlays on non-dwelling construction decreased by 7.6% compared with the previous year. This was primarily due to a fall in government investment of 14.2%, whereas private investment fell by 4.0%.

Expenditure on housing investment remained stable in 2013 following an annual decline of 10.5% in 2012. Although the private sector slightly increased its capital expenditure on residential property, this was partly offset by a drop in government investment on dwellings.

The number of permits issued by the Malta Environment & Planning Authority (MEPA) dropped by 359, or 11.7% in 2013, after having already decreased strongly in recent years (see Table 3.6). This drop was entirely driven by decreases in the largest residential category, namely apartments, which account for just over three-fourths of the total permits issued. Permits for this type of property fell by 427, or 17.2% in 2013. On the other hand, those granted for the construction of the remaining property categories rose by 68 in the aggregate.

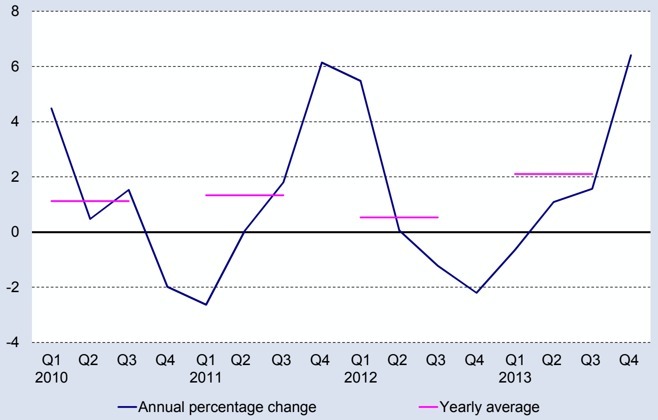
### *Residential property prices*[12]

The Bank's index of advertised residential property prices increased on average by 2.1% in 2013, after having risen by 0.5% in the previous year (see Chart 3.7).[13]

The annual rate of change in property prices was negative in the first quarter and turned positive in the second quarter. It accelerated in the second half of the year, especially in the last quarter.

Reflecting the continued weakness in the housing market, the number of advertised properties included in the Bank's survey declined by 7.5% in 2013. In the previous year, it had contracted by 15.4%.

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




Source: Central Bank of Malta.

[12] This section takes into account information as at 24 March 2014.

[13] 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.

The rise in the overall price index during 2013 reflects gains in all its major sub-components. The largest increases were registered in maisonettes, for which prices went up by 6.3%. Meanwhile, apartments, which form just over half of the properties surveyed, had a price increase of 1.5%. Finally, prices for the other property categories rose by around 4%.[14]

## The labour market[15]

Labour market statistics for the first nine months of 2013 show that employment continued to rise, with the average annual growth rate during this period standing higher than in the corresponding period of 2012. The number of persons seeking employment was generally greater as the labour supply grew at a faster pace than the number of employed persons.

### *Employment*

Labour Force Survey (LFS) data up to the third quarter of 2013 indicate that, on average, employment was 2.6% higher compared with the same period a year earlier (see Table 3.7).[16] As a result, the average employment rate rose by 1.6 percentage points to 60.5%.[17]

The increase in the number of jobs was broad-based, with growth being particularly strong in both the part-time and full-time categories. Part-time employment went up by 1,997 in absolute terms, while full-time jobs increased by 1,972. The number of employees working on reduced hours went up by 494.

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

| | 2012<br>Jan.-Sep. | 2013<br>Jan.-Sep. | Annual change<br>% |
|---|---|---|---|
| **Labour force** | **184,141** | **189,127** | **2.7** |
| Employed | 172,375 | 176,837 | 2.6 |
| *By type of employment:* | | | |
| Full-time | 148,301 | 150,273 | 1.3 |
| Full-time with reduced hours | 4,177 | 4,671 | 11.8 |
| Part-time | 19,897 | 21,894 | 10.0 |
| Unemployed | 11,767 | 12,290 | 4.4 |
| **Activity rate (%)** | **63.0** | **64.8** | |
| Male | 78.1 | 79.2 | |
| Female | 47.3 | 49.7 | |
| **Employment rate (%)** | **58.9** | **60.5** | |
| Male | 73.4 | 73.9 | |
| Female | 43.8 | 46.5 | |
| **Unemployment rate (%)** | **6.4** | **6.5** | |
| Male | 5.8 | 6.6 | |
| Female | 7.3 | 6.3 | |

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

14 Terraced houses, houses of character, villas and townhouses.
15 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 Employment and Training Corporation (ETC) according to definitions established by domestic legislation on employment and social security benefits.
16 The LFS defines the labour force as all persons active in the labour market aged 15 and over. This includes those in employment, whether full-time or part-time, and the unemployed, defined as those people without work, actively seeking a job and available for work. The ETC definition of the labour supply is more restricted: it consists of the sum of the full-time gainfully occupied population and the registered unemployed aged 16 and over.
17 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 15 - 64 years.

Between January and September 2013, the labour force was 2.7% more than its average level in the first nine months of 2012. Growth in the labour force marginally exceeded that in employment, as it was also boosted by an increase in the number of unemployed, based on persons in the survey who said they were interested in finding employment but did not find a job.

As the labour force expanded, the activity rate went up to 64.8%, adding 1.8 percentage points on a year earlier and reaching the highest level recorded since the survey began.[18] The female activity rate posted the strongest gain, although that of males also rose. In fact, the female activity rate increased by 2.4 percentage points to 49.7%, while that of males rose by 1.1 percentage points to 79.2%. The gap between the female activity rate in Malta and the EU average continued to narrow from 18.1 percentage points in 2012 to 16.1 percentage points in 2013.

The administrative records of the ETC also point to an improvement in the labour market. The gainfully occupied population, defined as all those in full-time employment, continued to increase, reaching the highest level on record (see Chart 3.8). Thus, on average, full-time employment rose by 2.3% in the first nine months of 2013. Employment increased in both the private and public sector but, as in 2012, was more pronounced in the former (see Table 3.8). In absolute terms, jobs in the private sector increased by 2,585 and by 897 in the public sector.

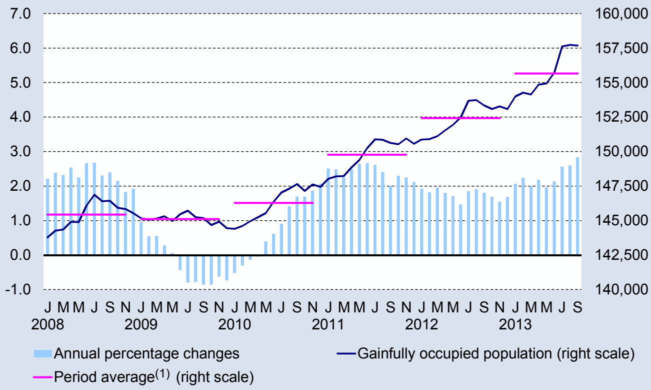
The increase in full-time private sector employment was propelled by market services, where employment rose by 2,970 or 3.7%. New jobs were created in most sectors in this category. However, the biggest increases were registered in administrative & support service activities, computer programming and education. The financial intermediation sector and the gaming industry also continued to generate new employment. On the other hand, jobs decreased in land transport and telecommunications.

During the first nine months of 2013, employment in direct production within the private sector fell by 385, or 1.2% on a year earlier, mainly reflecting losses in the construction sector. Employment also decreased in the manufacturing sector, albeit to a much lesser extent.

In the public sector, the number of full-time workers increased in the public administration & defence, education and human health activities, outweighing losses in the construction sector.

ETC data also show further growth in part-time employment. In the year to September, jobs on a part-time basis rose by 2,642, or 4.9% compared with a year earlier, with these new positions taken mainly by females. The retail trade and food & beverage sectors recorded the strongest additions of part-time workers. The increase was more pronounced in the number of those holding a part-time job as their only form of employment than among those having both a full-time and a part-time job.

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




(1) Period averages for 2008-2012 are based on averages for the whole year, while for 2013 the average is based on data for the first nine months of the year.

Source: NSO.

[18] The activity rate measures the number of persons in the labour force (whether employed or seeking work) as a proportion of the working-age population, which is defined as all those aged 15 - 64 years.

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

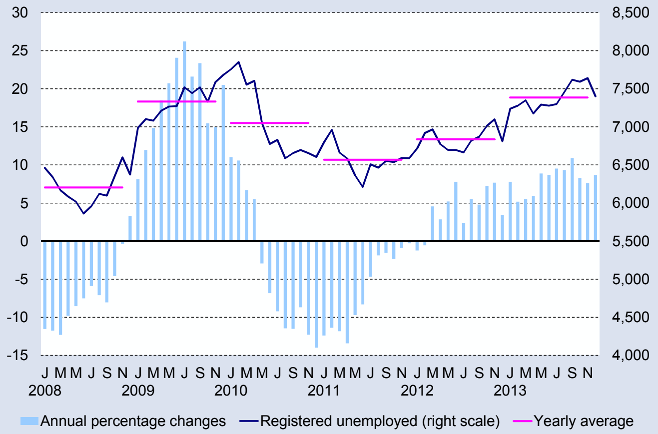
| | 2012 Jan.- Sep. | 2013 Jan.- Sep. | Annual change % |
|---|---|---|---|
| **Labour supply** | **158,968** | **162,990** | **2.5** |
| **Registered unemployed[2]** | **6,791** | **7,332** | **8.0** |
| **Gainfully occupied** | **152,176** | **155,658** | **2.3** |
| **Public sector** | **40,873** | **41,770** | **2.2** |
| **Private sector** | **111,303** | **113,888** | **2.3** |
| **Private direct production[3]** | **31,333** | **30,948** | **-1.2** |
| Manufacturing | 20,053 | 19,963 | -0.4 |
| Construction | 8,723 | 8,443 | -3.2 |
| **Private market services** | **79,970** | **82,940** | **3.7** |
| Wholesale & retail trade | 23,016 | 23,168 | 0.7 |
| Transportation & storage | 7,021 | 7,070 | 0.7 |
| Accommodation & food service activities | 9,796 | 9,922 | 1.3 |
| Information & communication | 4,515 | 4,778 | 5.8 |
| Financial & insurance activities | 6,400 | 6,584 | 2.9 |
| Real estate, professional & administrative activities[4] | 15,615 | 17,010 | 8.9 |
| Arts, entertainment & recreation | 3,378 | 3,553 | 5.2 |
| Education | 4,100 | 4,339 | 5.8 |
| Other | 6,129 | 6,516 | 6.3 |
| **Part-time employees** | **54,179** | **56,821** | **4.9** |
| Part-time as a primary job | 31,113 | 32,899 | 5.7 |
| Part-time holding a full-time job | 23,066 | 23,922 | 3.7 |

[1] Figures are based on averages for the first nine months.
[2] Statistics for all of 2013 are available for the number of registered unemployed. The average number increased by 8.0% between 2012 and 2013.
[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.

*Unemployment*

Based on ETC data the number of unemployed continued to rise, so that in 2013 the average number of unemployed persons increased by 8.0% over 2012 (see Chart 3.9). Regarding age categories, job-seekers rose among those aged 20 and over, but fell in the under-20 age bracket. In terms of duration of registration, the strongest rise was registered among those looking for a job for over a year. The number of those registering for work for more than 20 weeks but less than 53 weeks also rose. On the other hand, the number of people looking for a job for less than 20 weeks fell.

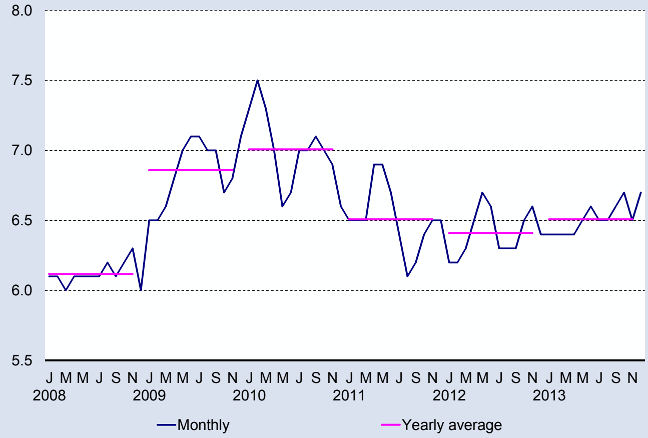
**Chart 3.9**
**REGISTERED UNEMPLOYED**
*(annual percentage changes; persons)*




Source: NSO.

LFS data for the first three quarters of 2013 also show an increase in the number of unemployed. According to this source, at 12,290, the number of jobseekers was on average 523 higher compared with the first nine months of 2012.[19] The unemployment rate averaged 6.5% between January and September 2013, 0.1 percentage point above the level recorded in the same period a year earlier.

**Chart 3.10**
**UNEMPLOYMENT RATE**
*(seasonally adjusted; per cent)*




Source: Eurostat.

The seasonally adjusted unemployment rate published by Eurostat averaged 6.5% in 2013, slightly higher than the average of 6.4% recorded in 2012 (see Chart 3.10).[20] The rate stood at 6.4% until April and then rose to 6.6% by June. Thereafter, it remained somewhat unchanged before reaching 6.7% in October. It then fell in November but rose again to 6.7% in December.

[19] According to the LFS, the unemployed comprise persons 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.

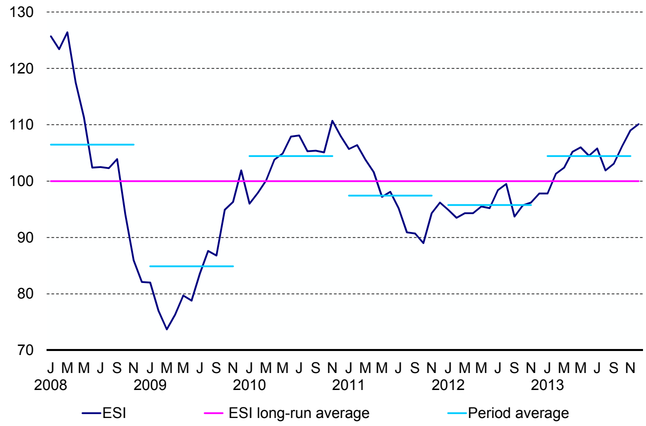
[20] Based on Eurostat calculations

## BOX 2: BUSINESS AND CONSUMER SURVEYS

During 2013 confidence generally rose among firms operating in the service sectors while sentiment also improved sharply among consumers. These developments contrast with those recorded by the manufacturing and construction sectors. In the manufacturing sector, business confidence deteriorated during most of the year and was, on average, only marginally better than in 2012. In the construction sector, firms were on balance more pessimistic than a year earlier.

The improving climate among service providers and consumers led to an 8.7 percentage points increase in the average economic sentiment indicator (ESI) reading in 2013. In December 2013, the ESI stood at 110.1, up from 97.8 in December 2012 (see Chart 1).[1] At this level the index was above its long-term average of 100.0.[2]

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

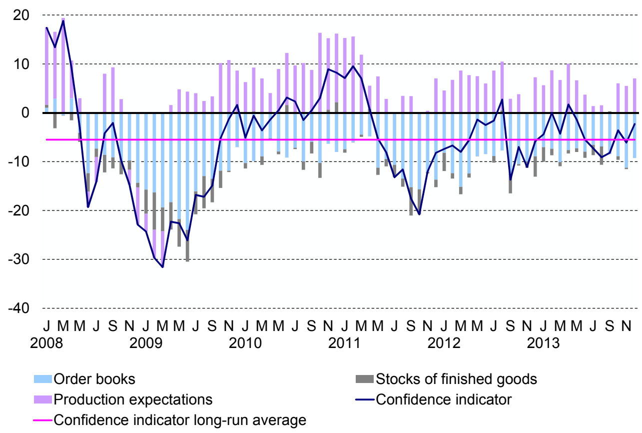



Source: European Commission.

### Industrial confidence surveys[3]

After declining towards the end of 2012, confidence among firms operating in the manufacturing sector generally remained negative up to March before turning positive in April (see Chart 2). This improvement was, however, short-lived as confidence remained negative during the rest of the year. Compared with the previous year, confidence improved only marginally, with the industry score averaging -4 in 2013 from -6 in 2012. However, the end-year score of -2 was higher than the sector's long-term average of -6.

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




Source: European Commission.

[1] The ESI summarises developments in confidence in the four surveyed sectors (industry, services, construction and consumers).

[2] Long-term averages are calculated over the entire period for which data are available. For the consumer and industrial confidence indicator, data became available in November 2002, while the services and construction confidence indicator data became available in May 2007 and May 2008, respectively. The long-term average of the ESI is computed from November 2002.

[3] 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 goods.

On average, during 2013 respondents continued to report above normal levels of stocks of finished goods. However, by the end of the year, stock levels were assessed to be very close to normal levels for the season. Meanwhile, production expectations were positive on balance, though marginally below the previous year's level. The majority of respondents continued to report weak order book levels, although the assessment was somewhat less negative than a year earlier.

At the end of 2013, the production expectations sub-indicator stood above its long-term average, while readings for the stock of finished goods and order book level were below their respective long-run average.

Supplementary data indicate that the share of respondents foreseeing a rise in employment was lower on average in 2013 compared with 2012. Throughout the year, respondents anticipated a decrease in their selling prices and a large number of respondents indicated insufficient demand as the main factor inhibiting business activity.

A breakdown of the main industrial groupings shows that on average, compared with a year earlier, in 2013 confidence improved among those producing food products, non-metallic mineral products, fabricated metal products, rubber & plastic products and computer & electronic equipment. Nevertheless, in most of these sectors confidence remained negative. On the other hand, confidence deteriorated among manufacturers of wearing apparel, pharmaceuticals, paper & paper products and those operating in the reproduction of recorded media sector.

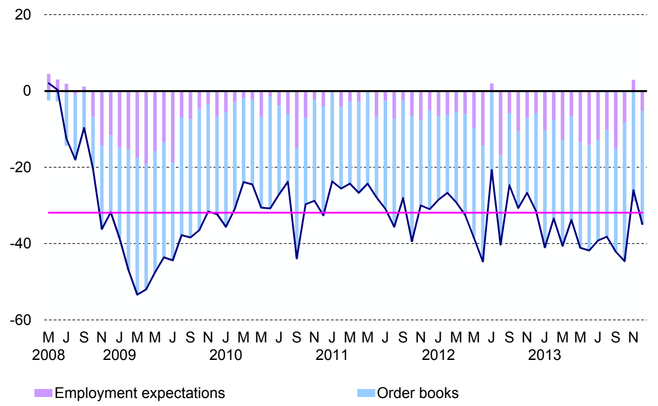
### Construction industry confidence surveys[4]

Confidence among construction firms remained in negative territory. For 2013 as a whole, its average value stood at -38, as against -31 in 2012. At the end of the year, at -35, the reading was below its long-run average of -32 (see Chart 3).

In line with the falling level of confidence during most of 2013, sentiment in the construction sector was on average more negative than a year earlier. Compared with the previous year, operators in this sector were on balance more pessimistic with regard to both the demand for construction-related activities and employment prospects in the sector. Throughout the year, the majority of firms continued to consider their order books to be below normal.

Regarding their labour complement, respondents generally expressed the intention to reduce their manpower levels. In November, however, there was a short-lived rise in employment expectations as firms were foreseeing a rise in their labour complement. The majority of operators considered insufficient demand as the primary factor

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

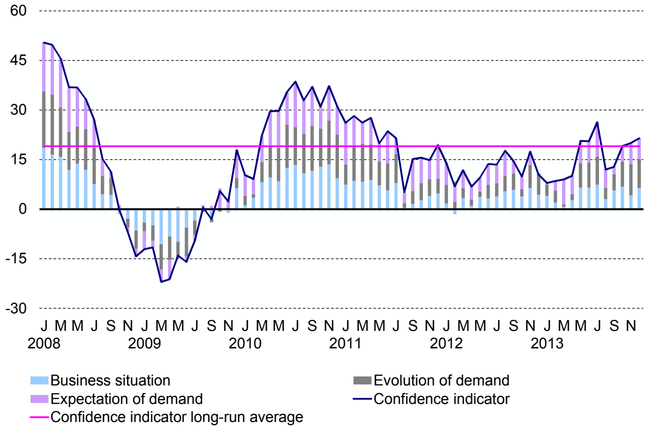



Source: European Commission.

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

inhibiting building activity. At the end of the year, the order book indicator stood below its long-term average, while that pertaining to employment was above.

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




Source: European Commission.

### Services confidence surveys[5]

Within the services sector, confidence rose nearly every month, except in June and August (see Chart 4). Thus, the overall balance remained positive throughout the year with the average level equal to 16, as against 12 in 2012. The confidence score in services ended the year at 21, thus moving above the long-run average of 19.

The improvement in confidence was evident in all components of the index. Throughout the year, the majority of respondents were more optimistic than in 2012 with regard to the evolution of demand over the near term. Moreover, the share of respondents anticipating a favourable business environment was higher. By the end of the year, the sub-indicators pertaining to the business situation and past demand stood above their respective long-term average, while the demand expectation sub-indicator was below.

Supplementary data indicate that employment prospects improved in 2013. Whereas on average in 2012 the majority of firms anticipated their employment levels to remain unchanged, in 2013 respondents were foreseeing an increase in employment.

Firms providing services related to warehousing & support, programming & broadcasting, real estate, food & beverage and rental & leasing reported a rise in confidence compared with 2012. Confidence also rose sharply in the gaming sector. In contrast, confidence deteriorated in the financial services sector.

### Consumer confidence surveys[6]

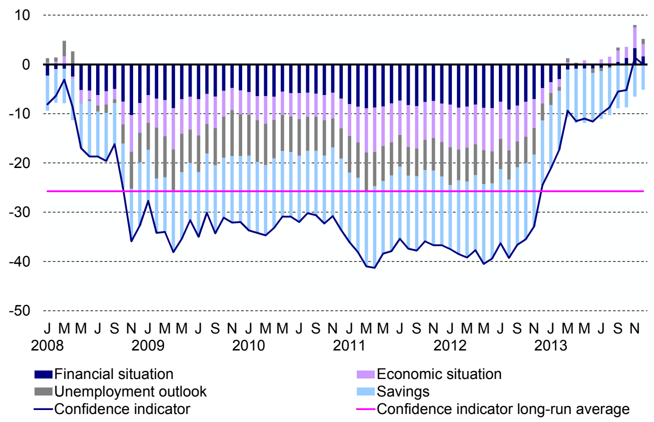
As the year progressed, the consumer confidence indicator reported strong gains, becoming less negative throughout the year before moving into positive territory in November for the first time since the commencement of the survey in 2002 (see Chart 5). The consumer confidence indicator fell slightly in December, ending 2013 at 0, but this was still well above the reading of -25 registered a year earlier and its long-term average of -26. Consumer confidence also improved in the European Union, where the relevant indicator stood at -16 in 2013 from -21 in 2012.

[5] The services confidence indicator is the arithmetic average of the seasonally adjusted 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.

[6] 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.

The rise in confidence was propelled by all components of the index. Consumers, on balance, were less pessimistic about their ability to save over the subsequent 12 months. Moreover, consumers' assessments with regard to their own financial position and the general economic situation in the following 12 months turned positive during the year. By December, the majority of respondents expected unemployment to fall. The sub-indicators related to savings, the financial position and the economic situation were higher at the end of 2013 compared with their respective long-term averages, whereas the unemployment sub-indicator stood below, indicating that consumers were anticipating better employment prospects.

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




Source: European Commission.

Further survey information shows an increase in the number of consumers considering the timing right to make major purchases compared with 2012. Meanwhile, the proportion of respondents expecting prices to increase fell over the year, while in December there was a majority of consumers who believed that prices would decrease over the subsequent three months.

## Consumer prices

### *Harmonised Index of Consumer Prices*[21]

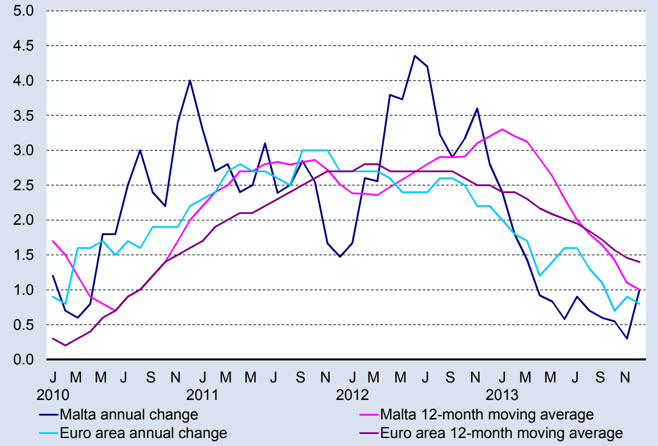
In 2013 the 12-month moving rate of inflation based on the Harmonised Index of Consumer Prices (HICP) declined to 1.0% from 3.2% in 2012 (see Chart 3.11). The year-on-year inflation rate followed a downward path almost throughout the year, falling to 1.0% by December.

Compared with the euro area, the moderation in prices in Malta was more pronounced, with the inflation differential averaging -0.3 percentage point during the year as a whole.

The deceleration in Malta's average inflation rate between 2012 and 2013 was mainly attributable to developments in service prices, more specifically hotel accommodation rates (see Chart 3.12). Although to a lesser extent, energy and non-energy industrial goods also contributed towards a lower inflation rate. Meanwhile, food prices continued to increase during 2013, but on balance did so at a slower pace when compared with 2012, owing to subdued growth in the prices of unprocessed food.

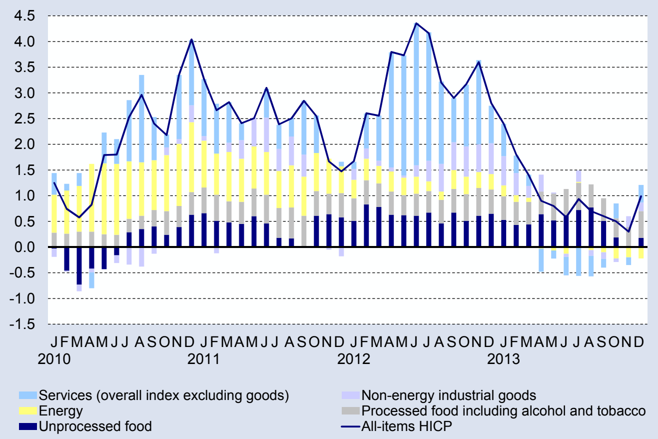
The inflation rate of the services index – which has the highest weight in the overall HICP index - swung from a positive 3.2% in 2012 to a negative 0.2% during 2013. As a consequence, its contribution to overall inflation fell from 1.5 percentage points to nil (see Table 3.8). This was mainly due to developments in accommodation prices and airfares, for which the 12-month moving average inflation rates turned negative. In addition, communication prices declined further during 2013, registering an average inflation rate of -8.8%, compared with -6.6% in the previous year. Drops in this sector reflected increasing competition among service providers, as evident in continued recourse to special offers on bundled packages. Meanwhile, restaurant prices increased at a slower pace than in 2012, with the annual rate of change easing from 3.4% to 1.9% in 2013.

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




Sources: NSO; Eurostat.

**Chart 3.12**
**CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION**
*(percentage points; annual percentage change)*




Source: Eurostat.

[21] In January 2013 the HIC weights were revised to reflect changes in household consumption patterns. As a result, the weight of non-energy industrial goods was reduced by 0.4 pp to 29.5%. In contrast, the weight related to energy increased by 0.3 pp to 7.6%, whilst the share allocated to food rose by 0.2 to 20.4%. The weight related to services remained unchanged to the first decimal place.

**Table 3.8**
**CONTRIBUTIONS TO HICP INFLATION**
*Percentage points*

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| Unprocessed food | 0.4 | 0.6 | 0.5 |
| Processed food including alcohol and tobacco | 0.5 | 0.5 | 0.5 |
| Energy | 0.8 | 0.3 | -0.1 |
| Non-energy industrial goods | 0.2 | 0.3 | 0.2 |
| Services (overall index excluding goods) | 0.5 | 1.5 | 0.0 |
| **HICP (annual average inflation rate)** | **2.5** | **3.2** | 1.0 |

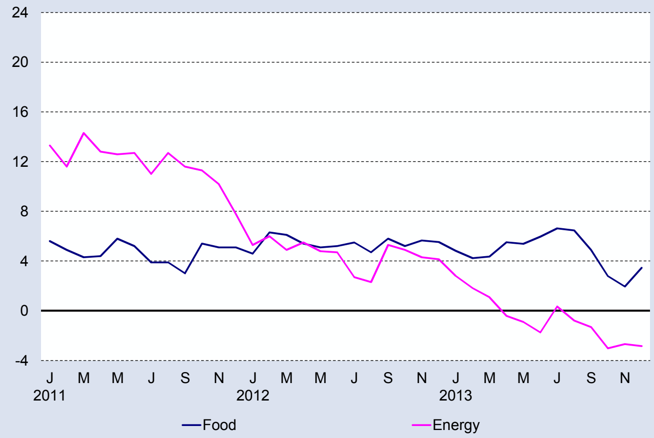
Source: Eurostat.

On average, energy prices declined by 0.7% in 2013, compared with an increase of 4.6% in the previous year. The contribution of this component to overall HICP inflation thus declined from 0.3 percentage point to a negative 0.1 point. This was almost entirely due to fuel prices, whose annual rate of change fell from 6.9% in 2012 to -0.7% in the year under review. The latter accounts for almost two-thirds of the energy component. Gas prices were also generally lower in 2013. However, their impact on overall inflation was limited in view of their small weight in the energy component. Meanwhile, electricity and water tariffs remained unchanged throughout the year under review.

In the case of non-energy industrial goods, their inflation rate fell from 1.1% in 2012 to 0.5% in 2013, mainly on account of a contraction in the prices of durable goods. Thus, the contribution of this category to inflation edged down by 0.1 percentage point to 0.2 percentage point.

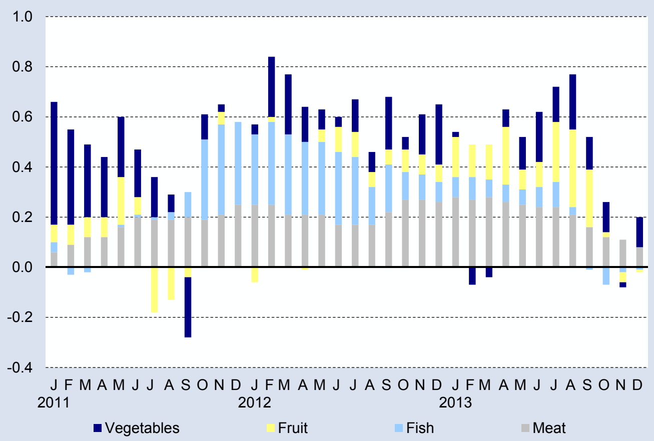
The annual rate of change in food prices, which account for just over a fifth of the HICP, decelerated to 4.7%, compared with 5.4% in 2012 (see Chart 3.13). This slower pace of food inflation was largely driven by developments in unprocessed food prices. Their annual growth rate moderated to 6.4% compared with 8.5% in the previous year mainly under the impact of subdued growth in prices of fish and related products, which were only partly dampened by an acceleration in fruit price inflation (see Chart 3.14). Processed food prices accelerated marginally, from an annual rate of 3.6% in 2012 to 3.7% in 2013, primarily reflecting an increase in alcohol and tobacco price inflation as excise duties were revised.

**Chart 3.13**
**FOOD AND ENERGY PRICE INFLATION**
*(annual percentage changes)*




Sources: NSO; Eurostat.

**Chart 3.14**
**CONTRIBUTION TO OVERALL HICP FROM UNPROCESSED FOOD**
*(percentage points; annual percentage change)*




Source: Eurostat.

## *RPI and core inflation*

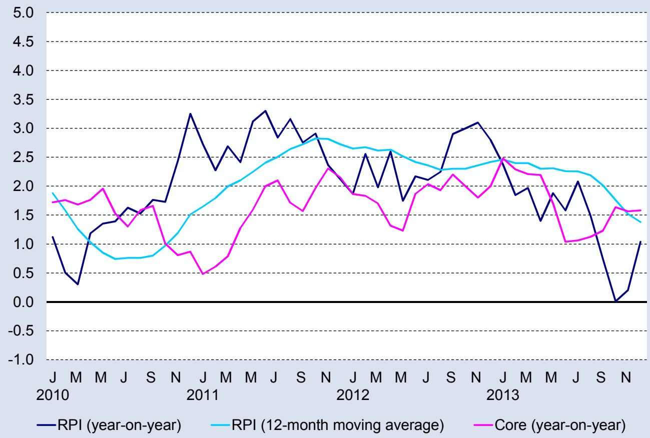
Following a similar trend to the HICP, the 12-month moving average inflation rate based on the Retail Price Index (RPI) dropped from 2.4% in 2012 to 1.4% during the year under review (see Chart 3.15). However, the annual rate exhibited more volatility than the HICP, with a peak level of 2.4% recorded in January and a low of 0.0% registered in October (see Chart 3.15).[22]

The slowdown in RPI inflation between 2012 and 2013 was mainly due to movements in the prices of transport & communication services. With prices of these services contracting by 2.3% during the year under review, their contribution to the overall inflation rate moved into negative territory at -0.5 point in 2013 (see Table 3.9). The contribution of the "other goods & services" category also declined from 0.3 percentage point to 0.1 point.

In contrast, prices of personal care & health, recreation & culture and housing services accelerated. Together these contributed half a percentage point to the overall inflation rate, up by 0.3 percentage point from a year earlier.

Meanwhile, food prices continued to increase, registering an inflation rate of 4.8% in the year under review, up slightly from 4.7% in 2012. Their contribution to RPI inflation remained unchanged at 1.0 percentage point. With prices of beverages

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




Sources: Central Bank of Malta estimates; NSO.

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

| | Weights | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| Food | 21.23 | 0.8 | 1.0 | 1.0 |
| Beverages & tobacco | 6.09 | 0.1 | 0.3 | 0.3 |
| Clothing & footwear | 7.41 | 0.0 | -0.1 | 0.0 |
| Housing | 7.61 | 0.4 | 0.0 | 0.1 |
| Water, electricity, gas & fuels | 3.36 | 0.1 | 0.0 | 0.0 |
| Household equipment & house maintenance costs | 6.59 | -0.1 | 0.1 | 0.1 |
| Transport & communications | 22.76 | 0.7 | 0.5 | -0.5 |
| Personal care & health | 8.57 | 0.1 | 0.1 | 0.2 |
| Recreation & culture | 9.28 | 0.1 | 0.1 | 0.2 |
| Other goods & services | 7.10 | 0.3 | 0.3 | 0.0 |
| **RPI (annual average inflation rate)** | **100.00** | **2.7** | **2.4** | **1.4** |

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

[22] 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.

and tobacco rising at broadly the same pace as a year earlier,[23] the contribution of this component to overall RPI inflation was also unchanged at the 0.3 percentage point level.

Underlying price pressures in the domestic economy may be gauged by the Bank's core RPI inflation measure, which excludes the more volatile components of the index. On this basis, the annual rate of underlying inflation averaged 1.7% in 2013, slightly down from 1.8% in the previous year. The core rate reached a low of 1.0% in June but then rose gradually to 1.6% in October, reflecting developments in the prices of household equipment and, to a lesser extent, those of recreation and culture services. The core rate remained at that level at the end of the year.

## Costs and competitiveness

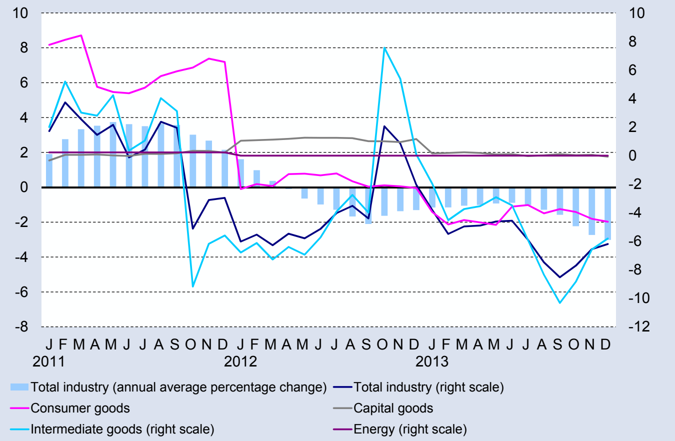
### *Producer prices[24]*

The industrial producer price index (PPI) measures the price of goods at the factory gate and thus provides a measure of inflationary pressures at the production stage. Throughout 2013 producer price inflation was in negative territory. In fact, the 12-month moving average rate of change stood at -3.0%, more negative than its 2012 outcome of -1.3%.

Turning to the components of the PPI, the contraction in producer prices during 2013 largely resulted from movements in the prices of intermediate goods, which include semiconductors, pharmaceutical, paper & plastic products. Intermediate goods prices contracted by an average of 5.5% during 2013, after having declined by 3.1% a year earlier (see Chart 3.16). As a result, their contribution to overall producer price inflation became more negative, falling to 2.6 percentage points from -1.5 percentage point in 2012. Meanwhile, the average annual rate of change of prices for consumer durables was also negative, standing at -1.6% compared with 0.3% in the previous year. As a consequence, their contribution to overall PPI inflation moved to a negative 0.5 percentage point, from 0.1 point a year earlier.

In the case of prices of capital goods, these rose marginally by 0.1% in the year under review, compared with 1.1% in 2012. Their contribution to PPI inflation thus edged down from 0.1 percentage point to nil. As energy prices were once again kept constant throughout the year, their impact on producer price inflation was negligible.

**Chart 3.16**
**INDUSTRIAL PRODUCER PRICE INFLATION**
*(annual percentage changes)*




Source: NSO.

### *Labour costs*

Central Bank of Malta estimates of wage inflation based on collective agreements show a slight moderation in wage growth to 2.6% in 2013

[23] 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.

[24] 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 measured according to their impact on the export and domestic markets of each of the groupings, with the bulk of the weight given to the export side.

**Table 3.10**
**ESTIMATED CHANGE IN AVERAGE NEGOTIATED WAGES**[1]
*Annual percentage changes*

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| Private sector | 4.5 | 2.4 | 2.7 | 2.4 |
| Public sector | 5.2 | 2.8 | 2.8 | 2.7 |
| Overall | 4.7 | 2.7 | 2.8 | 2.6 |

[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 for Finance.

from 2.8% in 2012 (see Table 3.10). The average wage in the private sector is estimated to have increased by 2.4% compared with 2.7% a year earlier, while in the public sector it is estimated to have declined marginally to 2.7% from 2.8% in 2012.

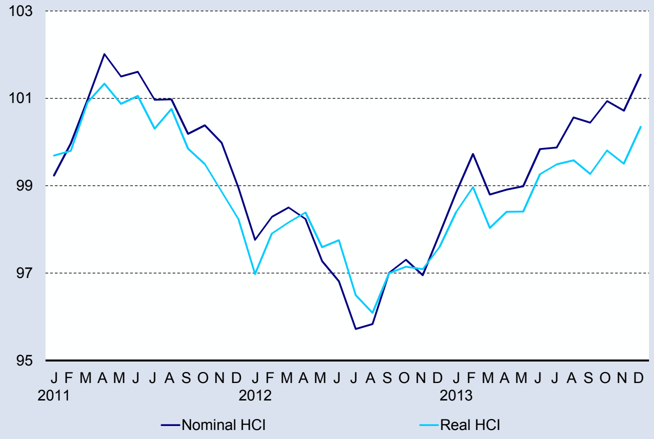
Meanwhile, wage developments based on information emanating from the LFS show that over the first three quarters of 2013 the average annual salary per employee increased by 1.4%, compared with a rise of 3.2% over the same period of 2012.

Meanwhile, national accounts data for 2013 show that overall compensation per employee grew by 0.6% in nominal terms, following an increase of 2.1% in 2012.

*External competitiveness*
Two measures of Malta's competitiveness in international product markets are the harmonised competitiveness indicator (HCI) and unit labour costs (ULC).

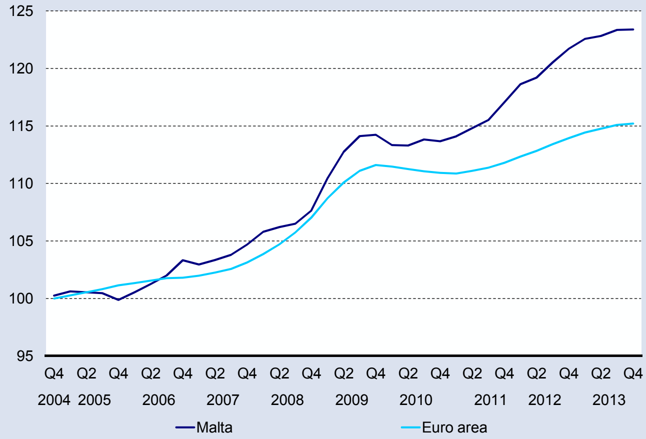
The nominal and real HCI indices largely followed an upward path during 2013. As a result, at the end of the year both were higher than in 2012. The rise in the nominal HCI mainly reflected the year-on-year appreciation of the euro vis-à-vis the dollar, sterling and the yen. In real terms, the HCI grew less rapidly compared with the nominal measure on account of Malta's relatively low inflation rate vis-à-vis that of its trading partners. The divergence between the two indicators widened over the year, on the back of an increasingly favourable inflation differential in Malta compared with its trading partners. By the end of the year, the nominal HCI index stood at

**Chart 3.17**
**HARMONISED COMPETITIVENESS INDICATORS**
*(May 2004 = 100)*




Source: ECB.

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




Sources: ECB; Eurostat.

3.7% above its 2012 level, while the real HCI index was 2.8% higher (see Chart 3.17).

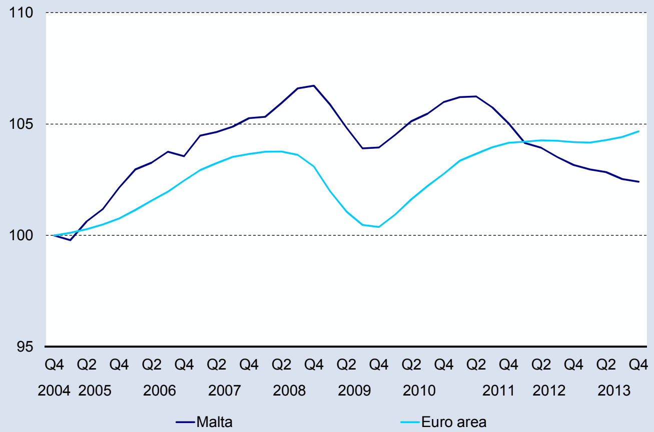
### *Unit labour costs*[25]

Malta's ULC index, measured as a four-quarter moving average, continued to rise during the year under review, albeit at a slower pace than in 2012. During 2013 the ULC index went up by 1.4%, following a 4.0% increase a year earlier (see Chart 3.18).

The increase in ULC recorded in 2013 resulted from both a drop in labour productivity and a rise in compensation per employee (see Charts 3.19 and 3.20). During 2013 compensation per employee grew by 0.6%, after it had increased by 2.1% in the previous year. Labour productivity continued to decline, contracting by 0.7% following a drop of 1.8% in 2012.

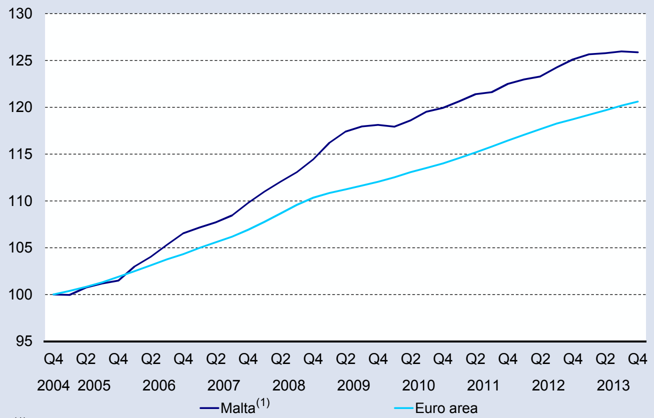
In the euro area ULC also increased during 2013, going up by 1.1%, compared with 1.9% in the previous year. The rise during the year under review was driven by developments in compensation per employee, which went up by 1.6% on an annual basis. However, this was partly offset by a 0.5% increase in productivity.

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




Source: ECB.

**Chart 3.20**
**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.

[25] 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 2014 AND 2015

### Outlook for the Maltese economy[1]

The Bank's latest economic projections indicate that, following a strong acceleration in GDP growth in 2013, the pace of expansion is set to remain sustained in 2014 and 2015. Compared with the Bank's previous projection exercise, which was concluded in November 2013, the latest exercise foresees higher growth.[2] Thus, real GDP growth is set to ease marginally from 2.4% in 2013 to 2.3% in 2014, but should rise again to 2.5% by 2015 (see Table 1).

**Table 1**
**PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA**

| | 2012 (1) | 2013 (1) | 2014 (2) | 2015 (2) |
|---|---|---|---|---|
| **Real economic activity (% change)** | | | | |
| GDP | 0.6 | 2.4 | 2.3 | 2.5 |
| Private consumption expenditure | -0.2 | 1.8 | 2.2 | 2.4 |
| Government consumption expenditure | 5.4 | -0.2 | 0.5 | 0.2 |
| Gross fixed capital formation | -2.0 | -3.8 | 7.9 | 5.4 |
| Inventories (% of GDP) | -1.5 | 0.9 | 0.9 | 0.8 |
| Exports of goods & services | 8.6 | -5.6 | 1.9 | 3.2 |
| Imports of goods & services | 6.2 | -5.2 | 2.1 | 3.1 |
| **Contribution to real GDP growth (in percentage pts)(3)** | | | | |
| Final domestic demand | 0.7 | 0.4 | 2.5 | 2.3 |
| Net exports | 2.6 | -0.7 | -0.1 | 0.2 |
| Changes in inventories | -2.6 | 2.6 | -0.1 | -0.1 |
| **Real disposable household income(4)** | 1.6 | 3.8 | 2.1 | 2.0 |
| **Household saving ratio(4)** | 6.8 | 8.7 | 8.7 | 8.5 |
| **Balance of payments (% of GDP)** | | | | |
| Goods and services balance | 6.0 | 5.6 | 4.6 | 4.8 |
| Current account balance | 2.0 | 1.4 | 0.2 | 0.5 |
| **Labour market (% change)** | | | | |
| Total employment | 2.5 | 3.1 | 1.3 | 1.7 |
| Unemployment rate (% of labour force)(5) | 6.4 | 6.6 | 6.6 | 6.3 |
| **Prices and costs (% change)** | | | | |
| RPI | 2.4 | 1.4 | 1.7 | 1.7 |
| Overall HICP | 3.2 | 1.0 | 1.6 | 1.9 |
| HICP excluding energy | 3.1 | 1.1 | 2.4 | 2.3 |
| Compensation per employee | 2.1 | 0.6 | 2.0 | 2.0 |
| ULC | 4.0 | 1.3 | 1.0 | 1.2 |
| **Public finances (% of GDP)(5)** | | | | |
| General government balance | -3.2 | -2.9 | -2.9 | -2.7 |
| General government debt | 70.8 | 71.3 | 71.8 | 70.7 |
| **Technical assumptions** | | | | |
| EUR/USD exchange rate | 1.29 | 1.33 | 1.36 | 1.36 |
| Oil price (USD per barrel) | 112.0 | 108.8 | 105.8 | 101.1 |

(1) Data on GDP were sourced from NSO *News Release* 047/2014 published on 11 March 2014. Data on the current account balance were sourced from NSO *News Release* 053/2014.
(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 and 2013 are Central Bank of Malta estimates.
(5) Data for 2013 are Central Bank of Malta estimates.

[1] The Bank's outlook for the Maltese economy is based on information available up to 14 March 2014 and is conditional on the technical assumptions shown in Table 1.
[2] See *Quarterly Review 2013:3*, Central Bank of Malta, pp. 86-89.

The upward revision to GDP growth in 2014 is mainly prompted by the release of GDP data covering the whole of 2013, which show that private consumption recovered much more strongly than had been anticipated in the previous projection exercise. This has a positive effect on private consumption over the forecast horizon. Moreover, compared with the previous exercise, net exports are set to make a smaller negative contribution to GDP growth in 2014. Both the November exercise and the latest exercise incorporate a decline in net exports in 2014. However, in the latest exercise, it is milder, reflecting the fact that import growth has been revised downward more strongly than export growth. This pattern of revisions reflects the outcome for 2013, which shows exports falling faster than imports, and much more strongly than had been foreseen last November. The Bank expects that in 2014 this development, which largely reflects outcomes in trade in goods, begins to be reversed.

### Final domestic demand

In the current exercise, the Bank expects growth in 2014 and 2015 to be driven by domestic demand, particularly private consumption and private investment, with the latter supported by specific large projects in energy and construction. In contrast, government consumption and government investment are expected to contribute only mildly to the expansion in 2014 and to have a broadly neutral effect in the following year. Changes in inventories (which include the statistical discrepancy) are assumed to remain broadly constant as a proportion of GDP, until 2015.

After having declined by 0.2% in 2012, private consumption expanded by 1.8% in 2013. While stronger than anticipated in the Bank's November 2013 projection exercise, growth in private consumption in 2013 was still below the rise in disposable income as estimated by the Bank, leading to an increase in household savings. The Bank expects that some of these savings will be spent in 2014 and 2015. Moreover, given the expectation of additional growth in employment, disposable income will continue to rise in 2014 and 2015. Consequently, private consumption is foreseen to accelerate, growing by 2.2% in 2014 and 2.4% in 2015.

Following a 0.2% drop in 2013, government consumption is set to increase by 0.5% in 2014 and by 0.2% in 2015. These relatively modest growth rates reflect the view that Government is likely to tighten its recurrent expenditure as it seeks to correct the excessive deficit. Moreover, growth in this component, which is largely composed of intermediate consumption and salaries paid to government employees, is set to be partly offset by expected intakes from the Individual Investor Programme.[3]

Investment is set to partially recover from the decline sustained in the last three years, growing by 7.9% in 2014. Overall investment growth is set to decelerate to 5.4% in the following year. This deceleration reflects the outlook for both private and government investment.

After contracting for the third year in sequence, private investment is set to expand by 8.7% in 2014. A further 6.4% expansion is envisaged in 2015. These projections continue to be shaped by the Bank's expectations about progress in relation to the new gas energy facilities, where investment is targeted to begin in 2014 and expected to continue in 2015. Moreover, as in the previous exercise, expenditure on the electricity interconnector between Malta and Sicily is set to diminish progressively over the forecast horizon, while the Valletta City Gate project should be completed in 2014. The remaining categories of private investment are set to increase moderately in 2014 overall, supported by a number of non-residential construction projects that began towards the end of 2013, ongoing growth in investment in IT and a slight underlying increase in investment in machinery. Private investment, excluding the above-mentioned large projects, is expected to pick up more strongly in 2015.

[3] Intakes from the Individual Investor Programme are expected to be classified as receipts from sales of government output, which offset government consumption expenditure.

Government investment is set to expand by 4.4% in 2014 after dropping sharply in 2013, reflecting the Bank's assessment that some outlays that did not materialise in 2013 will be carried forward to 2014, in order to utilise EU funds that were forthcoming to Malta under the 2007-2013 EU Financial Programme. In 2015 government investment is set to expand at the slower rate of 1.1%, as the utilisation of funds under the 2014-2020 financial programme is foreseen to be low initially and gather pace later.

### Net exports

Net exports, which declined notably in 2013 after recording strong growth in 2012, are set to fall further in 2014, as imports outpace exports. They are projected to pick up again in 2015, while making a small positive contribution to overall GDP growth.

Exports are set to rise in 2014, after having fallen in 2013. The increase is projected to be driven by merchandise exports, particularly exports of semiconductors, which are expected to recover from an estimated fall in 2013 in response to a more positive international outlook for the electronics industry. Service exports are also set to expand following a small fall in 2013, largely supported by the continued solid performance of the tourist industry, which is expected to benefit from the opening of new airline routes. Overall export growth is set to accelerate in 2015, in line with an expected improvement in foreign demand.

In 2014 imports are also set to partially recover from the contraction recorded in 2013 mainly on account of the foreseen strengthening of private consumption demand, higher capital imports related to investment in the energy sector and increased imports of semi-finished supplies for the semiconductor industry. Imports are projected to rise at a faster pace in 2015, as export growth accelerates.

### The balance of payments

The surplus on the goods and services balance is expected to narrow in 2014, but should increase in 2015.[4] The deterioration in the trade balance in 2014 is set to be driven by movements in the goods balance, in particular, the foreseen increase in capital imports. The trade surplus is set to increase in 2015, as exports outpace imports, but is estimated to remain below the relatively high levels recorded in 2013, at around 4.8% of GDP.

The current account balance is expected to remain in surplus over the forecast horizon. Nonetheless, the surplus is set to narrow slightly in 2014, in line with expected developments in the trade balance, and an expected deterioration in the income account. In 2015 the balance should improve, in line with the increase in the goods and services balance.

### The labour market

In 2013 employment continued to outpace real GDP growth, implying a drop in productivity. Over the projection period, however, employment is set to expand at a reduced pace. In 2014 private firms are expected to take a more cautious attitude towards recruitment to restore productivity. Moreover, the number of employees in the general government sector, which is estimated to have increased sharply in 2013, is assumed to fall slightly. Employment growth is set to accelerate slightly in 2015, with total employment rising by 1.7%.

In 2013 compensation per employee increased slightly, going up by 0.6%. As a result, and given the decline in productivity, ULCs increased moderately, by 1.3%. In 2014 productivity growth is set to turn positive following three consecutive annual declines. The favourable effect of increased productivity on ULCs, however, is partly offset by faster growth in average wages. Consequently, in 2014 ULCs

[4] Data on the trade balance used in this Box are consistent with NSO *News Release* 047/2014 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* 053/2014.

are set to increase by 1.0%, slightly less than in the previous year. With GDP continuing to outpace employment, a further gain in productivity is foreseen in 2015. As in 2014, however, growth in nominal compensation per employee is set to be stronger than that in productivity. As a result, ULCs are expected to increase.

Following a small rise in 2013, the unemployment rate is set to stabilise at 6.6% in 2014, before easing to 6.3% in 2015.[5]

### Fiscal position

The Bank estimates that the general government deficit-to-GDP ratio narrowed to 2.9% in 2013, from 3.2% in 2012. This narrowing is seen to have been driven by buoyant direct tax revenue (relative to GDP), receipts from sale of output and a drop in intermediate consumption, with the ongoing pension reform programme also assessed to have had an impact in limiting expenditure on social benefits.

The deficit ratio is expected to stabilise in 2014, before narrowing slightly to 2.7% in 2015.

In 2014 social benefits are set to rise more strongly compared with 2012 as employees who did not retire in 2013 as a result of the pension reform do so in 2014. This is counterbalanced by restraint in other expenditure categories, notably intermediate consumption and compensation of employees. The latter is assumed to moderate substantially following the exceptionally strong increase seen in 2013. The reduction in the deficit ratio in 2015 is also supported by inflows from the Individual Investor Programme announced in the 2014 Budget and direct taxes paid by corporations.

### Inflation

The average year-on-year inflation rate, as measured by the HICP eased to 1.0% in 2013 from 3.2% in 2012. This deceleration was largely driven by service prices, which contracted by 0.2% after they had increased by 3.2% in 2012. However, food and non-energy industrial goods inflation also slowed down, while energy prices fell.

In 2014 HICP inflation is set to accelerate to 1.6%, mainly owing to an upswing in services price inflation, which is expected to turn positive after an extraordinary negative outturn in 2013. In particular, accommodation prices are expected to accelerate. Slightly faster growth in prices of food and non-energy industrial goods is also expected to push up inflation. These developments outweigh a decline in energy prices, the latter reflecting the planned reduction in electricity tariffs announced by Government. Inflation is then expected to accelerate further, to 1.9% in 2015, reflecting movements in the prices of non-energy industrial goods and a further pick-up in services price inflation, mainly due to developments in accommodation rates and prices charged by restaurants.

The inflation rate projections for 2014 and 2015 are dampened by technical assumptions, which include a decline in the US dollar, the price of oil and a stronger euro.

### Risks to the projections

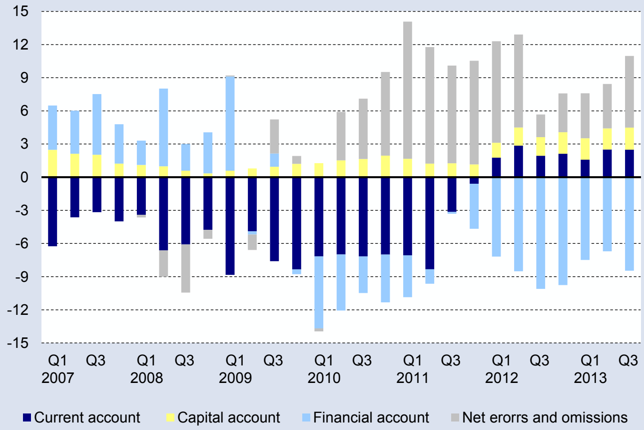
Risks to the GDP growth projections are slightly on the downside, reflecting the fragility of the global economic recovery. In particular, weaker than expected expansion in the euro area economy would weigh on external demand with negative implications for Malta's export growth. Investment could also be weaker than expected, if any of the major infrastructure projects under way encounter delays, and investment in construction takes longer to recover than envisaged. Risks to the inflation projections are also assessed on the downside and relate to weaker than expected price pressures in advanced economies and in the euro area, in particular.

[5] 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*.

# 4. BALANCE OF PAYMENTS

In the year to September 2013, the current account of the balance of payments recorded a surplus equivalent to 2.5% of gross domestic product (GDP). This was 0.6 percentage point higher than that registered in the 12-month period to September 2012 (see Chart 4.1). The higher surplus was attributable to positive developments on all the main components of the accounts. In contrast, the deficit in the income account widened as outflows were substantially higher than inflows over the period (see Table 4.1).

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




Source: NSO.

Meanwhile, the surplus capital and financial account dropped to 6.5% of GDP, as opposed to 8.4% of GDP a year earlier.[1] This was mainly driven by movements in the financial account. At the same time, the capital account recorded higher net inflows than in the corresponding period of 2012, while net errors and omissions were positive but lower than in the four quarters to September 2012.[2]

## The current account

Over the 12-month period under review, the current account surplus expanded by more than a third, to stand at €175.6 million in September 2013 (see Table 4.1). This was due to a significant narrowing of

**Table 4.1**
**BALANCE OF PAYMENTS**
*EUR millions*

| | 2010 | 2011 | 2012 | Four-quarter moving sums 2012 Q3 | Four-quarter moving sums 2013 Q3 |
|---|---|---|---|---|---|
| **Current account** | **-446.9** | **-39.8** | **145.0** | **131.6** | **175.6** |
| Goods | -1,223.0 | -1,080.9 | -939.8 | -955.8 | -849.7 |
| Services | 1,162.9 | 1,321.1 | 1,428.3 | 1,381.9 | 1,389.0 |
| Income | -426.6 | -309.7 | -407.8 | -352.8 | -444.8 |
| Current transfers | 39.7 | 29.7 | 64.4 | 58.2 | 81.1 |
| **Capital and financial account** | **-151.8** | **-193.5** | **-535.0** | **-570.9** | **-456.6** |
| Capital account | 124.4 | 76.7 | 134.0 | 114.0 | 141.2 |
| Financial account | -276.2 | -270.2 | -669.0 | -684.9 | -597.8 |
| Direct investment | 604.9 | 175.0 | 1.8 | 161.5 | 195.3 |
| Portfolio investment | -3,210.2 | -3,104.3 | -1,600.6 | -2,979.3 | -4,311.3 |
| Financial derivatives | 27.8 | 24.3 | 25.3 | -1.4 | -68.4 |
| Other investment | 2,325.0 | 2,582.1 | 1,025.9 | 2,247.7 | 3,526.2 |
| Reserve assets | -23.6 | 52.9 | -121.4 | -113.4 | 60.4 |
| Errors and omissions | 598.7 | 233.3 | 390.0 | 439.3 | 281.0 |

Source: NSO.

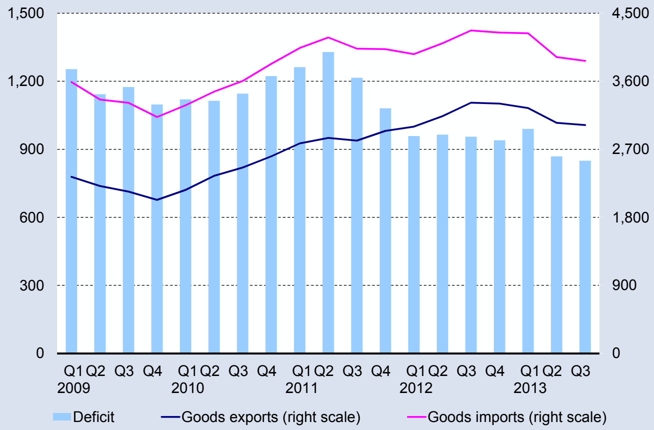
[1] In the financial account of the balance of payments, additions to assets and decreases in liabilities are considered as outflows. Conversely, increases in liabilities and decreases in assets are considered as inflows.
[2] Positive net errors and omissions imply an underestimation of the current account surplus and/or overestimation of the net outflows on the capital and financial account.

the merchandise trade gap, to an increase in net receipts on services and to higher net inward current transfers. Together, these offset a marked increase in net outflows on the income account.

### *Goods*

Balance of payments data indicate that in the four quarters to September 2013 both exports and imports contracted over the corresponding months of the previous year.[3] Nonetheless, as the drop of €401.7 million in imports outweighed a fall of €295.6 million in exports, the merchandise trade gap narrowed by 11.1%, to €849.7 million (see Chart 4.2).

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




Source: NSO.

Details on merchandise trade developments based on Customs data for 2013 are found in Box 4.

## BOX 4: MERCHANDISE TRADE DEVELOPMENTS IN 2013

Customs data show that in 2013 the merchandise trade gap widened by 0.7% to €1,756.2 million, as exports contracted more than imports (see Table 1). Movements in exports and imports were heavily influenced by developments in purchases and sales of fuels (see Table 2).[1]

Over 2013, the value of imported goods fell by €582.3 million or 9.4%, with fuel imports declining slightly more than a fifth, or €576.0 million. Meanwhile, foreign purchases of industrial supplies and consumer goods contracted by 2.3% and 1.4%, respectively. The drop in the former was largely spurred by lower imports of primary and semi-finished goods, whereas the latter mainly reflected a decline in purchases of food, beverages and tobacco. On the other hand, "capital goods & other" imports expanded by 5.5%.

In the year under review the value of exports fell by €593.8 million, or 13.4% over 2012. As referred to above, fuel re-exports were a major factor behind this drop, as these declined by €410.0 million, thereby responsible for 69.1% of the drop. Nonetheless, a significant contraction was also recorded in exports of machinery & transport equipment. Almost 40.0% of the fall in this component was caused by a base effect reflecting the exceptional sale of aircraft during 2012. Exports of semi-manufactured goods also recorded a decline. However, sales of organic chemicals and food, the latter mainly comprising fish exports, registered an expansion. Although in absolute terms increases in

[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, aircraft and ships.

[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 boats and aircraft.

**Table 1**
**MERCHANDISE TRADE BY BROAD ECONOMIC CATEGORY**
*EUR millions; annual percentage changes*

| | 2011[(1)] | 2012[(1)] | 2013[(1)] | 2012 | 2013 |
|---|---|---|---|---|---|
| | | *Amount* | | % | |
| **Imports** | **5,338.9** | **6,183.3** | **5,601.0** | **15.8** | **-9.4** |
| Industrial supplies | 1,549.0 | 1,565.0 | 1,528.5 | 1.0 | -2.3 |
| Capital goods & others | 875.9 | 810.9 | 855.5 | -7.4 | 5.5 |
| Consumer goods | 980.2 | 1,019.1 | 1,004.6 | 4.0 | -1.4 |
| Fuel & lubricants | 1,933.8 | 2,788.3 | 2,212.4 | 44.2 | -20.7 |
| **Exports** | **3,819.0** | **4,438.6** | **3,844.8** | **16.2** | **-13.4** |
| **Trade deficit** | **-1,519.9** | **-1,744.7** | **-1,756.2** | **14.8** | **0.7** |

(1) Provisional.
Source: NSO.

the above-mentioned two categories were small compared with the drops in fuel and the machinery & transport categories, they were quite significant compared with 2012 levels, at around 10% (see Table 2).

During 2013 the European Union remained Malta's major trading partner, accounting for 57.3% of total goods imported and 31.6% of merchandise exports (see Charts 1 and 2). This compares with 63.8% and 29.2%, respectively, in 2012. Merchandise trade with countries in the euro area accounted for 46.7% and 24.0%, respectively, of the total value of imports and exports, compared with 53.9% and 23.5% in the previous year. Overall, the fall in the value of goods imported from the euro area was mainly driven by lower purchases from Italy, Spain and France. Thus, in the case of Italy, while it remained

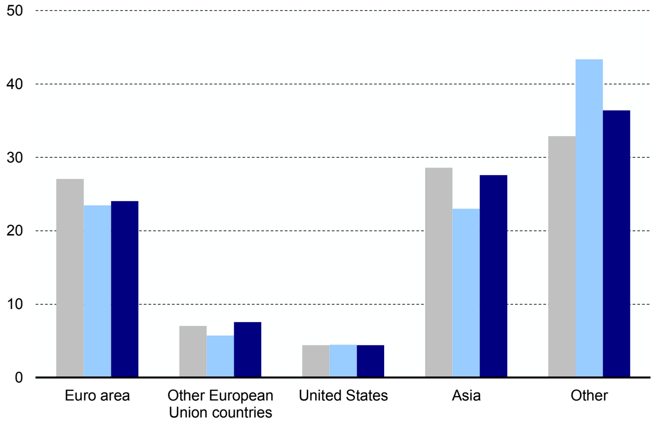
**Table 2**
**MERCHANDISE TRADE BY MAJOR COMMODITY GROUP**
*EUR millions; annual percentage changes*

| | 2011[(1)] | 2012[(1)] | 2013[(1)] | 2012 | 2013 |
|---|---|---|---|---|---|
| **Imports** | **5,338.9** | **6,183.3** | **5,601.0** | **15.8** | **-9.4** |
| Food, beverages and tobacco | 489.5 | 582.0 | 556.9 | 18.9 | -4.3 |
| Mineral fuels, lubricants & related materials | 1,943.2 | 2,791.3 | 2,218.4 | 43.6 | -20.5 |
| Chemicals | 434.1 | 447.5 | 432.8 | 3.1 | -3.3 |
| Semi-manufactured goods | 331.1 | 318.4 | 304.4 | -3.8 | -4.4 |
| Machinery & transport equipment | 1,695.1 | 1,567.6 | 1,650.0 | -7.5 | 5.3 |
| Miscellaneous manufactured articles | 379.1 | 408.7 | 386.0 | 7.8 | -5.6 |
| Others | 66.7 | 67.7 | 52.6 | 1.5 | -22.4 |
| **Exports** | **3,819.0** | **4,438.6** | **3,844.8** | **16.2** | **-13.4** |
| Food, beverages and tobacco | 151.5 | 227.2 | 248.9 | 50.0 | 9.6 |
| Mineral fuels, lubricants & related materials | 1,621.7 | 2,010.8 | 1,600.7 | 24.0 | -20.4 |
| Chemicals | 258.8 | 321.2 | 353.3 | 24.1 | 10.0 |
| Semi-manufactured goods | 132.9 | 126.5 | 115.9 | -4.8 | -8.4 |
| Machinery & transport equipment | 1,241.3 | 1,322.2 | 1,110.7 | 6.5 | -16.0 |
| Miscellaneous manufactured articles | 383.2 | 400.9 | 396.8 | 4.6 | -1.0 |
| Others | 29.6 | 29.8 | 18.5 | 0.6 | -37.8 |

(1) Provisional.
Source: NSO.

Malta's main source of imports, its share in goods imported declined notably to 24.6% from 32.1% in 2012. With regard to exports, Germany remained Malta's prime market, although the value of exports declined in nominal terms. Its share in total merchandise exports, however, rose over the year by 0.9 percentage point to 9.0%. Meanwhile, both imports from, and exports to the United Kingdom were below the previous year's levels.

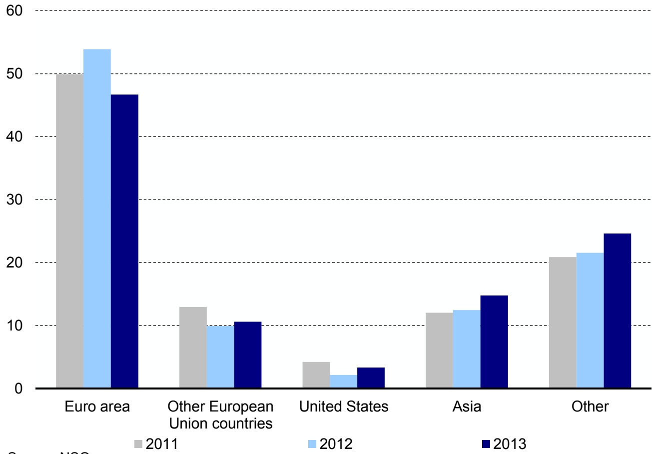
Chart 1
**DIRECTION OF EXPORTS**
*(percentage shares of total)*




Source: NSO.

Trade with Asia increased when compared with 2012, as imports rose by 7.5%, while exports edged up by 3.9% on a year earlier. As a result, the Asian markets' share in aggregate imports and exports reached 14.8% and 27.6%, respectively. With regard to the latter, the increase was partly driven by higher sales of electronic components to Singapore and higher exports of fish to Japan.

Chart 2
**DIRECTION OF IMPORTS**
*(percentage shares of total)*



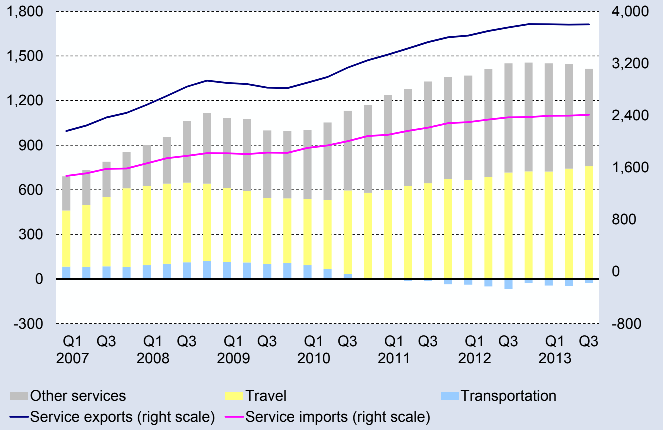

Source: NSO.

Exports to the United States declined during the year, while the value of imports increased by more than a third following a contraction in 2012. However, given Malta's limited merchandise trade with the United States, the share of this market in total imports and exports showed only a marginal change from the previous year. Other areas for Maltese merchandise goods were primarily dominated by the African market, which had a share of 9.2% in total trade. Moreover, in line with the decline in trade in fuels, sales to ships & aircraft stores fell by around 40%. Thus, the latter's share in total exports dropped by 5.4 percentage points to 11.1%.

### *Services*

In the year to September 2013, the positive balance on services edged up by €7.1 million, or 0.5%, to reach €1,389.0 million. The increase was driven by higher net travel receipts and lower net payments on transport services (see Chart 4.3).

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




Source: NSO.

Thus, the net surplus on travel rose by €42.2 million to €758.5 million, strongly influenced by the buoyancy in the tourism industry. This reflected an addition of €72.2 million in tourism earnings, which offset a €30.0 million increase in spending by residents travelling abroad.

At the same time, the negative balance on transport-related services dwindled to €25.1 million from €68.6 million in the corresponding period of 2012. The improvement was mainly due to lower net freight payments, reflecting to a large extent the contraction in the volume of merchandise trade flows.

The favourable developments in travel and transport services were partly dampened by a drop in net receipts on the "other services" component. Net inflows on the latter fell by €78.5 million to €655.6 million. This decline was driven by higher payments on services related to business & management consulting and advertising & market research. A slight contraction in exports of financial and audio-visual services also contributed.

### *Income account*

International banks and foreign-owned non-financial corporations were behind most of the flows on the income account, which, in the year to September 2013, recorded a negative balance of €444.8 million, €92.0 million more than in the corresponding period of 2012. This was mainly attributable to higher dividends paid by foreign-owned firms operating in Malta and to a rise in distributed profits, which were partly reinvested in their local subsidiaries. Lower earnings on portfolio investments by residents also contributed. Higher net outflows on the account were, however, partly offset by drops in interest payments by local banks on their outstanding loans from non-residents.

### *Current transfers*

Over the period under review, net inward current transfers stood at €81.1 million, as against €58.2 million in the corresponding period of 2012. This component continued to be heavily influenced by tax payments and refunds related to companies engaged in international business in Malta. It was also affected by transfers received from the European Union and by Malta's contribution to the EU budget.

## The capital and financial account

In the year to September 2013, the capital and financial account registered net outflows of €456.6 million, a drop of €114.3 million on a year earlier (see Table 4.1). Lower net outflows were mostly due to financial transactions, although higher net inflows on the capital account also contributed.

The surplus on the latter account surged by €27.2 million to €141.2 million, mainly as a result of large inflows of EU structural and cohesion funds, particularly in the final quarter of 2012 and in the third quarter of 2013.

Meanwhile, the financial account posted a negative balance of €597.8 million, which was €87.1 million lower than that recorded in the 12 months to September 2012. Movements on this account continued to be heavily influenced by transactions by internationally-oriented banks.

Developments on the financial account during the period surveyed were mainly driven by a substantial increase in net inflows on the "other investment" component, which were up by around €1.3 billion on a year earlier. The rise largely followed a sharp increase in the currency and deposit liabilities of banks involved in international operations. Lower net outflows on the financial account were also attributable to an increase of €33.9 million in net inward foreign direct investment, mainly reflecting injections of equity capital into a number of banking institutions.

The rise in net "other investment" liabilities was to a large extent matched by a marked addition in net portfolio investment assets. Net outflows on this account climbed by €1,332.0 million, as resident investors, primarily international banks, channelled funds into foreign debt securities. Similarly, net outflows arising from financial derivatives also increased notably, up to €68.4 million from €1.4 million in the year to September 2012.

Meanwhile, in the four quarters to September 2013, reserve assets contracted by €60.4 million, compared with an expansion of €113.4 million in the same period of 2012.

## International investment position

On the basis of data issued in a statement on Malta's international investment position (IIP), Malta continued to record a net external credit position vis-à-vis the rest of the world. This stood at €1,640.7 million at the end of June 2013, up by €179.9 million when compared with the net stock position a year earlier, but €85.1 million less compared with end-December 2012 data (see Table 4.2).[4]

The positive external position stemmed from a notable increase in foreign assets, which were only partly offset by an increase in liabilities. By end-June 2013, external assets rose to €48.7 billion, up by €1.0 billion from a year earlier, while external liabilities went up by €0.8 billion to €47.0 billion.

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

| | 2011 June | 2011 Dec. | 2012 June | 2012 Dec. | 2013 June |
|---|---|---|---|---|---|
| **Net international investment position** | **532.6** | **463.4** | **1460.8** | **1725.8** | **1640.7** |
| **Total assets** | **44,757.3** | **44,681.1** | **47,703.3** | **47,620.2** | **48,687.3** |
| Direct investment abroad | 1233.1 | 1084.5 | 1134.6 | 1108.3 | 1086.0 |
| Portfolio investment | 14,676.7 | 17,169.4 | 19,118.6 | 20,040.0 | 20,876.1 |
| Financial derivatives | 166.5 | 301.4 | 298.5 | 302.9 | 228.5 |
| Other investment | 28,308.6 | 25,730.0 | 26,601.8 | 25,635.3 | 26,047.4 |
| Reserve assets | 372.2 | 395.9 | 549.8 | 533.8 | 449.3 |
| **Total liabilities** | **44,224.7** | **44,217.7** | **46,242.5** | **45,894.5** | **47,046.7** |
| Direct investment in Malta | 11,746.8 | 11,946.5 | 11,975.5 | 12,356.1 | 11,423.3 |
| Portfolio investment | 520.6 | 472.0 | 478.4 | 475.5 | 548.9 |
| Financial derivatives | 215.7 | 377.3 | 472.8 | 455.1 | 379.9 |
| Other investment | 31,741.6 | 31,421.8 | 33,315.9 | 32,607.8 | 34,694.6 |

Source: NSO.

[4] The IIP statement issued by the National Statistics Office 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 improvement in the net external balance reflected the surplus on the current account, which was partly matched by net outflows on the financial account, as well as by the favourable impact of market valuation changes and exchange rate movements.[5]

Net portfolio investment assets increased, reflecting higher holdings of foreign debt securities, mostly bonds and notes, by banks resident in Malta. In addition, albeit to a lesser extent, a drop in net liabilities in the form of direct investment and financial derivatives also contributed. These positive developments were partly off-set by a rise in net "other investment" liabilities, predominantly in the form of currency and deposits, as well as by a drop in reserve assets.

[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 estimates, the general government deficit for the whole of 2013 was estimated to have declined to 2.9% of gross domestic product (GDP) from 3.2% in 2012, as current revenue was set to have grown at a stronger pace than current expenditure.[1] Meanwhile, general government debt was estimated to have reached 71.3% of GDP in 2013, up from 70.8% in 2012.[2]

### General government outcome

In the first nine months of 2013, the general government deficit widened by €62.5 million on the corresponding period of 2012, to €241.4 million as expenditure outpaced revenue. Revenue grew by €92.9 million, or 4.7% on the same period a year earlier, driven by strong growth in tax revenue (see Table 5.1). In particular, inflows from current taxes on income and wealth went up by €53.5 million, or 7.9% owing to higher income tax receipts from corporations and households. Intakes from taxes on production and imports rose by €21.9 million, or 3.3% mainly on the back of higher value added tax (VAT) revenue. Concurrently, inflows from social contributions increased by 3.0%. "Other" revenue also increased, but to a lesser extent, owing to higher inflows from sales by extra-budgetary units.

**Table 5.1**
**GENERAL GOVERNMENT BALANCE[(1)]**
*EUR millions*

| | 2012 Q1-Q3 | 2013 Q1-Q3 | Change Q1 - Q3 Amount | % |
|---|---|---|---|---|
| **Revenue** | **1,965.3** | **2,058.2** | **92.9** | **4.7** |
| Taxes on production and imports | 670.0 | 691.9 | 21.9 | 3.3 |
| Current taxes on income and wealth | 674.8 | 728.3 | 53.5 | 7.9 |
| Social contributions | 358.3 | 369.2 | 10.8 | 3.0 |
| Capital and current transfers | 112.2 | 111.1 | -1.1 | -1.0 |
| Other[(2)] | 150.0 | 157.7 | 7.7 | 5.1 |
| **Expenditure** | **2,144.3** | **2,299.6** | **155.4** | **7.2** |
| Compensation of employees | 679.4 | 728.1 | 48.7 | 7.2 |
| Intermediate consumption | 329.8 | 315.7 | -14.1 | -4.3 |
| Social benefits | 668.4 | 730.0 | 61.6 | 9.2 |
| Subsidies | 58.3 | 57.5 | -0.8 | -1.4 |
| Interest | 161.5 | 166.4 | 5.0 | 3.1 |
| Current transfers payable | 83.4 | 93.2 | 9.8 | 11.8 |
| Gross fixed capital formation | 136.5 | 136.8 | 0.3 | 0.2 |
| Capital transfers payable | 54.5 | 68.3 | 13.8 | 25.3 |
| Other[(3)] | -27.5 | 3.6 | 31.1 | - |
| **Primary balance** | **-17.5** | **-75.0** | **-57.6** | **-** |
| **General government balance** | **-178.9** | **-241.4** | **-62.5** | **-** |

[(1)] The general government balance is computed in line with the ESA95 methodology. For further details, see http://www.nso.gov.mt/docs/ESA95_Glossary.pdf

[(2)] "Other" revenue includes market output as well as income derived from property and investments.

[(3)] "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, which is defined to include extra-budgetary units, as well as 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 revenue. 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*.

In the first three quarters of 2013, general government expenditure rose by €155.4 million, or 7.2% above the level recorded in the same period of 2012. Around two-fifths of the overall increase was due to higher spending on social benefits, which went up by 9.2% mainly owing to increased outlays on retirement pensions. Concurrently, compensation of employees grew by 7.2%, partly under the impact of continued growth in employment within the education and health sectors, as well as of newly signed wage agreements that were concluded during the first half of the year.

"Other" expenditure increased significantly on a year earlier, when a one-off concession fee paid by a private firm to operate the National Lottery in 2012 lowered spending in that year.[3] At the same time, current transfers payable went up by 11.8% on the back of higher contributions to the EU budget, as well as following additional payments related to the new Parliament building. In line with the increasing debt profile, interest expenditure grew by 3.1%.

Moreover, capital transfers grew by 25.3%, reflecting a higher level of equity capital injected by Government into Air Malta during the year. Outlays on gross fixed capital formation rose by 0.2%.

Conversely, outlays on intermediate consumption fell by 4.3%. This area was targeted as part of the current spending review programme being carried out by Government to promote savings and to ensure an early correction of deviations from expenditure targets.

### Consolidated Fund

Between January and November 2013, the Consolidated Fund deficit declined by €34.8 million on a year earlier, as revenue grew by 8.6% while expenditure rose by 6.1% (see Table 5.2). The primary deficit, which is the headline balance net of interest payments, fell by €37.3 million in the same period.

Tax inflows contributed significantly towards the total increase in revenue. In particular, direct tax receipts rose by €105.4 million, or 9.8%, and alone accounted for more than half of the increase in revenue. Inflows from direct taxes were largely boosted by a surge of 11.8% in the intake from income tax. Social contributions went up by 5.8%, in line with continued growth in employment. Concurrently, indirect tax inflows rose by 7.3% mainly owing to an increase of 9.8% from VAT receipts. Customs and excise duties expanded by 15.2%, owing to the timing of duties on petroleum paid by Enemalta, the state-owned energy provider. Meanwhile, non-tax revenue grew by 7.9% as a result of higher grants from the European Union.[4]

The increase in expenditure primarily reflected greater recurrent spending, which went up by 5.4%. Around two-thirds of this rise was due to higher programme and other operational outlays. These resulted from additional spending on social benefits, but also from previously mentioned contributions to the EU budget and payments on the new Parliament building.

Personal emoluments grew by 6.3% following bigger outlays on wages in the health and education sectors. Contributions to government entities went up by 5.4%, also owing to higher transfers to entities related to health and education.

Capital expenditure grew by 11.1%, largely on account of a rise in transfers to Air Malta during the year. Moreover, spending on infrastructural projects co-financed by the European Union also increased.

[3] In line with ESA95 methodology, such revenue, which is related to the disposal of assets, is deducted from expenditure.

[4] The non-recurrence of the concession fee paid to Government for the operation of the National Lottery in 2012 had a negative effect on Consolidated Fund data for 2013. However, this effect was offset by an increase in grants paid to Government during the first 11 months of 2013.

**Table 5.2**
**CONSOLIDATED FUND BALANCE**
*EUR millions*

| | 2012 | 2013 | Change | |
|---|---|---|---|---|
| | Jan.-Nov. | Jan.-Nov. | Amount | % |
| **Revenue** | **2,205.6** | **2,395.6** | **189.9** | **8.6** |
| **Direct tax** | **1,072.2** | **1,177.6** | **105.4** | **9.8** |
| Income tax | 718.7 | 803.7 | 85.0 | 11.8 |
| Social security contributions(1) | 353.5 | 373.9 | 20.3 | 5.8 |
| **Indirect tax** | **858.2** | **921.1** | **62.9** | **7.3** |
| Value added tax | 501.8 | 551.1 | 49.3 | 9.8 |
| Customs and excise duties | 145.2 | 167.2 | 22.0 | 15.2 |
| Licences, taxes and fines | 211.3 | 202.9 | -8.4 | -4.0 |
| **Non-tax(2)** | **275.2** | **296.9** | **21.7** | **7.9** |
| **Expenditure** | **2,547.7** | **2,702.8** | **155.1** | **6.1** |
| **Recurrent(1)** | **2,242.4** | **2,363.6** | **121.1** | **5.4** |
| Personal emoluments | 510.8 | 543.1 | 32.3 | 6.3 |
| Programmes and other operational expenditure(3) | 1,334.1 | 1,409.9 | 75.8 | 5.7 |
| Contributions to entities | 192.8 | 203.2 | 10.5 | 5.4 |
| Interest payments | 204.8 | 207.4 | 2.5 | 1.2 |
| **Capital** | **305.2** | **339.2** | **34.0** | **11.1** |
| **Primary balance(4)** | **-137.2** | **-99.9** | **37.3** | **-** |
| **Consolidated Fund balance** | **-342.0** | **-307.2** | **34.8** | **-** |

(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.

## Government debt

Between the end of 2012 and November 2013 central government debt, excluding debt issued by extra-budgetary units and local councils, as well as debt held by Sinking Funds, increased by €415.7 million. At the end of November the outstanding amount stood at €5,064.9 million (see Table 5.3).

The increase in borrowing was substantially more than the amount needed to finance the shortfall recorded in the Consolidated Fund over the first 11 months of the year, as Government also built up its stock of financial assets, notably its bank deposits.

**Table 5.3**
**GOVERNMENT DEBT(1)**
*EUR millions*

| | 2012 | 2013 | Change |
|---|---|---|---|
| | end-Dec. | end-Nov. | Dec. 12 - Nov. 13 |
| **Government debt(1)** | **4,649.2** | **5,064.9** | **415.7** |
| Euro coins issued in the name of the Treasury | 50.1 | 55.0 | 4.9 |
| Treasury bills | 154.1 | 328.4 | 174.2 |
| Malta Government Stocks | 4,326.6 | 4,571.6 | 245.0 |
| Local loans | 56.4 | 56.4 | 0.0 |
| Foreign loans | 62.0 | 53.5 | -8.4 |

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

Source: Central Bank of Malta.

During 2013 the composition of debt changed in favour of higher issuance of Treasury bills, whose share in the total had fallen almost continuously since 2009. By November, the outstanding amount increased by €174.2 million from its level at the end of 2012, so that their share in total central government debt edged up to 6.5% from 3.3%. Conversely, Malta Government Stocks ended November at 90.3% of total debt, down from 93.1% at the end of 2012.

Over the same period, foreign loans decreased by €8.4 million as Government continued to repay external debt. Meanwhile, the value of euro coins in issue, which represent a liability for Government, increased by €4.9 million.

# PART II

# BANK POLICIES,

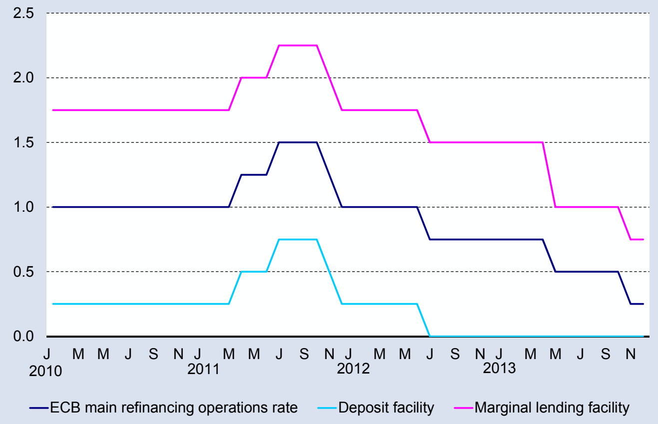
# OPERATIONS AND ACTIVITIES

# 1. THE CONDUCT OF MONETARY POLICY

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

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.

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




Source: ECB.

During 2013 the Eurosystem further eased the monetary policy stance. In May the Governing Council of the ECB decided to lower the rate on the main refinancing operations (MRO) by 25 basis points to 0.50%. In November the MRO was further reduced by 25 basis points to 0.25%, bringing key ECB rates to the lowest level since the introduction of the single currency (see Chart 1.1). Hence, at the end of 2013 the interest rates on the deposit facility and on the marginal lending facility stood at 0.00% and 0.75%, respectively. As a result, the interest rate corridor around the MRO became asymmetric.

## Monetary policy operations

The Central Bank of Malta implements the single monetary policy decisions of the Eurosystem in Malta. Thus, during the year the Bank regularly conducted open market operations with domestic credit institutions. It also offered standing facilities and administered the minimum reserve system.

### *Open market operations*

Open market operations are used to manage the level of liquidity in the money market and to steer short-term market interest rates close to the ECB's official rates. The Eurosystem has various types of open market operations at its disposal. 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 to deal with unexpected liquidity fluctuations in the market. These operations can be either liquidity-providing or liquidity-absorbing.

The Eurosystem continued to provide the financial system with a sufficient amount of liquidity by means of fixed rate tender procedures with full allotment on its MROs and LTROs. A total of 53 MROs were conducted by the ECB during the year, all at a fixed rate and with full allotment. Eligible domestic credit institutions participated in almost all of these weekly operations, bidding a total of €3.6 billion funds compared with €6.2 billion in the previous year (see Table 1.1).

Moreover, the ECB conducted 12 regular three-month LTROs, at a fixed rate and with full allotment, with the rate being equal to the average rate of the MROs during the lifetime of the operations. Local credit institutions obtained longer-term liquidity at various tenors to the tune of €0.1 billion, with 80.05% of this funding obtained through the three-month LTROs (see Chart 1.2).

**Table 1.1**
**PARTICIPATION OF ELIGIBLE DOMESTIC CREDIT INSTITUTIONS IN EUROSYSTEM OPEN MARKET OPERATIONS(1)**
*EUR billions*

| Type of operation | 2012 Amount bid | 2012 Amount allotted | 2013 Amount bid | 2013 Amount allotted |
|---|---|---|---|---|
| Main refinancing operations | 6.19 | 6.19 | 3.57 | 3.57 (2) |
| Longer-term refinancing operations | | | | |
| Maintenance period | 0.03 | 0.03 | 0.01 | 0.01 (2) |
| 3-month | 0.35 | 0.35 | 0.06 | 0.06 (2) |
| 6-month | - | - | - | - |
| 12-month | - | - | - | - |
| 36-month | 0.21 | 0.21 | - | - |
| Fine-tuning operations | | | | |
| Liquidity-providing fine-tuning operations | - | - | - | - |
| Liquidity-absorbing fine-tuning operations | - | - | - | - |
| Liquidity-absorbing operations (SMP-related) | 6.98 | 3.79 | 26.19 | 19.97 |
| US dollar collateralised operations | | | | |
| 7-day | 0.29 | 0.29 | - | - |
| 84-day | 0.32 | 0.32 | 0.12 | 0.12 (2) |

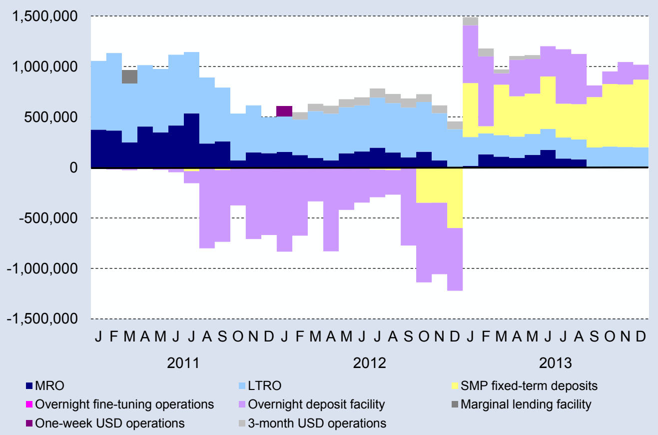
(1) A dash "-" indicates either that the Eurosystem did not conduct the relevant operations or that domestic credit institutions did not take part in them.
(2) In these Eurosystem open market operations, the amount allotted is equal to the amount bid due to the ECB's full allotment policy.
Source: Central Bank of Malta.

Furthermore, special-term refinancing operations were conducted. These had a tenor equivalent to the length of the relevant reserve maintenance period for every maintenance period during 2013. The fixed rate tender procedure with full allotment was adopted in these operations.

On 7 November 2013, the Governing Council of the ECB decided to continue conducting its MROs on a fixed rate and full allotment basis, for as long as necessary and at least until 7 July 2015. These procedures also remained in place for special-term refinancing operations, where the fixed rate in these operations was the same as the MRO prevailing at the time. Furthermore, the Governing Council decided to conduct the three-month LTROs by means of fixed rate tender procedures with full allotment. The rates in these operations were fixed at the average rate of the MROs over the life of the respective LTRO.

As from 2013, eligible credit institutions in the euro area had the option to pay back all or part of the amount of the three-year LTROs.

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




Source: Central Bank of Malta.

Although the Securities Markets Programme (SMP) was terminated with the announcement of the Outright Monetary Transactions (OMT) on 6 September 2012, the ECB continued to conduct the weekly, seven-day liquidity absorbing operation intended to neutralise the liquidity impact of the SMP. This operation is conducted with an intended volume related to the amount of securities outstanding at the end of the previous week.

The Eurosystem also took various measures in conjunction with other major central banks. In September the Governing Council of the ECB extended the liquidity swap arrangement with the Bank of England until 30 September 2014. Moreover, on 31 October the ECB, in cooperation with the Bank of Canada, Bank of England, the Bank of Japan, the Federal Reserve and the Swiss National Bank agreed that the existing temporary bilateral liquidity swap arrangements would be converted to standing arrangements, and that these arrangements would remain in place until further notice.

Furthermore, in October the ECB and the People's Bank of China agreed to establish a bilateral currency swap arrangement to purchase and subsequently repurchase Chinese yuan and euro from each other. From the Eurosystem's perspective, the swap arrangement was intended to serve as a backstop liquidity facility and to reassure euro area banks of the continuous provision of Chinese yuan. 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, net foreign assets and net assets denominated in euro .

### *Standing facilities*

During 2013 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. At end-2013, the width of the interest rate corridor stood at 75 basis points. From July 2012, the rate on the overnight deposit facility had remained at zero, while that on the marginal lending facility had dropped to 0.75% in November 2012.

During 2013 recourse to the overnight deposit facility from domestic counterparties amounted to €114.7 billion, a decrease of €42.06 billion from €156.79 billion in 2012. Recourse to the marginal lending facility also declined, totalling €0.02 billion during 2013 when compared with €0.04 billion in 2012.

## 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 2013, the nominal amount of eligible domestic marketable assets amounted to €4.9 billion.

After haircuts, the market value of securities that eligible domestic counterparties pledged in their pool of collateral with the Central Bank of Malta stood at €0.5 billion as at end-December 2013. This amount consisted of both domestic and cross-border securities.

During the course of 2013, the Bank adopted the new measures that were introduced by the Eurosystem with regard to the collateral framework, particularly on uncovered government-guaranteed bank bonds. The use of collateral in the form of uncovered government-guaranteed bank bonds issued by the counterparty itself, or by an entity closely linked to the counterparty, is no longer permitted as from 1 March 2015.

The Governing Council also amended the rules on the use of uncovered government-guaranteed banks bonds for the period until 28 February 2015. The national central banks (NCB) in the Eurosystem will now only be allowed to reject eligible uncovered government-guaranteed bank bonds as collateral if they were issued by the counterparty itself and if they do not comply with the Eurosystem's minimum credit rating threshold.

Furthermore, the ECB reviewed its risk control framework to increase transparency and standardisation.

### *Reserve requirements*

The ECB requires credit institutions established in the euro area to hold reserve deposits with NCBs. The objective of the Eurosystem's minimum reserve system is to contribute to the stabilisation of the 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. In 2013 the reserve requirement ratio remained unchanged at 1.0%.

## Reserve management

The Central Bank of Malta manages a financial assets portfolio, which has two components. One is the Bank's own portfolio, consisting of euro as well as non-euro denominated holdings. The other portfolio forms part of the Eurosystem's reserves.

The Bank applies a prudent approach to the management of its own portfolio, with the main objectives 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.

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 the formulation of the appropriate investment strategy within the parameters set by the Board of Directors. 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.

During 2013 the Central Bank of Malta introduced a tactical benchmark with a view to being in a position to make short-term adjustments in terms of operational strategy. The tactical benchmark is a dynamic tool that enables the Bank to fine-tune its position in accordance with short-term financial market movements.

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.

In terms of the European Exchange Rate Mechanism II (ERM II) agreement, and as a national central bank acting on behalf of the ECB, the Bank intervenes in those currencies participating in the ERM II regime. However, no such interventions were necessary during 2013.

The Bank's activity in the currency markets exhibited normal year-on-year fluctuations. Its foreign currency spot purchases during 2013 amounted to €669.0 million, less than the amount of €862.0 million reported in 2012. Meanwhile, spot foreign currency sales also fell to €664.0 million from €903.0 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 significantly to €15.7 billion in 2013 from €5.2 billion the year before. Meanwhile, sales in 2013 fell to €1.4 billion from €2.5 billion in 2012.

The Bank also 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 €17.3 billion, up from €16.6 billion in the previous year. This turnover partly stemmed from spot transactions, and, to a lesser extent, new swaps, amounting to €8.7 billion and €4.6 billion, respectively.

In turn, in 2013 the non-financial sector made up just under half of the spot deals. This 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 €23.8 million, significantly less than the €56.1 million reported in 2012. This was due to a reduced volume of spot transactions, while no new forwards were transacted.

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

## Market-making operations

During 2013 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, the Bank did not participate in the primary market for government securities and did not provide any other form of financing to Government.

The Bank publishes 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 quotes International Securities Market Association redemption yields on MGS on a daily basis.

During the year the Bank continued to provide advisory services on external financing and debt management to Government.

## Relations with financial institutions

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 two meetings during 2013. 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 government securities, in foreign exchange markets and in the domestic interbank market.

## 2. FINANCIAL STABILITY

In line with its statutory mandate, the Central Bank of Malta undertakes macro-prudential analysis and oversight to identify and evaluate potential systemic risks and vulnerabilities in the financial system. The objective is to protect and enhance the system's resilience through appropriate policy measures. Developments with systemic implications and Central Bank publications relating to financial stability continued to be analysed and discussed by the Bank's Financial Stability Committee. The Committee met three times during 2013.[1]

Following the recommendation of the European Systematic Risk Board (ESRB) on the macro-prudential mandate of national authorities, the Bank and the Malta Financial Services Authority (MFSA) established a Joint Financial Stability Board (JFSB) during 2013. This Board facilitates and establishes mechanisms of cooperation between the relevant authorities on matters related to financial stability. Such issues include the formulation of macro-prudential policy and the identification and assessment of macro-prudential instruments, as well as, where relevant, micro-prudential instruments. The JFSB focuses on strengthening the resilience of the financial system and on reducing the build-up of systemic risks, thereby promoting the contribution of the financial sector to sustainable economic growth.

The JFSB was established on the basis of a Memorandum of Understanding between the Bank and the MFSA. The JFSB was given legal status by virtue of amendments to the Central Bank of Malta Act, CAP 204, which came into effect in November 2013.[2] The Ministry of Finance is represented as an observer on the Board.

The JFSB held seven meetings during its first year of operation and discussions mainly related to various policy issues, including amendments to Banking Rule BR/09, implementation of and follow up to ESRB recommendations, results of stress tests and developments emanating from the new Single Supervisory Mechanism (SSM).

The Bank published its *Financial Stability Report* in August and an *Update* was placed on the Bank's website in December. In line with the practice adopted in the previous year, the analysis classifies banks into three groupings: core-domestic banks, non-core domestic banks and international banks. The distinction is based on the extent of each bank's linkages with the domestic economy.

The Bank enhanced its tool kit for early detection of risks emanating from the banking sector. In addition, there was further development of the Bank's credit risk model, which assesses credit risk in the loan portfolio of individual banks.

Using univariate stress testing techniques, the Bank continued to monitor the resilience of domestic credit institutions to various key shocks. The Bank enhanced the methodology of these exercises, while the scenarios against which the resilience was tested remained unchanged.

During the year the Bank also extended the 2011 European Banking Authority's (EBA) EU-wide stress-testing exercise to all core and non-core domestic banks. The data were updated and the methodology was further refined to better reflect domestic conditions. The overall robustness of the local banking system was confirmed and, in fact, most banks registered a slight improvement in their ability to absorb extreme yet plausible shocks, should they materialise.

The results of these stress-testing exercises were published in the *Financial Stability Report* and in the *Update.*

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

[2] The JFSB is chaired by the Governor, or, in his absence, the Deputy Governor and includes two other representatives of the Bank and two representatives of the MFSA.

The Bank, the MFSA and the Ministry for Finance maintained their regular exchange of information discussions within the Domestic Standing Committee, with senior officials focusing on issues related to crisis management. During 2013 the Memorandum of Understanding of the tripartite Crisis Management Task Force, which reports to the Domestic Standing Committee, was updated. This Committee's work mainly focused on the proposed EU Directive for Bank Recovery and Resolution.

Meanwhile, the Bank's Forum for Financial Stability, which includes representatives of the relevant authorities and major stakeholders in the financial services sector, met twice during 2013. The Forum fosters a structured dialogue on issues of common interest, with particular emphasis on the identification and management of risks in the financial system. Participants were also briefed on recent recommendations issued by the ESRB on developments relating to the creation of a Banking Union, EU legislation, such as the Capital Requirements Directive (CRD) IV and Capital Requirements Regulation (CRR) framework, on the upcoming EU Directive for Bank Recovery and Resolution, and on other policy issues.

During 2013 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 sub-structures. The Bank was also represented at meetings of the EBA.

Regulatory developments in the European Union focused on the creation of the banking union, particularly on the implementation by the ECB of the SSM. In this regard, bank officials participated in the High Level Group and Taskforce on Supervision of the SSM. On the basis of established criteria, Bank of Valletta plc, HSBC Bank Malta plc and Deutsche Bank (Malta) Limited were identified by the ECB as the Maltese banks that will be directly supervised by the ECB as from November 2014. The selected banks started to contribute to the Comprehensive Assessment that is being undertaken jointly with domestic supervisory authorities before the ECB assumes its supervisory responsibilities.

In December 2013, the MFSA set up a National Steering Committee to ensure that the appropriate governance structure would be in place to facilitate a successful implementation of the ECB's Comprehensive Assessment involving the Asset Quality Review and stress testing of the banks that would become subject to the direct supervision of the ECB once the SSM came into operation in the last quarter of 2014. The Governor and the Director General are members of the Committee, which is chaired by the Chairman of the MFSA. The Committee is chaired by the Chairman of the MFSA.

Together with the MFSA, the Bank conducted further rounds of the Quantitative Impact Study under the guidance of the Bank for International Settlements. This exercise estimates the effects of stricter global regulatory standards in line with the Basel III requirements on bank capital adequacy, leverage and liquidity. It also helps identify any possible effects of the new regulatory framework prior to its full implementation.

Other local policy developments in which the Bank was involved related to the joint work undertaken with the MFSA to amend the MFSA's Banking Rule 09.[3] This Rule was aligned to current standards with respect to both International Financial Reporting Standards (IFRS) and the EBA definitions on non-performing exposures. The amended Rule also requires banks to allocate as a reserve an amount of capital against their non-performing exposures. The reserve, as a minimum, is equal to 2.5% of a bank's non-performing loans less IFRS impairments and interest in suspense. Moreover, the Rule requires banks to set up appropriate governance structures, internal controls and reporting systems.

During the year the Bank continued to provide policy advice to Government on new EU Directives and Regulations related to the financial system. Such advice mainly related to the Banking Union, the new EU Directive for Bank Recovery and Resolution, and the new CRD IV/CRR framework, which was adopted on 17 July 2013 and became effective on 1 January 2014.

[3] Banking Rule 09 "Measures Addressing Credit Risks arising from the Assessment of the Quality of Asset Portfolios of Credit Institutions Authorised under the Banking Act 1994".

## 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 and the European Central Bank (ECB). The Bank issues coins on behalf of Government. Additionally, the Bank is responsible for the regulation and oversight of the payment and securities settlement systems in Malta. It also provides various banking services to Government and to credit institutions in Malta.

### Currency operations

The Bank continued to meet the currency requirements of banks operating locally, ensuring the authenticity and quality of banknotes and coins in circulation.

#### *Circulation of notes and coins*

The value of euro currency issued by the Bank continued to contract, though only by 0.3% to €896.1 million during 2013, compared with a decline of 1.7% in the previous year. The value of banknotes issued during 2013 decreased by 0.9%.

Net issuance generally followed the established seasonal pattern, with contractions in January and in the summer months, and an expansion in December. The latter relates to the increase in consumer spending over the Christmas period, while the moderation during summer reflects the buoyancy of the tourism industry, which leads to substantial inflows of currency from visitors to Malta (see Table 3.1).

All banknotes deposited at the Bank were examined for their authenticity and quality. During 2013 the Bank inspected more than 100 million banknotes with a value of over €1.9 billion. This was more than the 82 million banknotes examined in 2012, with the value of notes being €0.6 billion higher than in 2012. More than 25% of examined bank notes were found unfit and subsequently destroyed. The proportion of discarded banknotes rose to 22% in 2013 from 9% in 2012. The withdrawal of the old €5 series banknotes substantially boosted the proportion of destroyed banknotes in 2013. The Bank also continued to enhance its banknote examination capabilities to increase operational efficiency.

**Table 3.1**
**BANKNOTES ISSUED BY AND PAID INTO THE BANK IN 2013**
*EUR thousands*

| | | Issued | Paid in | Net issue | Issued and outstanding |
|---|---|---|---|---|---|
| **2012** | | 1,912,799 | 1,928,004 | -19,466 | 848,144 |
| 2013 | Jan. | 131,627 | 150,742 | -19,115 | 829,028 |
| | Feb. | 138,572 | 135,468 | 3,105 | 832,133 |
| | Mar. | 159,420 | 134,267 | 25,154 | 857,287 |
| | Apr. | 170,062 | 164,421 | 5,641 | 862,928 |
| | May | 172,201 | 173,305 | -1,105 | 861,823 |
| | June | 164,543 | 154,451 | 10,092 | 871,915 |
| | July | 184,857 | 200,645 | -15,788 | 856,128 |
| | Aug. | 166,032 | 184,153 | -18,122 | 838,006 |
| | Sep. | 162,764 | 173,709 | -10,946 | 827,060 |
| | Oct. | 174,450 | 187,061 | -12,611 | 814,449 |
| | Nov. | 160,883 | 159,196 | 1,687 | 816,137 |
| | Dec. | 192,473 | 168,044 | 24,428 | 840,565 |
| **2013** | | 1,977,884 | 1,985,463 | -7,579 | 840,565 |

Source: Central Bank of Malta.

During the first four months of 2013, the Bank finalised the preparations for the launch of the Eurosystem's second euro banknote series (ES2). The €5 note was launched in May 2013. The Bank, through the internal working group specifically set up to focus on the new ES2 notes launching, has also made preparations for the issue of the new €10 banknote, which is set for September 2014. The new series of euro banknotes includes further security-enhancing features.

The Bank acts as agent for 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 is due to Government.

As can be seen in Table 3.2, the outstanding value of coins issued by the Bank rose by 9.5% during 2013, reaching €55.6 million at the end of the year.

During 2013, 61.1 million euro coins, with a value of €34.0 million, were examined by the Bank. Both volume and value were higher than in 2012.

In the context of the euro area framework for the recycling of euro banknotes, in November the Bank amended Directive No 10 on the authenticity, fitness and recirculation of banknotes. 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 closely monitor the operations of credit institutions and of professional cash handlers, as well as the testing of various types of banknote handling machines. In November 2013, the Central Bank of Malta Directive No 12 entered into force. The latter focuses on administrative measures and penalties for offences and infringements under the Central Bank of Malta Act. As a result, the Bank may impose measures and penalties when cash handlers fail to fulfil any obligation arising from the Act or from any of the Directives issued by the Bank.

In order to promote cash handling skills, in December the Bank entered into an agreement with a company that provides training and certification to professional cash handlers using the "Knowledge of Banknotes e-learning tool". It is envisaged that in 2014 this certification would be extended to incorporate aspects relating to money laundering.

**Table 3.2**
**COINS ISSUED BY AND PAID INTO THE BANK IN 2013**
*EUR thousands*

| | | Issued | Paid in | Net issue | Issued and outstanding |
|---|---|---|---|---|---|
| **2012** | | 39,029 | 34,767 | 4,262 | 50,375 |
| 2013 | Jan. | 2,773 | 3,012 | -239 | 50,484 |
| | Feb. | 2,405 | 2,452 | -47 | 50,437 |
| | Mar. | 2,925 | 2,257 | 668 | 51,105 |
| | Apr. | 3,327 | 2,989 | 338 | 51,442 |
| | May | 3,487 | 2,906 | 582 | 52,024 |
| | June | 3,312 | 2,747 | 565 | 52,589 |
| | July | 4,043 | 3,122 | 921 | 53,510 |
| | Aug. | 3,925 | 2,995 | 930 | 54,440 |
| | Sep. | 3,163 | 3,052 | 111 | 54,551 |
| | Oct. | 3,601 | 3,274 | 327 | 54,879 |
| | Nov. | 3,247 | 2,825 | 422 | 55,301 |
| | Dec. | 3,032 | 2,777 | 255 | 55,555 |
| **2013** | | 39,239 | 34,406 | 4,833 | 55,555 |

Source: Central Bank of Malta.

### *Collection and disposal of the Maltese lira banknotes*
During 2013 the Bank continued to collect and dispose of Maltese lira banknotes, which ceased to be legal tender in 2008. In total, over 81,100 Maltese lira banknotes with a face value of over Lm0.8 million (equivalent to €1.9 million) were collected during the year. By the end of the year, the value of Maltese lira banknotes still in circulation amounted to Lm18.4 million (equivalent to €42.8 million).

### *Numismatic and commemorative coins*
The Bank's coin programme for 2013 was officially launched during a Coin Symposium held in February 2013, during which presentations on the themes commemorated by the coins to be issued in 2013 were made.

In February 2013, the Bank issued a numismatic coin commemorating the Maltese national poet, Dun Karm Psaila. The coin, available in both silver and gold, was issued as part of the Europa Programme 2013. The Bank also commemorated Malta's first post-war Prime Minister, Sir Paul Boffa, with a silver coin issued in November. In October the Bank issued a €2 coin commemorating the self-government constitution of 1921. This coin was the third in a series of five relating to Malta's constitutional history.

A new euro coin set dated 2013, and offered in brilliant uncirculated version, was issued in June. The set included the eight Maltese euro coins, as well as a €2 coin commemorating the constitution of 1921 and bearing the mark of the Dutch mint. This coin was issued again in October, as stated above, in circulation and proof versions, and without the mint mark of the Royal Dutch Mint. The set also contained a replica of a coin from the Byzantine period, the original of which is currently exhibited at the Bank's museum.

The Bank participated in two international coin programmes during the year. Under the "Fabulous 15 Silver Collections", the Bank issued a silver coin featuring Grandmaster Emmanuel Pinto in March. Under the "Smallest Gold Coin in the World", in April the Bank issued a gold coin depicting the "*Picciolo*", a small copper coin used in Malta during the time of the Order of St John.

In July the Bank issued a coin, available in gold or silver, displaying the Auberge de Provence in Valletta as part of a series of coins depicting the Auberges of the Knights of St John.

### *Anti-counterfeit measures*
During 2013 the Bank's Currency Surveillance Unit, which is responsible for promoting awareness on counterfeiting and for examination of suspected counterfeit currency, continued to examine banknote and coins, in liaison with the ECB.

The total amount of counterfeit banknotes withdrawn from circulation in 2013 was 1,751, or 5.2% more than the 2012 level. The counterfeit face value was €107,900. The Unit analysed over 1,700 suspect banknotes and shared its findings with the ECB's Counterfeit Monitoring System.

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

Following the Eurosystem's coordinated assessment of the bilateral links involving the local securities settlement system carried out in 2012 and 2013, MaltaClear was declared eligible both as an investor and issuer for the Eurosystem credit operations. Furthermore, during 2013 the Bank, together with the Malta Financial Services Authority (MFSA), launched an assessment of MaltaClear as part of its ongoing oversight of payments and securities settlement systems. The assessment was required as a pre-requisite for joining TARGET2-Securities (T2S) platform, which is a Eurosystem project providing a single IT platform for securities settlement aimed at maximising safety and efficiency in the settlement of euro-denominated securities transactions. Since both the Malta Stock Exchange (MSE) and the Bank will join T2S in the first migration wave in June 2015, the T2S National User Group continued its preparations and liaison with the local market for the participation in this project.

In 2013 the Bank managed once more 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 through the Malta Clearing House fell by 2.1%, while the overall value declined by 0.8%, compared with the previous year.

The Bank's operations in TARGET2, which is the payment settlement system through which Eurosystem central bank operations and large-value interbank transfers are settled, increased further during 2013. Total payment flows rose by 19,368, over a year earlier, to stand at 59,997. However, the value of payment flows decreased significantly to €97.9 billion from €263.8 billion in 2012. Low interest rates reduced the incentive for counterparties to hold overnight deposits with the Bank.

Following the appointment of the Central Bank of Malta as the Single Euro Payment Area (SEPA) Competent Authority, the Bank held several meetings with various stakeholders to ascertain the smooth migration to SEPA by 1 February 2014, the changeover date. The SEPA project aims to increase the efficiency of payments in the single euro payments area through the adoption of a single standard for credit transfers and direct debits, thus removing the current fragmentation that exists in the electronic payments landscape in Europe. The project's objective is to make retail cross-border payments as safe and as efficient as domestic payments, and with similar charges.

The Bank successfully completed the migration of all direct credits to SEPA credit transfers in relation to students' maintenance grants, the government payroll and all social security benefits. The value of SEPA credit transfers processed by the Bank in 2013 stood at €1.4 billion, up from €914.3 million a year earlier. In collaboration with the Ministry of Finance and the Malta Bankers' Association, the Bank organised and participated in 30 information sessions that were targeted to raise awareness on SEPA and to encourage a timely migration.

Also during 2013, the Bank met various representatives from payment, financial and e-money institutions that had applied for licences from the MFSA. These discussions provide the Bank with more awareness on new business being set up and on what type of new payment systems and instruments are offered to clients. This information is required as approval from the Central Bank of Malta as overseer is needed when a new payment system is set up.

### 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, particularly through SEPA credit transfers, were reflected in the lower number of cheques it issued. In 2013 these declined by 4.9% compared with the previous year, while their total value decreased by 2.2%.

During the same period, payments effected by the Bank in connection with the servicing of Government's external debt amounted to €13.8 million. Meanwhile, allocations to external debt sinking funds during 2013 stood at €57.9 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 10% to €286.6 million in 2013 when compared with 2012. With regard to foreign exchange payments effected on behalf of Government and public sector entities, these declined by 11.6% to €249.9 million. Year-on-year fluctuations in 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 2013 the Bank continued to provide portfolio management services in relation to the Investor Compensation Scheme and the Depositor Compensation Scheme on the basis of parameters set by management committees appointed by the MFSA to regulate such schemes.[1] 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.

[1] 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 2013 the Board was composed of Professor Josef Bonnici, Governor and Chairman, Mr Alfred DeMarco, Deputy Governor, and Mr Victor Busuttil, Ms Antoinette Caruana (until the expiry of her term of appointment on 13 April 2013) and Ms Philomena Meli as non-executive Directors. Mr Peter J. Baldacchino and Dr Romina Cuschieri were appointed as non-executive Directors on 14 April and 17 December, respectively.[1] Dr Bernadette Muscat was Secretary to the Board of Directors. During the year, the Board met 13 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, the Director General and Executive Directors of the Bank. There were no changes in the composition of the Committee during 2013, which met 22 times.

The Management Committee, composed of the Bank's Heads of Department, is mandated to ensure that Bank operations are carried out economically, effectively and efficiently. The Management Committee met 19 times.

During 2013 the Bank restructured the Information Systems and Knowledge Management Department within the Financial Stability and Information Systems Directorate. The Directorate is now split into two departments: Information Systems Department and Knowledge Management Department. The former focuses on the Bank's IT requirements. The latter is responsible for the organisation and implementation of knowledge services within the Bank.

The Bank also hived off the Legal Office from the Communications and Legal Department with both functions reporting separately to the Governors. Thus, the Communications Department now focuses solely on the communications function and is responsible for all matters relating to public relations, communications, publications and the website.

### *Governor's 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.

In January, during a seminar organised by the Malta branch of the Institute of Directors, the Governor delivered a speech on the challenging nature of economic and financial governance following the euro area crisis.

At a press launch in April, the Governor presented the Bank's *Annual Report 2012.* In May the Governor delivered two presentations to the newly-established Economic and Financial Affairs Parliamentary Committee, focusing on the International Monetary Fund's (IMF) Article IV Consultation on Malta and on the challenges and way forward of the Economic and Monetary Union.

[1] In accordance with the Central Bank of Malta Act as amended in November 2013, Mr Alexander Demarco was appointed as the Bank's second Deputy Governor with responsibility for Financial Stability, from 1 January 2014.

In June the Governor addressed a seminar on business ethics organised by the Faculty of Theology at the University of Malta, during which he spoke about the role of ethics and values in economic decision making. In July the Governor delivered a presentation during a career development programme organised for students in economics, management and accountancy at the University of Malta. The Governor delivered a presentation to the Malta Bankers' Association on the access to finance of Maltese businesses in August.

The Governor gave a presentation on the future of financial services in Malta during the KPMG Biennial Financial Services Conference in November. He was also the keynote speaker at the annual dinner of the Institute of Financial Services held in November. On this occasion, he spoke about achieving Malta's potential growth in challenging times.

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

### *Governor's activities overseas*

The Governor participated in meetings of the ECB's Governing Council, General Council and the European Systematic Risk Board (ESRB). He also took part in three informal dialogues organised by the ECB with chief executive officers from the financial and non-financial business sectors. The Governor also attended two informal Economic and Financial Affairs (ECOFIN) Council meetings during the year.

In April the Governor participated in the IMF/World Bank Spring meetings in Washington, while in June he attended a conference on the changing role for central banks in Vienna organised by Oesterreichische Nationalbank, the central bank of Austria.

In July the Governor was a guest at the Official Monetary and Financial Institutions Forum and at Market News International Connect in London, where he delivered presentations on the monetary policy scenario in the euro area and Malta's economic performance, respectively. 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 September the Governor spoke about the debt crisis, financial reform and the common good at a conference organised by the *Fondazione Centesimus Annus – Pro Pontifice* in the Vatican City. He also attended the Euro Conference in Latvia. In October the Governor attended the IMF and World Bank Annual Meetings in Washington. Later in the month, he was a moderator and panellist during the Institute Fund Summit Euro 2013 organised by the Sovereign Wealth Fund Institute in Frankfurt.

In December the Governor attended a conference in Rome that was organised by the Banca d'Italia on "Money and monetary institutions after the crisis".

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

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

## Strategy and planning

The Bank launched its strategic plan for 2013-2015 in the early part of 2013. The plan outlines the key strategic priorities of the Bank. Primarily, the Bank focuses on making an effective contribution to the formulation and implementation of the Eurosystem monetary policy, and also on providing independent advice on economic and financial policy matters by providing timely analysis of relevant issues. The Bank also seeks to fulfil its financial stability function by assuming a leadership role in macro-prudential decisions.

Another strategic priority is to ensure the robustness and smooth functioning of the financial market and of the payment system, and the effective management of currency issuance.

Finally, the Bank seeks to manage its resources in an economic, effective and efficient way, thus ensuring a sustainable financial position. These priorities are backed by cross-organisation and departmental initiatives, whose implementation and progress are monitored to ensure adherence to Bank strategy.

## Governor's Office

The Governor's Office provided expert support prior to 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 preparation for the development of policy positions of the Bank, particularly those related to Malta and the euro area. It also contributes to 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 2013 the Committee was chaired by Mr Victor Busuttil, with Mr Alfred DeMarco and Mr Peter J. Baldacchino, who replaced Ms Philomena Meli, as members.

The Committee met on six occasions during the year and addressed various issues, including internal audit methodologies, plans and operations, exposures to risk, particularly at a macro level, and other policy matters.

## Internal Audit Department

In fulfilling its assurance obligations, the Bank's internal auditors conducted local risk-based audit engagements, focusing on evaluating the adequacy and effectiveness of governance, risk management and control processes deployed in a number of critical business areas. Based on the findings, the internal auditors issued a number of recommendations to management at various levels, suggesting improvements in the design and discharge of policy, procedures, systems and monitoring mechanisms. The primary objective of the recommendations was the enhancement of risk mitigation measures through the efficient and economic utilisation of resources.

As in previous years, the internal audit department also conducted several procedural, statutory and ad hoc audits. During the year ongoing follow-up activities were carried out to assess the status of the implementation of previous recommendations raised at both local and ESCB levels.

In discharging its consulting role, the department provided support to other business areas within the Bank, particularly with regard to the cost-effective implementation of control and oversight activities, project management, issues related to policy deployment, and the consolidation and enhancement of the Bank's risk assessment and information security framework.

Following the engagement of an independent service provider in 2013, an external quality assessment of the Bank's internal audit function was carried out. The assessment once again confirmed general adherence to the Institute of Internal Auditors Standards and compliance in form and substance with the ESCB's Internal Auditors Committee (IAC) manual, and with the Bank's Internal Audit Charter and Audit Manual.

In fulfilling its ESCB responsibilities, the internal audit department participated as a full member in the IAC and completed the six audits approved by the Governing Council, which had been planned for 2013 on behalf of the ESCB.

## Risk assessment

The roll out of the operational risk management (ORM) framework and the ORM Tolerance Policy within the Bank was finalised during 2013. The Bank also reviewed the internal structure to assess its overall risks, including financial, operational and legal risk, and decided to establish a Risk Committee, chaired by the Deputy Governor.

During the course of the roll-out of the ORM framework, and with the assistance of an expert from the Central Bank of Ireland, the Bank reviewed lessons learnt from earlier phases of the roll-out. The Bank also drafted a revision of the Incident Reporting Policy, which is expected to be implemented during 2014.

The Bank continued to update and test its business continuity plans. Furthermore, the Bank commenced a review of the maximum tolerable outage of each process and is now finalising a prioritisation list. Following prospective business impact assessments and a review of business continuity plans, the Bank would be in a position to assess the required resources to recommence operations in the shortest time possible in the event of a major disruption and to consider an alternative disaster recovery location.

## Data Protection and Freedom of Information

The Bank continued to comply with the requirements of the Data Protection Act and the Freedom of Information Act. The Bank carried out its annual review of personal data held and processed to ensure that all legal obligations in this regard were adhered to. During the year, the Bank received one request for information under the Freedom of Information Act.

## Information security

The Bank started a review of its information security standards and policies to ensure that these were in line with ISO/IEC 27002:2013. This work is scheduled to be finalised in 2014.

## Legal issues

During 2013 the Bank was involved in drafting changes to Maltese legislation relating to the Central Bank of Malta Act and directives issued under this Act. The Legal Office advised senior management on issues related to the Bank's governance structure and on various activities and projects, notably the setting up of a legal risk management policy.

A number of revisions to the Central Bank of Malta Act were enacted in November 2013. The main amendment concerned the setting-up of the Joint Financial Stability Board composed of representatives of the Central Bank of Malta and the MFSA to cooperate on matters affecting financial stability. The amendments also included the insertion of a new mandate to formulate and implement macro-prudential policy. In consequence, the Bank's Board structure was strengthened with the appointment of a second Deputy Governor responsible for financial stability. Other amendments related to fine-tuning of the Bank's powers with regard to the regulation of payment systems and payment services, and a general update of the Act to bring it in line with recent EU legislative developments.

The Central Bank of Malta (Penalties for Offences and Infringements) Regulations (SL.204.05) were repealed following the changes to the Central Bank of Malta Act since the Bank is now empowered to impose administrative penalties for infringement of the Act and Directives issued thereunder.

During 2013 the Bank amended a number of directives under powers granted to it in terms of the Central Bank of Malta Act. These included:

- Directive No. 6 on the Harmonised Conditions for participation TARGET-2 Malta
- Directive No. 8 on Monetary Policy Instruments and Procedures
- Directive No. 10 on the Authentication, Fitness Checking and Recirculation of Euro Banknotes and Coins

The Bank also issued a number of new directives, which include:

- Directive No. 11 on macro-prudential policy aimed at implementing the Recommendation of the ESRB of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3)
- Directive No. 12 on Administrative Measures and Penalties for Infringements under the Central Bank of Malta Act implementing new powers granted to the Bank under the revised Central Bank of Malta Act to impose administrative penalties
- Directive No. 13 laying down the objective of macro-prudential policy and the way the Bank intends to implement macro-prudential policy

As in previous years, the Bank continued to be represented on the Board of Governors of the Financial Analysis Intelligence Unit and on the Sanctions Monitoring Board.

## Economics and research

The Bank regularly analyses economic and financial developments in Malta and abroad. Bank staff provided input to 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 and presented to the Governor, the Deputy Governor and the Bank's senior management. The Bank published the analysis of economic developments in its *Quarterly Review* and *Annual Report*. It also released a monthly commentary on monetary developments in Malta.

The Bank participated 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. A separate projection exercise was undertaken in the context of the Bank's *Annual Report*. The Bank also prepared detailed fiscal forecasts as part of the ESCB forecast exercises. Further work was carried out during the year on changes that would strengthen the Bank's short-term forecasting capability.

During 2013 the Bank contributed to Eurosystem research projects on competitiveness in the euro area, on wage and price setting at firm level, on assessing the sensitivity of the economy to fiscal shocks and on the impact of fiscal consolidation on medium-term economic growth.

The overhaul of the Bank's structural econometric model was completed early in the year and a working paper documenting the model was published on the Bank's website. The model was also used to carry out a range of simulations as part of an EU-wide exercise.

Other working papers in the Bank's series that were published on the Bank's website during the year focused on the effects of structural reforms in Malta; the sustainability of government debt; inflation differentials between Malta and the euro area; and the evolution of economic governance in Europe. An additional working paper reported on results of the survey on household finances and consumption patterns in Malta. Further analytical work was carried out on labour market issues, inflation persistence, competitiveness and pension reform.[2]

Bank staff also presented the results of their research at a number of international conferences. The topics covered included pension reforms and pension adequacy, as well as joint work on modelling tourism demand. Papers written by a staff member on adapting the Hodrick-Prescott filter for very small economies and on assessing the sustainability of pension reforms in Europe were also published in economics journals abroad.

[2] Working papers were prepared mainly by staff in the Economics & Research Department, though authors from other departments also contributed.

## Statistics

The Bank is primarily responsible for the development, collection, processing and dissemination of a wide range of monetary and financial statistics for analytical and policy making purposes. In cooperation with the National Statistics Office (NSO), the Bank also participates in the compilation of balance of payments and financial accounts statistics.

During the year, the Bank took a number of steps to enhance public accessibility to statistical data. Answers to frequently asked questions on its website assist the public in looking up and interpreting a wide range of statistics. During 2013 the Bank started to release a set of financial soundness indicators pertaining to core banking institutions and published additional historic monetary statistics.

The Bank continued to fulfil its international statistical reporting obligations, mainly those stemming from the ECB, ESRB and the IMF. It also participated in the IMF's Special Data Dissemination Standard, the General Data Dissemination System and in various surveys of the Fund.

Preparations are also well under way to implement a number of new European regulations. These include the Regulation on the European System of National and Regional Accounts in the European Union (ESA 2010), the new ECB Regulations in the area of securities holding and payment systems statistics, the revised ECB Regulations and Guidelines in the area of monetary and financial statistics, and the new edition of the IMF's Balance of Payments Manual.

During the course of 2013, the Central Bank of Malta and the MFSA thoroughly revised and integrated the reporting requirements pertaining to registered Investment Service Providers. Such information, which will enhance information on securities held by custodians on behalf of their customers, will also allow the Bank to collect information on households' investments abroad.

During 2013 the Bank conducted a survey on the payment habits of the Maltese society. Processing of the data will be completed in 2014 and the findings will establish a base for recommendations to be put forward as part of a future national payments strategy.

Meanwhile, the Bank stepped up its preparations for the second wave of the survey on households' finances and consumption patterns in Malta. The fieldwork will be conducted in early 2014, while the imputation, estimation and compilation of results will be undertaken by early 2015. In 2010 the Bank has participated in a similar survey conducted by the ESCB's Household Finance and Consumption Network together with a number of EU central banks.

Preparatory work was also undertaken for the second wave of the Eurosystem's collaborative Wage Dynamics Network project. A survey of sampled companies is scheduled for 2014 to identify key features of Malta's wage and price setting behaviour, including labour market characteristics.

In 2013 the Bank further strengthened its financial accounts statistics, primarily by enhancing the database of micro-statistics on the corporate sector. The Bank intends to publish Malta's non-consolidated financial accounts statistics as from 2014.

The processing of statistics requires a robust, efficient and adaptable IT solution. In 2013 the Bank continued in its efforts to identify the optimal solution and started negotiations with a major central bank in the euro area to establish costs and service levels. Preliminary validation was complemented by IT and technical investigations, together with on-site visits.

At a national level, the Bank continued to be represented on the Government Finance Statistics Committee, which includes officials from the NSO and the Ministry for Finance, and is responsible for the reporting of government finance statistics under the EU Commission's Excessive Deficit Procedure notification.

Moreover, the Bank and the NSO continued their close cooperation on the improvement of the quality of Malta's macroeconomic statistics, targeting primarily the enhancement of the NSO's business register and the two institutions' residential property price indices. In March the two institutions signed a revised version of their Memorandum of Understanding by virtue of which they agreed to be bound by various covenants and to assist each other in fulfilling their respective duties in the area of statistics.

In a drive to broaden the contribution of statistical information to the formulation of policy, Bank representatives participated in the Building Industry Consultative Council, providing the necessary statistical support.

The Technical Committee on Financial Statistics continued to meet during 2013. This Committee is chaired by the Bank and includes representatives from credit institutions, the MFSA, the NSO and the Malta Bankers' Association. It coordinates the smooth transition to new reporting systems, while seeking to enhance existing ones.

## Human resources

At the end of 2013, a total of 332 full-time staff were employed at the Bank, 11 more than in the previous year. The number of part-timers stood at 27, seven more than at the end of 2012. In terms of full-time equivalents, the staff complement rose to 327 from 317 in 2012.

During 2013 the Bank recruited 29 employees (18 Officers II, one Legal Officer and ten Part-time Officers I). At the same time, 11 employees resigned from the Bank, three of whom had worked on a part-time-basis.

In 2013 two employees returned from secondment, while three others were seconded to offices within the public sector and a charitable organisation.

In addition, seven employees took up short-term contracts with the ECB in the areas of risk management, market operations, currency, payments and market infrastructure, human resources and secretarial support. The Bank also took on two interns who worked on specific research projects.

During the summer the Bank also provided temporary summer work placement for eight students from the University of Malta, and for three other students from the Malta College of Arts, Science and Technology.

### *Training and development*

During the year the Bank allocated further resources to staff training, both within the Bank and outside, through courses organised by local and foreign providers.

The in-house programme was varied, offering 48 different courses mainly in IT, economics, statistics, health and safety, and staff development programmes. Induction programmes were also organised for all new employees. In addition, the Bank held a number of seminars to outline its strategic objectives in the medium term.

As Table 4.1 shows, the number of staff members who participated in external training programmes rose to 259 from 223 in the previous year. Foreign courses were provided by the ECB, various central banks and other professional institutions.

**Table 4.1**
**STAFF TRAINING DURING 2012**

| Type of training | Number of courses/seminars | | Number of participants | |
|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 |
| In-house | 44 | 48 | 587 | 1189 |
| External | 140 | 154 | 223 | 259 |
| Local | 81 | 84 | 160 | 185 |
| Overseas | 59 | 70 | 63 | 74 |

Source: Central Bank of Malta.

**Table 4.2**
**ACADEMIC AND PROFESSIONAL COURSES**
*Number of employees*

| Type of programme | Courses completed | | Courses being pursued | |
|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 |
| Postgraduate courses | 13 | 8 | 18 [1] | 23 [1] |
| Honours first degree courses | 5 | 0 | 3 | 0 |
| Diploma courses | 2 | 4 | 3 | 0 |

[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 year a number of employees benefited from the Bank's study programmes (see Table 4.2). A total of 12 beneficiaries successfully completed their degree studies in 2013, while 23 continued with their studies.

Throughout 2013 the Human Resource Assessment Task Force continued its revision of job descriptions, identifying new roles, skills and competency levels. The Task Force developed a standard list of competencies based on managerial, general and technical competencies, and will proceed to identify skill gaps in the various departments of the Bank.

## Information Systems and Knowledge Management

Following the re-structuring of the Information Systems and Knowledge Management Department, the redesigned Information Systems Department will focus primarily on all the Bank's IT requirements, including software development and technology infrastructure. Meanwhile, the newly established Knowledge Management and Information Security Department will be responsible for the implementation of knowledge services.

### *Information Systems*

The development of the Bank's in-house software solutions proceeded throughout 2013, along with an upgrade of the Bank's technology infrastructure and a further strengthening of knowledge management services, which are designed to enhance the management and exchange of information.

Apart from the continued improvement of the Bank's information systems, a number of high profile technology related projects were completed in 2013, including the upgrade of the email system. Towards the end of year, the upgrade of the SharePoint and SQL Server platforms to include the latest releases was initiated, with completion scheduled for the first quarter of 2014.

The Bank also upgraded its market data information service to the latest Reuters EIKON platform. Progress continued in the Bank's business applications architecture project, which seeks to identify appropriate IT solutions that would meet the Bank's evolving business needs.

In 2013 the Bank widened the SEPA application to cater for public service payroll payments, stipends and Department of Social Security transactions, and for the projected increase in monthly transactions. Other enhancement releases are also planned for 2014 to cater for payments by the Malta Stock Exchange.

The Bank contributed towards the further evolution of the ESCB IT infrastructure through its representation on the working groups reporting to the ESCB IT Committee. The Bank continued to improve the dedicated environment for the exchange of data within the ESCB community to comply with the ECB's requirements. Preparations have commenced to establish IT applications in connection with the ECB's Single Supervisory Mechanism.

### *Knowledge Management*
During the year the Microsoft SharePoint continued to be employed as the main collaborative tool for internal management of documents and information. Over the coming years, the Bank will implement a new document and information management system, and a move towards an e-document system for archives.

As in previous years, the Bank's library offered its services to staff and fulfilled requests from external users engaged in economic and financial research. It enhanced its print and electronic collections, and acquired new books and periodicals, including specialised publications related to central banking. It also continued to house a collection of publications issued by international financial institutions. Many of the library's services are now available electronically within the Bank through the library portal.

## Premises and procurement
During 2013 work continued on the embellishment of the Bank's premises and its environs. The roof garden on the bastions at St James Counterguard neared completion, while works on the restoration of the bastion walls and ancillary infrastructure were completed.

With regard to the Annexe 2 building at St James Counterguard, the first stages of demolition, consolidation and excavation works were completed. Construction works were expected to commence in 2014 while work on the tendering process for project completion was at an advanced stage.

Throughout the year, the Bank continued to participate in a Eurosystem procurement coordination programme that enabled members of the Eurosystem to benefit from efficiencies in the procurement of supplies and services.

## Corporate Social Responsibility

### *Environmental initiatives*
The Bank continued with its strategy of encouraging waste separation at source, energy efficiency, reduction in water consumption and green procurement. Measures included the recycling of paper, through which 8.3 tonnes were recycled. During 2013 the Bank embarked on a rain harvesting project with the building of a water cistern at St James Counterguard.

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

### *Social commitments*
The Bank provided financial support to institutions in areas connected to its functions. In this regard, the Bank sponsored for a second consecutive year the "Central Bank of Malta Chair in Economics" at the University of Malta through the latter's Research, Innovation and Development Trust.

In the cultural sphere, the Bank assisted various organistions, including *Fondazzjoni Patrimonju Malti*, the Malta Philharmonic Orchestra and *Din L-Art Ħelwa*.

It also extended its assistance to various charities, including the Malta Community Chest Fund, Caritas, *Kummisjoni Emigranti* and *Dar tal-Providenza*. Moreover, one staff member was seconded to a charitable instititon.

## Information and public relations
Throughout the year, the Bank provided information to the public on its policies, operations and activities though its website, which also carries press and statistical releases and a library of all official Bank publications. The Bank also replied to requests from both local and foreign media and organised a number of corporate events, as well as educational school visits. In the course of the year, the Bank hosted three ESCB meetings.

The Bank was responsible for several events relating to numismatics and commemorative coins. In February the Bank organised a numismatic symposium to introduce its Coin Issuance Programme for 2013 and raise public awareness of the historical significance of the coins minted in the course of the year. In May the Bank organised a national information campaign for the launching of the ES2 €5 banknote of the Europa series. For the fourth consecutive year, the Bank opened its doors to the public on the occasion of the Notte Bianca in October.

## 5. INTERNATIONAL RELATIONS

As a member of the Eurosystem, (which comprises the European Central Bank [ECB] and all euro area national central banks [NCB]) and of the European System of Central Banks (ESCB), in 2013 the Central Bank of Malta continued to participate in the decision-making processes of these institutions and to collaborate closely with the ECB. The Bank also maintained strong relations with other international institutions, notably the European Commission, the European Bank for Reconstruction and Development (EBRD), the International Monetary Fund (IMF) and the World Bank Group.

**Table 5.1**
**EUROSYSTEM/ESCB COMMITTEES**

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

### Eurosystem and European System of Central Banks

During the year the Governor continued to participate in the Governing Council of the ECB, which is made up of the ECB's Executive Board members and the Governors of the NCBs of euro area Member States. The Council is responsible for the formulation of monetary policy within the euro area and decides on the implementation of tasks entrusted to the Eurosystem. The Governor is also a member of the General Council of the ECB, which mainly performs an advisory role and comprises the President and Vice-President of the ECB, and NCB governors of all Member States in the European Union.

The Governing Council and the General Council are supported by a number of committees, working groups and other structures. Throughout the year, senior Bank officials participated in the 18 Eurosystem/ESCB committees (listed in Table 5.1) and in other high level structures of the ESCB. In addition, other staff members took part in various committee sub-structures and task forces. In collaboration with the Malta Financial Services Authority (MFSA), the Bank was also actively involved in preparations leading to the setting up of the Single Supervisory Mechanism under the leadership of the ECB.

During 2013 the Governor was a signatory to a number of multilateral agreements related to operations of the Eurosystem and the ESCB. These included, among others, agreements on the Correspondent Central Banking Model, TARGET2 and arrangements related to the accession of Latvijas Banka, the central bank of Latvia, to the Eurosystem in 2014.

The Governor also attended informal dialogue meetings with investors and chief executive officers from the non-financial business sector, which were organised by the ECB.

Following Croatia's accession to the European Union in July, the Bank's weight in the key for the ECB's capital subscription went up marginally to 0.0635% from 0.0632%. This led to a slight increase in the Bank's share in the ECB's total subscribed and paid-up capital to €6.9 million from €6.8 million.

In 2013 the ECB and 11 NCBs, including the Central Bank of Malta, completed an EU-funded technical cooperation programme with the National Bank of the Republic of Macedonia (NBRM). The programme covered ten areas of central banking and included an assessment of the NBRM's current institutional and operational framework, together with recommendations to further strengthen its institutional capacity and bring it closer to EU central banking standards. The Bank provided technical assistance on matters related to balance of payments statistics and the compilation of the international investment position.

Also in 2013, in coordination with the ECB and other Eurosystem NCBs, the Bank committed itself to participate in a new technical cooperation programme with the Bank of Albania. This programme, which is scheduled to be completed in 2014, includes a needs analysis with recommendations on how to reinforce the institutional capacity of the Albanian central bank and bring its practices more in line with EU standards.

### European Systemic Risk Board

The Governor, as member, participated in the three General Board meetings of the European Systemic Risk Board (ESRB) that were held during 2013, while senior officials of the Bank participated in the ESRB's Advisory Technical Committee and its sub-structures.

During the year the ESRB made significant progress towards a comprehensive framework linking the preservation of financial stability to a group of intermediate objectives and to an indicative set of macro-prudential instruments to help achieve these objectives. It also issued recommendations on money market funds, on the funding of credit institutions and on macro-prudential policy.

### Other EU institutions

During 2013 the Governor participated in two informal meetings of the Economic and Financial Affairs Council, while the Deputy Governor and other Bank officials regularly took part in meetings of the Economic and Financial Committee (EFC). EFC discussions continued to play a key role in addressing the current challenges in economic governance, fiscal and macroeconomic surveillance, international economic coordination and the stability of the financial sector.

In particular, the Bank participated in EFC discussions on issues relating to Member States' macroeconomic and fiscal policies in the context of the Second European Semester, in-depth surveillance of the economic and fiscal situation and programme implementation, and the implementation of measures to strengthen the banking system, particularly the setting up of a banking union. The EFC also continued to monitor the impact of ensuing developments in the banking and sovereign debt markets on financial stability and the Single Market.

During the year the EFC also played a crucial role in the preparation of European positions at the G-20 meetings and in other relevant international institutions, such as the IMF and the Financial Stability Board (FSB).

Bank officials also participated in meetings of a number of EFC sub-committees, which discussed sovereign debt, IMF matters and currency issues.

Furthermore, the Bank participated directly in various other committee structures of the European Union and contributed extensively, through consultations with Malta's official representatives within the respective EU structures, to discussion on matters of an economic and financial nature.

### European Bank for Reconstruction and Development

The Bank monitored developments at the EBRD and collaborated with the Ministry for Finance on issues related to Malta's membership in this institution. The Bank provided advice on resolutions that required a decision by the EBRD's Board of Governors.

In May a senior Bank official represented Malta at the annual meeting of the EBRD held in Istanbul, Turkey, where the EBRD announced strong financial results, although its operating environment remained difficult.

## International Monetary Fund

In his capacity as Governor for Malta on the Board of Governors of the IMF, the Governor attended the IMF/World Bank spring meetings in April and annual meetings in October. In consultation with the Ministry responsible for finance, he voted on a number of resolutions proposed by the Fund's Executive Board.

Since the IMF Resolution concerning the 14th General Review of Quotas had not yet come into effect at the end of 2013, Malta's quota in the IMF in 2013 remained unchanged at SDR102.0 million. The increase in quotas is expected to come into effect after the ratification of the proposed amendments to the IMF's Articles of Agreement concerning the reform of its Executive Board. These proposals require approval by three-fifths of the Fund's members, who have 85% of the Fund's total voting power. Under the quota review resolution, Malta's quota share would then rise by SDR66.3 million to SDR168.3 million.

In May 2013, IMF staff members visited Malta in connection with the 2013 Article IV consultation with Malta. The IMF mission held a number of meetings with senior officials of the Central Bank of Malta, the Government of Malta, the MFSA and various public and private sector entities. On 15 May the Fund released a concluding statement on its mission to Malta and on 12 July it published a detailed report of its findings.

During 2013 Malta's net cumulative allocation of SDRs, which is computed in proportion to its quota share, remained unchanged at SDR95.4 million, though the Bank's holdings decreased to SDR89.5 million from SDR91.0 million at the end of December 2012. This reflected sales 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 value of new loans extended by the Bank exceeded repayments. As a result, Malta's reserve tranche rose from SDR33.2 million to SDR37.2 million, while the Fund's holdings of the national currency with the Bank decreased from the equivalent of SDR68.8 million to SDR64.8 million by the end of the year.

From 1 April 2013, the Fund discontinued its drawings under the 2010 IMF bilateral borrowing agreement with the Central Bank of Malta.[1] Around €18.3 million (amounting to SDR16.0 million) were drawn under this agreement from the Bank's original total loan commitment to the IMF of €120 million. During 2013 no drawings were made under the 2012 bilateral loan agreement between the Bank and the IMF, which covers commitments up to the equivalent of €260 million.

## World Bank Group

In line with normal practice, the Bank continued to cooperate with the Ministry responsible for finance in monitoring developments within the World Bank Group and provided advice on relevant proposals from the Group.

## Other matters

The Bank monitored developments related to initiatives endorsed by the FSB and the Bank for International Settlements. It also participated in seminars organised by the Financial Stability Institute, which was jointly created in 1999 by the Bank for International Settlements and the Basel Committee on Banking Supervision to assist in the improvement and strengthening of financial systems.

In August the Central Bank of Malta hosted a regional seminar on economic modelling and forecasting that was conducted by experts from the Bank of England's Centre for Central Banking Studies. The seminar targeted economists who are involved in econometric modelling and forecasting. Officials from the central

[1] On joining the IMF, each member is assigned a quota based broadly on its relative size in the world economy. The quota determines the country's maximum contribution to the IMF's financial resources. Since the onset of the global crisis, the IMF has signed a number of bilateral loan agreements to supplement its quota resources, which serve only as a temporary back-stop to IMF quota resources. The first round of bilateral borrowing took place between 2009-2010. As economic and financial conditions in the euro area worsened in 2011, IMF resources were increased further through a second round of bilateral borrowing agreements.

banks of Cyprus, France, Italy, Libya, Portugal and Spain participated in this seminar, along with staff members from the Central Bank of Malta, the Ministry for Finance and the University of Malta.

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

## ECONOMIC AND FINANCIAL POLICY CALENDAR 2013

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

### Monetary policy measures of the Eurosystem

2 May: The Governing Council of the European Central Bank (ECB) decided to reduce the interest rate on the main refinancing operations (MRO) and on the marginal lending facility by 25 basis points each to 0.50% and 1.00%, respectively. The interest rate on the deposit facility remained unchanged at 0.00%.

4 July: The ECB introduced forward guidance, stating that its policy stance would remain accommodative for as long as necessary, with key interest rates at present or at lower levels for an extended period of time. This guidance was conditional on the medium-term outlook for inflation, given the broad-based weakness in the real economy and subdued monetary dynamics.

7 November: The Governing Council of the ECB decided to lower the interest rate on the MRO and on the marginal lending facility by 25 basis points each to 0.25% and 0.75%, respectively. The interest rate on the deposit facility remained unchanged at 0.00%. The Bank also decided to continue conducting its MROs as fixed rate tender procedures with full allotment at least until July 2015. This procedure would also remain in use for the Eurosystem's special-term refinancing operations until the end of the second quarter of 2015.

### Central Bank of Malta legislation

5 November: Act No. XIII of 2013, entitled Central Bank of Malta (Amendment) Act, 2013, amends a number of articles in the Act. Among other changes that the Act now incorporates is the statutory establishment of the Joint Financial Stability Board (JFSB). It also provides for the appointment of a second Deputy Governor with responsibilities for financial stability and for an additional member on the Board of Directors. Other changes to the Act concern provisions dealing with macro-prudential policy, payment systems and payment services.

20 December: Legal Notice 446, entitled Central Bank of Malta (Penalties for Offences and Infringements) (Revocation) Regulations, 2013, revokes the Central Bank of Malta (Penalties for Offences and Infringements) Regulations, which allowed the Minister of Finance to impose administrative penalties for infringements of the Central Bank of Malta Act without recourse to a court hearing. The power to impose penalties was transferred to the Central Bank of Malta by virtue of Act XIII of 2013.

3 May: Central Bank of Malta Directive No.11 implements the recommendation of the European Systemic Risk Board (ESRB) of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3). It outlines the objective of macro-prudential policy and explains how the Bank intends to implement it. The Bank shall develop, issue and apply macro-prudential instruments as appropriate, taking into account those defined and explained by the ESRB.

### Joint Financial Stability Board

17 January: The Central Bank of Malta and the Malta Financial Services Authority (MFSA) announced the creation of a JFSB to enhance cooperation between the two entities to safeguard financial stabil-

ity and to formulate macro-prudential policy in Malta. The setting up of the JFSB is in line with the recommendation adopted by the ESRB in December 2011.

### MFSA amendments to Banking Rule BR/09

31 December: The MFSA amended Banking Rule BR/09 entitled "Measures Addressing Credit Risks arising from the Assessment of the Quality of Asset Portfolios of Credit Institutions Authorised under the Banking Act 1994". The MFSA and the Central Bank of Malta began work on the revised BR/09 in 2011. Following a consultation process with various stakeholders, including the major banks, during the last quarter of 2013 the JFSB endorsed a final draft of the Rule and the MFSA proceeded with its publication. The Rule became applicable from 31 December 2013.

The main thrust of the amendments to BR/09 lies in the introduction of a new principle whereby banks are required to allocate an amount of capital to a reserve, which is equal to 2.5 percentage points of a bank's non-performing loans (NPL) less impairments and interest in suspense, as defined in International Financial Reporting Standards (IFRS). For certain overdue NPLs the metric increases to 5.0 percentage points and can be raised further by the competent authority if necessary. Moreover, the Rule aligns the definition of NPLs and forbearance with the newly established European Banking Authority (EBA) draft Technical Standard on Supervisory Reporting on Forbearance and Non-Performing Exposures. Another aim of the Rule is for credit institutions to recognise incurred losses as early as possible within the context of the IFRS. It thus also requires institutions to set up appropriate governance structures, a robust credit risk management framework and reporting systems.

### Institutional developments regarding financial stability in Europe

1 January: The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union entered into force. The Treaty stipulates that national budgets must be in balance or in surplus and requires that the structural budget deficit does not exceed 0.5% of gross domestic product (GDP). The Treaty also includes a new debt rule for countries with general government debt exceeding 60% of GDP. It obliges Member States to incorporate tighter budgetary rules in national law and requires them to report to the Commission and the Council their debt issuance plans and structural reforms. Following approval by the House of Representatives in June, the Treaty became effective in Malta on 1 July.

8 February: The European Council agreed on the multi-annual financial framework (MFF), laying down EU budgetary priorities for 2014 to 2020. The deal cut the amount of financial resources available to the European Union from the previous MFF. On 2 December the Council adopted a regulation laying down the MFF. Malta should be receiving a net amount of €627.0 million over the seven-year period covered by the MFF.

13 May: The Economic and Financial Affairs (ECOFIN) Council adopted the "two-pack" regulations, which entered into force on 30 May, to further improve economic governance in the euro area. The regulations focus on enhanced monitoring and assessment of draft budgetary plans of Member States and on enhanced surveillance of Member States facing serious financial difficulties.

13 May: The ECOFIN Council adopted a directive amending EU rules on credit rating agencies, with the aim of reducing investors' over-reliance on external credit ratings, of mitigating the risk of conflicts of interest in credit rating activities, and of increasing transparency and competition in the sector.

20 June: The ECOFIN Council adopted the Capital Requirements Directive IV, amending EU rules on capital requirements for banks and investment firms in line with the Basel 3 agreement approved by the G20 in November 2010. The new rules began to apply from 1 January 2014.

20 June: The Eurogroup agreed on the main features of the European Stability Mechanism's (ESM) direct bank recapitalisation instrument. There would be strict eligibility criteria for this instrument, with private capital resources to be explored as a first solution. The volume of possible direct bank recapitalisations would be limited to €60.0 billion. On 1 July the ESM became the sole and permanent mechanism for responding to new requests for financial assistance by euro area Member States, replacing the European Financial Stability Fund.

21 June: The ECOFIN Council approved country-specific recommendations for 23 Member States, including Malta, on the economic policies set out in their national reform programmes, as well as in their respective stability or convergence programmes. The recommendations addressed to Malta were wide ranging and touched on fiscal consolidation, pension reform, labour market participation, education, energy and measures to strengthen the banking sector, among other issues.

21 June: The ECOFIN Council adopted a recommendation to allow Latvia to join the euro area on 1 January 2014, while setting the fixed conversion rate for the Latvian lats.

15 October: The ECOFIN Council adopted regulations creating a Single Supervisory Mechanism (SSM). The establishment of the SSM is one of the main pre-conditions for the creation of a European banking union. The ECB, which will have direct oversight over key euro area banks, will be responsible for the entire functioning of the SSM. The ECB's monetary tasks will be strictly separated from its new supervisory tasks. Meanwhile, the EBA will retain its tasks of developing a single rulebook for the European banking industry and for ensuring convergence and consistency in supervisory practice. In November the ECB began its comprehensive bank review in preparation for assuming full responsibility for supervision as part of the SSM. The exercise, which will be completed in November 2014, consists of a supervisory risk assessment, an asset quality review and a stress test to examine the resilience of banks' balance sheets to stress scenarios.

15 November: The ECOFIN Council confirmed that if the ECB identified capital shortfalls within the euro area banking system as a result of its comprehensive bank assessment, private sources had to be used first to strengthen capital positions. If private funding were insufficient for this purpose, then national frameworks, including resolution mechanisms and public backstops, had to be activated. Euro area instruments, such as the ESM, were to be used only as a last resort.

18 December: The ECOFIN Council agreed on a draft regulation regarding the Single Resolution Mechanism (SRM), one of the main pillars required for the creation of a banking union. The Bank Recovery and Resolution Directive is aimed at providing national authorities with common powers and instruments to resolve issues concerning failing financial institutions in an orderly way, while minimising taxpayer losses. A single resolution fund would be financed by bank levies raised at national level, with strict bail-in rules. A common backstop would also be put in place for situations in which the single resolution fund was not sufficiently covered by the banking sector. A minimum level of losses would have to be imposed on the institution's shareholders and creditors before access could be granted to the resolution fund. The SRM Directive, which would cover all banks in the euro area and in other EU Member States participating in the SSM, is expected to enter into force on 1 January 2015. Bail-in and resolution functions would apply from 1 January 2016.

## Fiscal policy

8 April: The Budget Estimates for 2013 were presented to Parliament, with the general government deficit for the year targeted at 2.7% of GDP. The House of Representatives approved the Estimates on 10 April.

April: The Government published the fifth *Update of the Stability Programme*, setting out its medium-term budgetary objectives until 2016. The *Update* foresees a gradual narrowing of the general government deficit-to-GDP ratio to -0.8% in 2016, while the debt ratio is projected to peak in 2013 and 2014, before dropping to 70.0% in 2016. The Government also published the National Reform Programme for Malta, highlighting its economic plans in line with the Stability and Growth Pact and the Europe 2020 strategy.

10 April: The European Commission announced that following a review of macroeconomic imbalances it found that the Maltese economy did not have excessive imbalances. However, high private debt, the long-term sustainability of government finances and banks' high exposure to the real estate market could pose risks.

21 June: The European Council opened an Excessive Deficit Procedure (EDP) against Malta as the general government deficit reached 3.3% of GDP in 2012. Malta was instructed to take corrective action by 1 October 2013 to bring its deficit-to-GDP ratio to below the reference 3% value by 2014.

9 July: The ECOFIN Council issued its recommendations to Malta on the National Reform Programme. The Council recommended that steps be taken to correct the excessive budget deficit by 2014. Furthermore, Malta must seek to reform its pension, healthcare and justice systems, increase female participation in the labour market and maintain strict banking supervision.

1 October: The Government submitted Malta's Economic Partnership Programme to the European Commission, in which it outlined its fiscal and economic reforms to address the ECOFIN Council's Country Specific Recommendations. The Government also submitted its *Report on Effective Action*, in which it outlined the measures taken to address Malta's excessive government deficit.

4 November: The Budget Estimates for 2014 have foreseen a general government deficit of 2.7% of GDP in 2013, down from 3.3% in 2012. The fiscal balance has been expected to gradually improve over the forecast horizon, with the deficit narrowing to 2.1% of GDP in 2014 and falling further to 0.7% in 2016. Meanwhile, general government debt has been forecast to peak at 72.9% of GDP in 2013, before declining to 72.6% in 2014. The House of Representatives passed the Budget on 21 November.

13 November: The European Commission published its *Alert Mechanism Report*, which forms part of the Macroeconomic Imbalance Procedure. The *Report* noted improvements in several areas of the Maltese economy, though issues remain with regard to high private sector debt, the long-term sustainability of public finances and the recent increase in banks' NPLs.

15 November: The European Commission presented its budgetary surveillance conclusions. Malta appeared to have taken effective action in response to the ECOFIN Council's recommendation on its excessive government deficit. However, the Draft Budgetary Plan for 2014 was at risk of non-compliance with the EDP recommendation for 2014, while Malta's Economic Partnership Programme showed limited progress on structural reforms. On 22 November the Eurogroup took note of additional measures taken by the Maltese Government to address the Commission's concerns about the Draft Budgetary Plan for 2014.

### *Issues of Malta Government Stocks*

15 February: The Government, through Legal Notice 63, announced the issue of two Malta Government Stocks (MGS) for a total amount of €120.0 million, subject to an over-allotment option of up to €80.0 million. In all, €44.6 million was allotted to the 3% MGS 2019 (III) and €155.1 million to the 4.5% MGS 2028 (II).

10 May: The Government, through Legal Notice 143, announced the issue of two MGS for a total amount of €100.0 million, subject to an over-allotment option of €70.0 million. The issue consisted of a 3% MGS 2019 (III) Fungible issue, to which €38.4 million was allotted, and a 4.5% MGS 2028 (II) Fungible issue, to which €131.6 million was allotted.

10 September: The Government, through Legal Notice 268 of 2013, announced the issue of two MGS for a total amount of €50.0 million, subject to an over-allotment option of €30.0 million. The issue consisted of two floating rate MGS linked to the six-month EURIBOR, namely an MGS 2018 (VI) issue and an MGS 2019 (IV) issue, with €38.6 million and €40.8 million being allotted to the two issues, respectively.

18 October: The Government, through Legal Notice 338 of 2013, announced the issue of two MGS for a total amount of €120.0 million, subject to an over-allotment option of €60.0 million. The issue was divided between the 3% MGS 2019 (III) Fungible issue, to which €39.5 million was allotted, and the MGS 2032 (I), to which €140.5 million was allotted.

26 November: The Government, through Legal Notice 420 of 2013, announced that part of the 5.1% MGS 2014 (III) would be converted into a 3.2% MGS 2019 (V), a 3.35% MGS 2020 (IV), or a combination of the two. As a result, the outstanding nominal balance of the 5.1% MGS 2014 (III) was reduced by €150.0 million to €238.9 million, with €83.7 million allotted to the 3.2% MGS 2019 (V) and €64.0 million allotted to the 3.35% MGS 2020 (IV).

### *Double taxation relief agreements*

15 January: Legal Notice 25 of 2013 declares relief from double taxation on the Zakat and on the natural gas investment tax imposed by the Kingdom of Saudi Arabia.

8 March: Legal Notice 117 of 2013 declares relief from double taxation on income tax imposed by the States of Guernsey.

8 March: Legal Notice 118 of 2013 declares relief from double taxation on various taxes imposed by the Kingdom of Norway.

8 March: Legal Notice 119 of 2013 declares relief from double taxation on income tax on business income, personal income and non-residents income on tax for social security assistance, and on capital tax imposed by Uruguay.

18 June: Legal Notice 159 of 2013 declares relief from double taxation on organisation tax and income tax imposed by the Russian Federation.

18 June: Legal Notice 160 of 2013 declares relief from double taxation on income tax and corporation tax imposed by the Republic of Turkey.

2 August: Legal Notice 239 of 2013 declares relief from double taxation in relation to the federal income tax and business flat rate tax imposed by Mexico.

25 October: Legal Notice 343 of 2013 declares relief from double taxation in relation to income tax, company tax (including tax on capital gains), tax imposed on gains from the alienation of property according to the Real Estate Taxation Law and profit tax imposed by the State of Israel.

20 December: Legal Notice 448 of 2013 declares relief from double taxation in relation to income tax, including any surcharge thereon, imposed by the Republic of India.

## Financial sector developments

### *Surrender of licence*

19 February: The MFSA announced that Fortis Bank Malta Ltd had surrendered its licence as a credit institution.

### *Legislation related to banking and finance*

#### *MFSA Rule*

1 January: MFSA Rule 02 of 2012, modelled on the Recommendation of the ESRB on US dollar (USD) Funding (ESRB/2011/2), outlines the general principles regulating USD-denominated funding.

#### *Acts*

17 May: Act III of 2013, entitled Budget Measures Implementation Act, 2013, implements the budget and other administrative measures for the financial year 2013.

28 June: Act VI of 2013, entitled Government Borrowing and Granting of Loans to the Hellenic Republic (Amendment) Act, 2013, amends the earlier Act by adding the Loan Facility Agreement entered into on 19 December 2012 between euro area Member States and Greece.

#### *Legal Notices*

18 January: Legal Notice 28 of 2013, entitled Consumer Credit (Amendment) Regulations, 2013, implements the provisions of Commission Directive 2011/90/EU of 14 November 2011 by providing additional assumptions for the calculation of the annual percentage rate of charge for consumer credit agreements.

1 March: Legal Notice 81 of 2013, entitled Financial Markets Act (Over-the-Counter [OTC] Derivatives, Central Counterparties and Trade Repositories) Regulations, 2013, appoints the MFSA as the competent authority in Malta for implementing the relevant provisions of EU Regulation No. 648/2012 on OTC derivatives, central counterparties and trade repositories.

8 March: Legal Notices 113, 114, 115, and 116 introduce four new Regulations under the Investment Services Act. These implement Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM), establishing common requirements governing the authorisation and supervision of AIFMs in the European Union.

2 July: Legal Notice 165 of 2013, entitled Companies Act (Investment Companies with Variable Share Capital) (Amendment) Regulations, 2013, amends various regulations relating to multi-fund companies and adds a new regulation on the issue of shares by an investment company with variable share capital.

5 July: Legal Notice 167 of 2013 introduces new taxation rules governing individuals who wish to apply for special tax status under the new Global Residence Programme 2013. Under this special tax status, an individual who owns a qualifying property holding and who is not a national of the European Union, European Economic Area or Switzerland, will pay a rate of 15% on any income arising outside Malta, subject to a minimum tax amount payable of €15,000.

9 July: Legal Notice 179 of 2013, entitled European Union Directives (Amendment) Regulations, 2013, implements Council Directive 2013/13/EU of 13 May 2013 amending a number of EU Directives in the field of taxation to account for the accession of the Republic of Croatia into the European Union.

9 July: Legal Notice 180 of 2013, entitled Joint Council of Europe/Organisation for Economic Co-Operation and Development Convention on Mutual Administrative Assistance in Tax Matters Order, 2013, implements the provisions of the Convention ratified by Malta on 23 May 2013.

12 July: Legal Notice 182 of 2013, entitled Financial Conglomerates Regulations, 2013, implements the provisions of Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 regarding financial conglomerates.

12 July: Legal Notices 183 and 184 of 2013 issue Regulations under the Insurance Business Act by transposing Article 1 of Directive 2011/89/EU of the European Parliament and of the Council of 16 November 2011 regarding the supplementary supervision of financial entities in financial conglomerates.

19 July: Legal Notice 214 of 2013, entitled Investment Services Act (Alternative Investment Fund Manager) (Third Country) (Amendment) Regulations, 2013, amends a number of the original regulations by changing the definition of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and by including European AIFMs, in addition to Maltese AIFMs, in the provisions of the principal regulations.

20 September: Legal Notice 283 of 2013, entitled Financial Collateral Arrangements (Amendment) Regulations, 2013, includes a general update of the Regulations.

25 October: Legal Notice 344 of 2013, entitled Investment Services Act (Marketing of UCITS) (Amendment) Regulations, 2013, amends the original regulations by exempting European UCITS marketing their units in Malta from the provisions on prospectus and investment advertisements.

29 November: Legal Notice 424 of 2013, entitled Financial Markets Act (Off-Market Deals) (Amendment) Regulations, 2013, adds a new regulation enabling the competent authority to issue binding Financial Market Rules on activities of regulated markets, on central securities depositories and others, and on off-market deals in listed financial instruments cleared through a central securities depository.

29 November: Legal Notices 425 and 426 of 2013, respectively entitled Investment Services Act (Control of Assets) (Amendment) Regulations, 2013, and Investment Services Act (Performance Fees) (Amendment) Regulations, 2013, amend the original regulations by including Alternative Investment Funds within their scope.

27 December: Legal Notice 452, entitled Reinsurance Special Purpose Vehicles Regulations, 2013, amends the Insurance Business Act by allowing the business of a reinsurance special purpose vehicle (SPV) in or from Malta, on condition that the SPV meets the criteria as set out in the Regulations and is authorised by the MFSA. Legal Notice 451, issued on the same date and entitled Insurance Intermediaries Act (Amendment) Regulations, 2013, includes the reinsurance SPVs as part of an insurance manager's intermediary activities.

## International assessments

16 January: Standard & Poor's downgraded Malta's long-term sovereign credit rating from A- to BBB+ with a stable outlook. This decision was taken on the back of the Maltese Government's high debt burden, loss-making state enterprises and the delay in passing the 2013 budget.

16 April & 3 May: In two separate reports, Fitch Ratings highlighted the fact that Malta did not face the same risks to the banking system as Cyprus. It noted that Malta's share of banking sector assets to GDP was inflated by international banks with negligible links to the domestic economy.

24 April: Standard and Poor's reported that the assets of systematically important banks in Malta retained their credit quality while their exposure to insolvent borrowers remained low and manageable. Furthermore, the size of these systematically important institutions that the Government would hypothetically need to support in a crisis was small.

19 July: Standard & Poor's affirmed Malta's long-term credit rating at BBB+ with a stable outlook. This reflected improved prospects for economic reforms, strong institutional and governance effectiveness, and a prosperous economy on the upside, and a sizable government debt burden and external imbalances on the downside.

21 September: Fitch Ratings downgraded Malta's rating to A from A+, with a stable outlook. This reflected the fiscal slippage that occurred in 2012 and the agency's projected higher deficit in 2013, along with the high government debt ratio.

4 October: Moody's Investors Service changed the outlook on Malta's A3 government bond rating to stable from negative. This reflected the agency's expectation of the stabilisation of debt metrics in 2014, Malta's limited contagion risk from the euro area, and the resilience of the banking system.

December: Fitch Ratings published a report on Malta's banking sector, maintaining its stable outlook on the back of Malta's strong economic performance relative to the euro area, good profitability and adequate capitalisation.

# PART III

# FINANCIAL STATEMENTS

# FOR THE YEAR ENDED

# 31 DECEMBER 2013

## 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 2013.

### 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 2013, 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 2013 are set out on pages A-6 to A-42 and disclose an operating profit of €58.4 million (2012: €66.8 million). The amount payable to the Government of Malta is €50.0 million (2012: €52.0 million).

### Board of Directors

The members of the Board of Directors during the year ended 31 December 2013 and up to the date of authorisation for issue of the financial statements were:

Professor Josef Bonnici – Governor
Mr Alfred DeMarco – Deputy Governor Monetary Policy
Mr Alexander Demarco – Deputy Governor Financial Stability (appointed on 1 January 2014)
Ms Philomena Meli
Mr Victor Busuttil (re-appointed on 1 January 2013)
Mr Peter J Baldacchino (appointed on 14 April 2013)
Dr Romina Cuschieri (appointed on 17 December 2013)
Ms Antoinette Caruana (up to 13 April 2013)

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

### Auditors

KPMG were the Bank's auditors up to the financial year ending 31 December 2013. The Bank has appointed PricewaterhouseCoopers as auditors for five years with effect from the financial year ending 31 December 2014.

By order of the Board

| | | |
|---|---|---|
| Professor Josef Bonnici<br>Governor | Mr Alfred DeMarco<br>Deputy Governor | Mr Alexander Demarco<br>Deputy Governor |

Pjazza Kastilja
Valletta VLT 1060
Malta

21 March 2014

## 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 2013 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 2013, the Profit and Loss Account for the year then ended and a summary of significant accounting policies and other explanatory information.

### 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 (a) 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 (b) the requirements of the Central Bank of Malta Act (Chapter 204, Laws of Malta). They are also responsible 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 2013, 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

21 March 2014

## Balance Sheet as at 31 December 2013

| | Assets | 2013 €'000 | 2012 €'000 |
|---|---|---|---|
| **A 1** | **Gold and gold receivables** | **12,517** | **13,402** |
| **A 2** | **Claims on non-euro area residents denominated in foreign currency** | **418,795** | **512,064** |
| A 2.1 | Receivables from the IMF | 157,759 | 161,909 |
| A 2.2 | Balances with banks and security investments, external loans and other external assets | 261,036 | 350,155 |
| **A 3** | **Claims on euro area residents denominated in foreign currency** | **137,523** | **224,156** |
| **A 4** | **Claims on non-euro area residents denominated in euro** | **607,233** | **382,689** |
| A 4.1 | Balances with banks, security investments and loans | 607,233 | 382,689 |
| 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** | **200,050** | **378,150** |
| A 5.1 | Main refinancing operations | 6,000 | - |
| A 5.2 | Longer-term refinancing operations | 194,050 | 378,150 |
| 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** | **15,441** | **405** |
| **A 7** | **Securities of euro area residents denominated in euro** | **1,435,524** | **1,304,549** |
| A 7.1 | Securities held for monetary policy purposes | 90,445 | 128,015 |
| A 7.2 | Other securities | 1,345,079 | 1,176,534 |
| **A 8** | **General government debt denominated in euro** | **-** | **-** |
| **A 9** | **Intra-Eurosystem claims** | **52,166** | **51,457** |
| A 9.1 | Participating interest in ECB | 15,367 | 15,050 |
| A 9.2 | Claims equivalent to the transfer of foreign reserves | 36,799 | 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** | **6,163** | **6,281** |
| **A 11** | **Other assets** | **724,639** | **729,930** |
| A 11.1 | Coins of euro area | 258 | 328 |
| A 11.2 | Tangible and intangible fixed assets | 21,499 | 20,699 |
| A 11.3 | Other financial assets | 645,804 | 555,844 |
| A 11.4 | Off-balance sheet instruments revaluation differences | 433 | 7,316 |
| A 11.5 | Accruals and prepaid expenses | 44,580 | 48,352 |
| A 11.6 | Sundry | 12,065 | 97,391 |
| **Total Assets** | | **3,610,051** | **3,603,083** |

* Only an ECB balance sheet item

| | Liabilities | 2013<br>€'000 | 2012<br>€'000 |
|---|---|---|---|
| **L 1** | **Banknotes in circulation** | **803,195** | **757,451** |
| **L 2** | **Liabilities to euro area credit institutions related to monetary policy operations denominated in euro** | **1,144,040** | **1,474,004** |
| L 2.1 | Current accounts (covering the minimum reserve system) | 327,300 | 252,574 |
| L 2.2 | Deposit facility | 146,740 | 621,430 |
| L 2.3 | Fixed-term deposits | 670,000 | 600,000 |
| L 2.4 | Fine-tuning reverse operations | - | - |
| L 2.5 | Deposits related to margin calls | - | - |
| **L 3** | **Other liabilities to euro area credit institutions denominated in euro** | **-** | **-** |
| **L 4** | **Debt certificates issued*** | **-** | **-** |
| **L 5** | **Liabilities to other euro area residents denominated in euro** | **340,040** | **297,027** |
| L 5.1 | General government | 299,653 | 247,294 |
| L 5.2 | Other liabilities | 40,387 | 49,733 |
| **L 6** | **Liabilities to non-euro area residents denominated in euro** | **1,828** | **84,840** |
| **L 7** | **Liabilities to euro area residents denominated in foreign currency** | **61,105** | **151,639** |
| **L 8** | **Liabilities to non-euro area residents denominated in foreign currency** | **2** | **2** |
| L 8.1 | Deposits, balances and other liabilities | 2 | 2 |
| L 8.2 | Liabilities arising from the credit facility under ERM II | - | - |
| **L 9** | **Counterpart of special drawing rights allocated by the IMF** | **106,688** | **111,210** |
| **L 10** | **Intra-Eurosystem liabilities** | **709,349** | **290,655** |
| 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 | 37,370 | 90,692 |
| L 10.4 | Other liabilities within the Eurosystem (net) | 671,979 | 199,963 |
| **L 11** | **Items in course of settlement** | **-** | **-** |
| **L 12** | **Other liabilities** | **49,754** | **53,578** |
| L 12.1 | Off-balance sheet instruments revaluation differences | - | - |
| L 12.2 | Accruals and income collected in advance | 33,872 | 40,062 |
| L 12.3 | Sundry | 15,882 | 13,516 |
| **L 13** | **Provisions** | **19,700** | **11,677** |
| **L 14** | **Revaluation accounts** | **9,851** | **17,756** |
| **L 15** | **Capital and reserves** | **314,499** | **301,244** |
| L 15.1 | Capital | 20,000 | 20,000 |
| L 15.2 | Reserves | 294,499 | 281,244 |
| **L 16** | **Profit for the year** | **50,000** | **52,000** |
| **Total Liabilities** | | **3,610,051** | **3,603,083** |

* Only an ECB balance sheet item

## Profit and Loss account for the year ended 31 December 2013

| | | 2013<br>€'000 | 2012<br>€'000 |
|---|---|---|---|
| 1.1 | Interest income | 78,377 | 86,093 |
| 1.2 | Interest expense | (4,975) | (11,291) |
| **1** | **Net interest income** | **73,402** | **74,802** |
| 2.1 | Realised gains/losses arising from financial operations | 12,756 | 16,289 |
| 2.2 | Write-downs on financial assets and positions | (9,018) | (4,095) |
| 2.3 | Transfer to/from provisions for foreign exchange rate, interest rate, credit and gold price risks | (8,300) | (11,400) |
| **2** | **Net result of financial operations, write-downs and risk provisions** | **(4,562)** | **794** |
| 3.1 | Fees and commissions income | 87 | 95 |
| 3.2 | Fees and commissions expense | (631) | (622) |
| **3** | **Net income/expense from fees and commissions** | **(544)** | **(527)** |
| **4** | **Income from equity shares and participating interests** | **1,633** | **588** |
| **5** | **Net result of pooling of monetary income** | **(485)** | **1,353** |
| **6** | **Other income** | **4,907** | **4,852** |
| | **Total net income** | **74,351** | **81,862** |
| **7** | **Staff costs** | **(9,955)** | **(9,605)** |
| **8** | **Administrative expenses** | **(5,073)** | **(4,863)** |
| **9** | **Depreciation of tangible and intangible fixed assets** | **(610)** | **(562)** |
| **10** | **Banknote production services** | **(283)** | **-** |
| **11** | **Other expenses** | **(7)** | **(5)** |
| | **Profit for the year** | **58,423** | **66,827** |
| | **Transfer to reserves for risks and contingencies** | **(8,423)** | **(14,827)** |
| | **Payable to the Government of Malta in terms of article 22(2) of the Central Bank of Malta Act (Cap. 204)** | **50,000** | **52,000** |

The financial statements on pages A-6 to A-42 were approved for issue by the Board of Directors on 21 March 2014 and were signed on its behalf by:

Professor Josef Bonnici
Governor

Mr Alfred DeMarco
Deputy Governor

Mr Alexander 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 2013

## 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 (IFRSs) 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 2013 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, fixed income funds and all financial instruments, on-balance sheet and off-balance sheet.

### 3 Accounting policies

#### (a) Basic accounting principles

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

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

#### (b) Recognition of assets and liabilities

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

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

[2] Amended by Guideline ECB/2011/27 of 21 December 2011 OJ L19, 24.1.2012, p. 37 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 revalued at market prices prevailing at the year end. No distinction is made between price and currency revaluation differences for gold, but a single gold revaluation difference is accounted for on the basis of the euro price per defined unit of weight of gold derived from the euro-US dollar exchange rate at the balance sheet date.

Foreign currency positions (including off-balance sheet transactions) are revalued on a currency-by-currency basis. In the case of securities and fixed income investment funds, 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 are 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 and daily changes in the variation margins of future 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. Futures are accounted for and revalued on an item-by-item basis.

Gains and losses arising from off-balance sheet instruments 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 2013, mid-market prices at that date were used.

The Bank holds securities which are designated as part of an earmarked portfolio comprising investments held as a counterpart to the Bank's capital and statutory reserves.

The Bank also holds securities forming part of another earmarked portfolio comprising Malta Government securities and Treasury bills purchased on the secondary market in its role as a market maker.

These two earmarked portfolios 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 other liabilities' while unrealised losses are recognised in asset sub-item A11.6 'Sundry other 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 IMF at the close of business on the last working day of the year.

In 2013, the IMF Reserve Tranche Position is presented on a net basis, following ECB recommendation for harmonisation which is the national quota minus balances in euro at the disposal of the IMF. The euro account for administrative expenses is included under item L6 'Liabilities to non-euro area residents denominated in euro'.

### (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.

### (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

Tangible and intangible fixed assets are stated at historical cost less depreciation, with the exception of land and works of art which are stated at historical cost. 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.

As from financial year 2013, computer hardware and software under €1,000 and other items under €2,500 are expensed in the year they are paid.

### (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 decides on the size and use of the provision on the basis of a reasoned estimate of its risk exposure.

### (o) Fixed Income Investment Funds

The policy adopted for the measurement of the fixed income investment funds is on a net asset value basis. The underlying assets and liabilities are measured at fair value. Profits and losses are accounted for in accordance with the accounting guideline ECB/2010/20 as amended, except that unrealised profits are recognised in the profit and loss account.

### (p) 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 2013 was 0.0635% (2012: 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[4] Eurosystem NCBs. The Bank's share during the financial year ended 31 December 2013 was 0.0913% (2012: 0.0903%).

## 5 Change to the capital key

On 1 July 2013, a change of the ECB's capital key occurred as a result of the accession of Croatia (2012: no change). On 1 January 2014, the ESCB experienced a quinquennial capital key change in accordance with Article 29.3 of the Statute. As at the same date, the Eurosystem also expanded due to the accession of Latvijas Banka which paid its capital share in full.

## 6 Banknotes in circulation

The ECB and the seventeen participating NCBs, which together comprise the Eurosystem, issue euro banknotes.[5] 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.[6]

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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 Latvijas Banka joined the Eurosystem on 1 January 2014 bringing the total number of Eurosystem NCBs to eighteen.

5 ECB Decision of 13 December 2010 on the issue of euro banknotes (recast) (ECB/2010/29), OJ L35, 9.2.2011, p. 26, as amended.

6 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.

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 0.0840% share (2012: 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 by banknotes withdrawn from circulation, gives rise to intra-Eurosystem balances remunerated[7] 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[8] 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,[9] 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 ended 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.[10] It is distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation, and securities purchased under the SMP and OMT, and subject to any decisions by the Governing Council to make transfers to the provision for foreign exchange rate, interest rate, credit and gold price risks. The Governing Council may also decide to charge costs incurred by the ECB in connection with the issue and handling of euro banknotes against income earned on euro banknotes in circulation. 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 mostly 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

[7] 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.

[8] 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.

[9] 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.

[10] 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, as amended.

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 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 2013, gold was revalued at €871.220 (2012: €1,261.179) per fine troy ounce. The resultant unrealised valuation write-down of €4,525,791 is disclosed in note 2.2 'Write-downs on financial assets and positions' to the profit and loss account as against unrealised valuation gain of €519,859 disclosed under liability item L14 'Revaluation accounts' in 2012.

| | €'000 | Fine troy ounces |
|---|---|---|
| Balance as at 31 December 2012 | 13,402 | 10,626 |
| Net transactions during the year | 4,161 | 3,741 |
| Decrease in valuation on 31 December 2013 | (5,046) | |
| **Balance as at 31 December 2013** | **12,517** | **14,367** |

### 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:

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| US dollar | **248,804** | 303,262 | (54,458) |
| Great Britain pound | **6,837** | 42,586 | (35,749) |
| Special Drawing Rights | **157,759** | 161,909 | (4,150) |
| Other | **5,395** | 4,307 | 1,088 |
| **Total** | **418,795** | 512,064 | (93,269) |

### A 2.1 Receivables from the IMF

#### (a) IMF quota

Malta's membership subscription to the IMF amounts to SDR102,000,000 (2012: SDR102,000,000). The Bank's financial position relating to this subscription at 31 December 2013 is reflected in the balance sheet as follows:

The Reserve Tranche Position included in the table below is equivalent to SDR37,251,368 (2012: SDR33,153,437). 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 IMF.

During the period under review, Malta's reserve tranche increased by SDR4,097,931 due to net purchases under the IMF Financial Transaction Plan less administrative expenditure.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Reserve Tranche Position (net) | **41,658** | 38,647 | 3,011 |
| SDR holdings | **100,053** | 106,126 | (6,073) |
| IMF Borrowing Agreement | **16,048** | 17,136 | (1,088) |
| **Total** | **157,759** | 161,909 | (4,150) |

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 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. While the required threshold for the quota increase has been attained, for the proposed amendment on reform of the Executive Board to enter into force, a threshold of 85% of the total voting power of the IMF is required. Members having 76.1% of total voting power have so far accepted the amendment. However, until the required number of acceptances to the reform to the IMF Executive Board is achieved, the proposed quota increase will not become effective.

Malta's quota will increase by SDR66,300,000 to SDR168,300,000. Twenty-five per cent of the quota increase amounting to SDR16,575,000 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.

### (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 IMF arranges between prospective buyers and sellers of SDRs. During 2013, there was a sale of SDR1,600,000 under this agreement (2012: nil). Malta's SDR holdings, as at 31 December 2013, including interest received thereon, stood at SDR89,468,722 (2012: SDR91,040,916).

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 IMF.

### (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 IMF on a weekly basis. The 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 IMF 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 2013, the amount still outstanding under this facility stood at €16,047,613 equivalent to SDR14,350,000 (2012: €17,135,783 equivalent to SDR14,700,000). On 29 March 2013, the IMF Executive Board decided that, as of 1 April 2013, the IMF will cease to make drawings under the 2010 Bilateral Loan Agreement.

In January 2013, the IMF and the Bank signed a new bilateral borrowing agreement whereby the Bank has agreed to lend to the IMF 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.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Marketable debt securities other than those held-to-maturity | **180,451** | 218,015 | (37,564) |
| Held-to-maturity debt securities | **47,666** | 50,434 | (2,768) |
| Fixed-term deposits with banks | **24,125** | 41,662 | (17,537) |
| Current accounts and overnight deposits with banks | **8,105** | 39,381 | (31,276) |
| Other | **689** | 663 | 26 |
| **Total** | **261,036** | 350,155 | (89,119) |

### 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:

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| US dollar | **137,499** | 211,493 | (73,994) |
| Great Britain pound | **24** | 6,763 | (6,739) |
| Other | **-** | 5,900 | (5,900) |
| **Total** | **137,523** | 224,156 | (86,633) |

This item also consists of claims from reverse operations with Eurosystem counterparties in connection with the short-term US dollar liquidity providing programme (the temporary reciprocal currency arrangement with the Federal Reserve). Under this programme, US dollar were provided by the Federal Reserve to the ECB by means of a temporary swap line with the aim of offering short-term US dollar funding to Eurosystem counterparties with euro area NCBs that have adopted the euro, which used the resulting funds to conduct liquidity-providing operations with the Eurosystem counterparties in the form of reverse and swap transactions. The back-to-back swap transactions between the ECB and NCBs resulted in intra-Eurosystem balances reported under ‘Other claims within the Eurosystem (net)’. As at year end, there were no claims (2012: €75,792,027).

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€’000** | €’000 | €’000 |
| Marketable debt securities other than those held-to-maturity | **107,493** | 98,537 | 8,956 |
| Fixed-term deposits with banks | **29,730** | 49,777 | (20,047) |
| Current accounts and overnight deposits with banks | **300** | 50 | 250 |
| US dollar liquidity-providing operations | **-** | 75,792 | (75,792) |
| **Total** | **137,523** | 224,156 | (86,633) |

## 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.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€’000** | €’000 | €’000 |
| Marketable debt securities other than those held-to-maturity | **194,723** | 167,491 | 27,232 |
| Held-to-maturity debt securities | **290,659** | 214,399 | 76,260 |
| Fixed Term Deposits | **120,000** | - | 120,000 |
| Current accounts and overnight deposits | **1,851** | 799 | 1,052 |
| **Total** | **607,233** | 382,689 | 224,544 |

## 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 €752,288,220,516 (2012: €1,126,018,847,720) of which the Bank holds €200,050,000 (2012: €378,150,000). In accordance with Article 32.4 of the Statute, losses from monetary policy operations, if they were to materialise, are shared in full by the Eurosystem NCBs, in proportion to the prevailing ECB capital key shares (please see note L13 ‘Provisions’).

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 (MRO) 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 2013, 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 €3,565,800,000 (2012: €6,185,000,000) while outstanding MROs at the end of the year amounted to €6,000,000 (2012: nil).

The following table highlights the changes in the MRO rate during 2012 and 2013 as decided by the Governing Council:

| **With effect from:** | Changes in basis points (bps) | Effective rate (%) |
|---|---|---|
| | 2012 | |
| 1 January | - | 1.00 |
| 11 July | -25 bps | 0.75 |
| | **2013** | |
| **8 May** | **-25 bps** | **0.50** |
| **13 November** | **-25 bps** | **0.25** |

### A 5.2 Longer-term refinancing operations

These operations aim to provide counterparties with additional longer-term refinancing. In 2013, as well as in 2012, 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.

During 2013, banks had the option to pay back part or the entire amount from the thirty-six-month LTROs conducted in December 2011 and March 2012.

The aggregate LTROs carried out during 2013 amounted to €73,200,000 (2012: €586,300,000), while outstanding LTROs at the end of the year amounted to €194,050,000 (2012: €378,150,000).

### 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.

No fine-tuning reverse operations were conducted by the ECB during 2013 while one liquidity-providing fine-tuning operation was conducted during 2012, although there was no participation by domestic counterparties in this operation.

### 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 and 2013.

## 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 2013, the aggregate volume of such transactions with the Bank amounted to €20,000,000 (2012: €37,239,871). There were no outstanding balances as at 31 December 2012 and 2013.

The following table highlights the changes in the marginal lending facility rate during 2012 and 2013 as decided by the Governing Council:

| **With effect from:** | Changes in basis points (bps) | Effective rate (%) |
|---|---|---|
| | 2012 | |
| 1 January | - | 1.75 |
| 11 July | -25 bps | 1.50 |
| | **2013** | |
| **8 May** | **-50 bps** | **1.00** |
| **13 November** | **-25 bps** | **0.75** |

## A 5.6 Credits related to margin calls

This sub-item refers to cash paid to counterparties in those instances where the market value of the collateral exceeds an established trigger point implying an excess of collateral with respect to outstanding monetary policy operations.

Since the Bank operates a general pooling system, no payments to counterparties are effected.

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

This item relates to claims on credit institutions within the euro area which do not relate to monetary policy operations, consisting mainly of balances and placements with banks.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Fixed-term deposits | **15,000** | - | 15,000 |
| Current accounts and overnight deposits | **441** | 405 | 36 |
| **Total** | **15,441** | 405 | 15,036 |

## 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] the SMP[12] as well as OMTs.[13] The Bank decided to participate in the SMP but no OMTs were carried out as at balance sheet date.

[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.

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. In September 2012 the Governing Council decided to terminate purchases under the SMP with immediate effect. 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.

The total Eurosystem NCBs' holding of SMP securities amounts to €165,985,090,361 (2012: €192,608,053,842), of which the Bank holds €90,444,918 (2012: €128,014,753). The net decrease of €37,569,835 was mainly due to redemptions in 2013. In accordance with Article 32.4 of the Statute, losses from holdings of SMP securities, if they were to materialise, are shared in full by the Eurosystem NCBs, in proportion to the prevailing ECB capital key shares.

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. As a result of an impairment test conducted as at 31 December 2013, the Governing Council decided that all future cash flows on these securities are expected to be received.

### 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.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Marketable debt securities other than those held-to-maturity | **359,550** | 386,077 | (26,527) |
| Held-to-maturity debt securities | **985,529** | 790,457 | 195,072 |
| **Total** | **1,345,079** | 1,176,534 | 168,545 |

### 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 ESCB NCBs are the sole subscribers to the capital of the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29 of the Statute and are subject to adjustment every five years.

On 1 July 2013 a change of the ECB's capital key occurred as a result of the accession of Croatia.

Based on the Council Decision of 15 July 2003 on the statistical data to be used for the determination of the key for subscription of the capital of the ECB, the capital key shares of NCBs were adjusted as follows on 1 July 2013, by means of transfers among the NCBs:

| | **Key for subscription of the ECB's capital until 30 June 2013** | **Key for subscription of the ECB's capital from 1 July 2013** |
|---|---|---|
| Nationale Bank van België/ Banque Nationale de Belgique | 2.4256 | 2.4176 |
| Deutsche Bundesbank | 18.9373 | 18.7603 |
| Eesti Pank | 0.1790 | 0.1780 |
| Central Bank of Ireland | 1.1107 | 1.1111 |
| Bank of Greece | 1.9649 | 1.9483 |
| Banco de España | 8.3040 | 8.2533 |
| Banque de France | 14.2212 | 14.1342 |
| Banca d'Italia | 12.4966 | 12.4570 |
| Central Bank of Cyprus | 0.1369 | 0.1333 |
| Banque centrale du Luxembourg | 0.1747 | 0.1739 |
| Central Bank of Malta | 0.0632 | 0.0635 |
| De Nederlandsche Bank | 3.9882 | 3.9663 |
| Oesterreichische Nationalbank | 1.9417 | 1.9370 |
| Banco de Portugal | 1.7504 | 1.7636 |
| Banka Slovenije | 0.3288 | 0.3270 |
| Národná banka Slovenska | 0.6934 | 0.6881 |
| Suomen Pankki | 1.2539 | 1.2456 |
| **Subtotal for euro area NCBs** | **69.9705** | **69.5581** |
| Българска народна банка (Bulgarian National Bank) | 0.8686 | 0.8644 |
| Česká národní banka | 1.4472 | 1.4539 |
| Danmarks Nationalbank | 1.4835 | 1.4754 |
| Hrvatska narodna banka | - | 0.5945 |
| Latvijas Banka | 0.2837 | 0.2742 |
| Lietuvos bankas | 0.4256 | 0.4093 |
| Magyar Nemzeti Bank | 1.3856 | 1.3740 |
| Narodowy Bank Polski | 4.8954 | 4.8581 |
| Banca Națională a României | 2.4645 | 2.4449 |
| Sveriges Riksbank | 2.2582 | 2.2612 |
| Bank of England | 14.5172 | 14.4320 |
| **Subtotal for non-euro area NCBs** | **30.0295** | **30.4419** |
| **Total** | **100** | **100** |

In accordance with Article 48.3 of the Statute, the subscribed capital of the ECB is automatically increased when a new Member State accedes to the EU and its NCB joins the ESCB. The increase is determined by multiplying the prevailing amount of the subscribed capital (i.e. €10,760,652,403) by the ratio, within the expanded capital key, between the weighting of the entering NCB(s) and the weighting of those NCBs that are already members of the ESCB. Therefore, on 1 July 2013 the subscribed capital of the ECB was increased to €10,825,007,070.

Consequently, on 1 July 2013, the share that the Bank held in the subscribed capital of the ECB increased from 0.0632% to 0.0635% and sub-item A9.1 'Participating interest in the ECB' increased from €6,800,732 to €6,873,879.

As a result of the aforementioned capital key changes, the relative shares of NCBs in the accumulated net profits of the ECB (also referred to as net equity) as at 1 July 2013 changed. Sub-item A9.1 'Participating interest in the ECB', also reflects the net increase of Bank's share of €243,101 (2012: nil) totalling €8,492,672 (2012: €8,249,571) in this respect.

With effect from 29 December 2010 the ECB increased its subscribed capital by €5,000,000,000 to €10,760,652,403.[14] In addition, the Governing Council decided that the euro area NCBs would pay their additional capital contributions resulting from this increase in three equal annual instalments.[15] The first and second instalments were paid on 29 December 2010 and 28 December 2011 respectively. The final instalment, amounting to €1,166,175,000, was paid on 27 December 2012.

| | **Subscribed capital until 30 June 2013** | **Paid-up capital until 30 June 2013** | **Subscribed capital from 1 July 2013** | **Paid-up capital from 1 July 2013** |
|---|---|---|---|---|
| Nationale Bank van België/ Banque Nationale de Belgique | 261,010,385 | 261,010,385 | 261,705,371 | 261,705,371 |
| Deutsche Bundesbank | 2,037,777,027 | 2,037,777,027 | 2,030,803,801 | 2,030,803,801 |
| Eesti Pank | 19,261,568 | 19,261,568 | 19,268,513 | 19,268,513 |
| Central Bank of Ireland | 119,518,566 | 119,518,566 | 120,276,654 | 120,276,654 |
| Bank of Greece | 211,436,059 | 211,436,059 | 210,903,613 | 210,903,613 |
| Banco de España | 893,564,576 | 893,564,576 | 893,420,308 | 893,420,308 |
| Banque de France | 1,530,293,899 | 1,530,293,899 | 1,530,028,149 | 1,530,028,149 |
| Banca d'Italia | 1,344,715,688 | 1,344,715,688 | 1,348,471,131 | 1,348,471,131 |
| Central Bank of Cyprus | 14,731,333 | 14,731,333 | 14,429,734 | 14,429,734 |
| Banque centrale du Luxembourg | 18,798,860 | 18,798,860 | 18,824,687 | 18,824,687 |
| Central Bank of Malta | 6,800,732 | 6,800,732 | 6,873,879 | 6,873,879 |
| De Nederlandsche Bank | 429,156,339 | 429,156,339 | 429,352,255 | 429,352,255 |
| Oesterreichische Nationalbank | 208,939,588 | 208,939,588 | 209,680,387 | 209,680,387 |
| Banco de Portugal | 188,354,460 | 188,354,460 | 190,909,825 | 190,909,825 |
| Banka Slovenije | 35,381,025 | 35,381,025 | 35,397,773 | 35,397,773 |
| Národná banka Slovenska | 74,614,364 | 74,614,364 | 74,486,874 | 74,486,874 |
| Suomen Pankki | 134,927,820 | 134,927,820 | 134,836,288 | 134,836,288 |
| **Subtotal for euro area NCBs*** | **7,529,282,289** | **7,529,282,289** | **7,529,669,242** | **7,529,669,242** |
| Българска народна банка (Bulgarian National Bank) | 93,467,027 | 3,505,014 | 93,571,361 | 3,508,926 |
| Česká národní banka | 155,728,162 | 5,839,806 | 157,384,778 | 5,901,929 |
| Danmarks Nationalbank | 159,634,278 | 5,986,285 | 159,712,154 | 5,989,206 |
| Hrvatska narodna banka | - | - | 64,354,667 | 2,413,300 |
| Latvijas Banka | 30,527,971 | 1,144,799 | 29,682,169 | 1,113,081 |
| Lietuvos bankas | 45,797,337 | 1,717,400 | 44,306,754 | 1,661,503 |
| Magyar Nemzeti Bank | 149,099,600 | 5,591,235 | 148,735,597 | 5,577,585 |
| Narodowy Bank Polski | 526,776,978 | 19,754,137 | 525,889,668 | 19,720,863 |
| Banca Naţională a României | 265,196,278 | 9,944,860 | 264,660,598 | 9,924,772 |
| Sveriges Riksbank | 242,997,053 | 9,112,389 | 244,775,060 | 9,179,065 |
| Bank of England | 1,562,145,431 | 58,580,454 | 1,562,265,020 | 58,584,938 |
| **Subtotal for non-euro area NCBs*** | **3,231,370,115** | **121,176,379** | **3,295,337,826** | **123,575,168** |
| **Total*** | **10,760,652,403** | **7,650,458,669** | **10,825,007,070** | **7,653,244,411** |

*Due to rounding, subtotals and totals may not correspond to the sum of all figures shown.

[14] Decision ECB/2010/26 of 13 December 2010 on the increase of the European Central Bank's capital, OJ L 11, 15.1.2011, p. 53.
[15] Decision ECB/2010/27 of 13 December 2010 on the paying-up of the increase of the European Central Bank's capital by the national central banks of Member States whose currency is the euro, OJ L 11, 15.1.2011, p. 54 and 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 European Central Bank's reserves and provisions, OJ L 11, 15.1.2011, p. 58.

### A 9.2 Claims equivalent to the transfer of foreign reserves

This asset represents the Bank's claims arising from the transfer of foreign reserve assets to the ECB, when the Bank joined the Eurosystem. The remuneration of these claims is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations, adjusted to reflect a zero return on the gold component.

The adjustments to the capital key weightings of the ECB on 1 July 2013 also resulted in the adjustment of the claim of the Bank with respect to the foreign reserve assets transferred to the ECB. In order to reflect its increased capital key share, the euro-denominated claim of the Bank increased from €36,407,323 to €36,798,912 on 1 July 2013.

| | **Claim equivalent to the transfer of foreign reserves until 30 June 2013** | **Claim equivalent to the transfer of foreign reserves from 1 July 2013** |
|---|---:|---:|
| Nationale Bank van België/ Banque Nationale de Belgique | 1,397,303,847 | 1,401,024,415 |
| Deutsche Bundesbank | 10,909,120,274 | 10,871,789,515 |
| Eesti Pank | 103,115,678 | 103,152,856 |
| Central Bank of Ireland | 639,835,662 | 643,894,039 |
| Bank of Greece | 1,131,910,591 | 1,129,060,170 |
| Banco de España | 4,783,645,755 | 4,782,873,430 |
| Banque de France | 8,192,338,995 | 8,190,916,316 |
| Banca d'Italia | 7,198,856,881 | 7,218,961,424 |
| Central Bank of Cyprus | 78,863,331 | 77,248,740 |
| Banque centrale du Luxembourg | 100,638,597 | 100,776,864 |
| Central Bank of Malta | 36,407,323 | 36,798,912 |
| De Nederlandsche Bank | 2,297,463,391 | 2,298,512,218 |
| Oesterreichische Nationalbank | 1,118,545,877 | 1,122,511,702 |
| Banco de Portugal | 1,008,344,597 | 1,022,024,594 |
| Banka Slovenije | 189,410,251 | 189,499,911 |
| Národná banka Slovenska | 399,443,638 | 398,761,127 |
| Suomen Pankki | 722,328,205 | 721,838,191 |
| **Total*** | **40,307,572,893** | **40,309,644,424** |

*Due to rounding, totals may not correspond to the sum of all figures shown.

### 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 the end of 2012 and 2013, the Bank had no claims in this respect but had a liability which is presented in liability sub-item L10.3 'Net liabilities related to the allocation of euro banknotes within the Eurosystem'.

### A 9.5 Other claims within the Eurosystem (net)

As at the end of 2012 and 2013, the Bank's claims were netted off from liability sub-item L10.4 'Other liabilities within the Eurosystem (net)'.

### 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 2012 | 23,585 | 5,305 | 28,890 |
| Additions | 953 | 457 | 1,410 |
| **As at 31 December 2013** | **24,538** | **5,762** | **30,300** |
| **Accumulated depreciation** | | | |
| As at 31 December 2012 | 4,041 | 4,150 | 8,191 |
| Charge for the year | 204 | 406 | 610 |
| **As at 31 December 2013** | **4,245** | **4,556** | **8,801** |
| **Net book value** | | | |
| As at 31 December 2012 | 19,544 | 1,155 | 20,699 |
| **As at 31 December 2013** | **20,293** | **1,206** | **21,499** |

The table above includes an amount of €1,460,422 (2012: €632,557) related to assets not yet available for use.

### A 11.3 Other financial assets

Other financial assets comprise debt securities held by the Bank as part of an earmarked portfolio as a counterpart to the Bank's capital and statutory reserves. During the year the Bank decided to transfer these securities to the Bank's other holdings classified as held-to-maturity. This earmarked portfolio is being funded with securities which are measured at mid-market prices prevailing at the balance sheet date (see note 3(h) 'Securities' in the general notes to the financial statements).

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 two fixed income investment programmes to be managed by external asset managers in the form of contractual funds. The objective of this investment programme is to achieve higher levels of diversification in investment style and exposure whilst also increasing the volume of assets under management. During the year, the Bank implemented both programmes. The first fund was launched in January with a nominal amount of €150,000,000 whilst the second fund was launched in March with a nominal amount of €100,000,000. These contractual funds are being recognised in the Balance Sheet at net asset value.

| | 2013 | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Malta Government stocks | **331,813** | 302,252 | 29,561 |
| Marketable Debt Securities | **61,708** | - | 61,708 |
| Held-to-maturity debt securities | **-** | 253,592 | (253,592) |
| Fixed Income Investment Funds | **252,283** | - | 252,283 |
| **Total** | **645,804** | 555,844 | 89,960 |

## 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 2013. At year end, these unrealised gains amounted to €433,286 (2012: €7,315,545).

## A 11.5 Accruals and prepaid expenses

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

| | 2013 | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Accrued interest income | **44,580** | 48,289 | (3,709) |
| Prepaid expenditure | **-** | 63 | (63) |
| **Total** | **44,580** | 48,352 | (3,772) |

Accrued interest income at 31 December 2013, includes an amount of €275,956 (2012: €706,967) attributable to interest on intra-Eurosystem claims.

## A 11.6 Sundry

Sundry assets consist of advances, loans and other minor items. Since in 2013, the Reserve Tranche position is presented on a net basis (see note 3(j) 'Claims on the International Monetary Fund' in the general notes to the financial statements), the IMF Currency Subscription previously reported under this sub-item is netted under sub-item A 2.1 'Receivables from the IMF'.

## 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 2013, the total value of banknotes in circulation within the Eurosystem increased by 4.8% from €912,592,443,055 to €956,185,499,325. According to the banknote allocation key, the Bank had euro banknotes in circulation worth €803,195,400 at the end of the year compared with €757,451,360 at the end of 2012.

The value of the euro banknotes actually issued by the Bank in 2013 decreased by 0.9% from €848,143,705 to €840,565,030. As this is more than the allocated amount, the difference of €37,369,630 (compared to €90,692,345 in 2012) 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.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Current accounts (covering the minimum reserve system) | **327,300** | 252,574 | 74,726 |
| Deposit facility | **146,740** | 621,430 | (474,690) |
| Fixed term deposits | **670,000** | 600,000 | 70,000 |
| **Total** | **1,144,040** | 1,474,004 | (329,964) |

### 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 latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations

### L 2.2 Deposit facility

The overnight deposit facility is available to eligible counterparties to make overnight deposits with NCBs at pre-specified rates. Under normal circumstances, the interest rate on the facility provides a floor for the overnight market interest rate. During 2013, the aggregate volume of such transactions with the Bank amounted to €114,732,820,879 (2012: €156,788,107,913). The outstanding balance as at year end amounted to €146,739,832 (2012: €621,430,495).

In July 2012 the Governing Council of the ECB decided to reduce the interest rate on the overnight deposit facility from 0.25% to 0.00%.

### L 2.3 Fixed-term deposits

These liabilities relate to liquidity-absorbing fine-tuning operations for a fixed-term at variable rate tender. No liquidity-absorbing fine-tuning operations were conducted by the ECB during 2012 and 2013. Accordingly, there were no outstanding liquidity-absorbing fine-tuning operations at the end of the year.

In line with the SMP, weekly seven-day liquidity-absorbing operations were conducted with an intended volume covering the amount of securities settled by the previous week. The aggregate volume of such transactions with the Bank during the year amounted to €19,966,617,650 (2012: €3,791,294,230). The outstanding balance as at year end amounted to €670,000,000 (2012: €600,000,000).

### L 2.4 Fine-tuning reverse operations

Fine-tuning liquidity-absorbing reverse operations are executed on an ad hoc basis with the purpose of managing the liquidity situation in the market and setting interest rates. Liquidity-absorbing fine-tuning reverse operations are executed, as a rule, through bilateral procedures. Moreover, their frequency and maturity are not standardised. No fine-tuning absorption reverse operations were conducted during 2012 and 2013.

### L 2.5 Deposits related to margin calls

This sub-item refers to cash received from counterparties in those instances where the market value of the collateral 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 marginally by counterparties during 2013, on those instances where their respective pool of collateral fell below the mentioned trigger level. No margin calls were outstanding as at end of 2012 and 2013.

### 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.[16]

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Current accounts | **242,944** | 146,078 | 96,866 |
| Sinking fund accounts | **56,709** | 101,216 | (44,507) |
| **Total** | **299,653** | 247,294 | 52,359 |

16 These balances, during 2014, will be remunerated in accordance with the provisions established by the Governing Council of the European Central Bank, which are set out in Guideline ECB/2014/8 issued on 26 February 2014.

### 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 and fixed-term deposits are subject to fixed interest rates.[17]

### 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 No. 2 current account for administrative expenses of €22,824. With respect to 2012, this item includes the IMF No. 1 and No. 2 accounts amounting to €80,216,323 and €13,391 respectively. See note 3(j) 'Claims on the International Monetary Fund' in the general notes to the financial statements. These liabilities are principally non-interest bearing.

### 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 interest rates based on weekly average rates applied to call accounts.[18]

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Government of Malta current accounts | **27,255** | 81,328 | (54,073) |
| Government of Malta sinking fund accounts | **569** | 796 | (227) |
| Other current accounts and fixed-term deposits | **33,281** | 69,515 | (36,234) |
| **Total** | **61,105** | 151,639 | (90,534) |

### 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 2012 (€53,322,715) is due to the decrease in banknotes put into circulation by the Bank in 2013 (which represents a decrease of 0.9%), as well as an increase in banknotes in circulation in the Eurosystem as a whole (increase of 4.8% compared to 2012). The remuneration of this liability is calculated at the MRO rate (refer to note 6 'Banknotes in circulation' in the general notes to the financial statements).

[17] See footnote 16.
[18] See footnote 16.

### L 10.4 Other liabilities within the Eurosystem (net)

These liabilities mainly include the TARGET2 balance which is subject to interest at the prevailing 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 interim profit distribution.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€’000** | €’000 | €’000 |
| TARGET2 balance | **672,468** | 201,265 | 471,203 |
| Net result from pooling of monetary income | **761** | (783) | 1,544 |
| ECB profit distribution | **(1,250)** | (519) | (731) |
| **Total** | **671,979** | 199,963 | 472,016 |

With respect to 2013, the Governing Council decided that an amount of €386,953 (2012: €1,166,175,000) should be retained by the ECB from its seigniorage and the SMP income (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 2013.

### 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).

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€’000** | €’000 | €’000 |
| Accrued interest payable | **177** | 868 | (691) |
| Deferred income in respect of demonetised | | | |
| Maltese Lira currency notes | **32,770** | 38,636 | (5,866) |
| Other | **925** | 558 | 367 |
| **Total** | **33,872** | 40,062 | (6,190) |

### L 12.3 Sundry

Sundry liabilities mainly include unrealised revaluation gains attributable to Malta Government stocks held as part of an earmarked portfolio amounting to €11,018,921 (2012: €8,671,278).

## L 13 Provisions

In accordance with the decision of the Governing Council taken under 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 reviewed the appropriateness of the volume of this provision and decided to reverse in full the outstanding Eurosystem provision of €310,000,000. In the case of the Bank, the resulting income amounted to €276,644 (2012: €570,244) (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 €18,900,000 (2012:€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 interest rate risk calculations have been based the Option Adjusted Duration (OAD) of the marketable securities other than those held to maturity. OAD is an interest-rate risk sensitivity measure that quantifies the potential loss in capital value resulting from an upward shift in yields. The provision also includes the Expected Value (EV) of credit losses on held-to-maturity securities, calculated on the basis of probabilities of default (PD) and loss-given-default (LGD) for a projected holding period for the Bank's portfolios of marketable securities after having categorised them into rating classes.

## 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, marketable securities and other instruments at year-end.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Gold | **-** | 520 | (520) |
| Foreign currency positions | **1** | 15 | (14) |
| Securities | **9,850** | 17,221 | (7,371) |
| **Total** | **9,851** | 17,756 | (7,905) |

## 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 2012 | 20,000 | 75,505 | 155,293 | 50,446 |
| Net issuance of euro coins | - | - | - | 4,832 |
| Transfer from profits for the year | - | - | 8,423 | - |
| **Balance as at 31 December 2013** | **20,000** | **75,505** | **163,716** | **55,278** |

### 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.

| | 2013 | 2012 | Change |
|---|---|---|---|
| | €'000 | €'000 | €'000 |
| Marketable debt securities | | | |
| - In euro | **62,443** | 65,935 | (3,492) |
| - In foreign currency | **4,467** | 4,015 | 452 |
| Fixed-term deposits | | | |
| - In euro | **11** | 16 | (5) |
| - In foreign currency | **14** | 930 | (916) |
| Current accounts and overnight deposits | | | |
| - In euro | **-** | - | - |
| - In foreign currency | **7** | 20 | (13) |
| IMF | **36** | 45 | (9) |
| Monetary policy operations | | | |
| - Main refinancing operations | **411** | 1,077 | (666) |
| - Longer-term refinancing operations | **8** | 218 | (210) |
| - Floating rate longer-term refinancing operations | **1,296** | 3,792 | (2,496) |
| - Fine-tuning reverse operations | **-** | - | - |
| - Marginal lending facility | **1** | 2 | (1) |
| - Securities Markets Programme | **7,942** | 9,886 | (1,944) |
| Intra-Eurosystem claims | | | |
| - Claims arising from the transfer of foreign reserves | **174** | 277 | (103) |
| - Net claims related to the allocation of banknotes within the Eurosystem | **106** | 813 | (707) |
| - TARGET2 balances | **1,856** | 17 | 1,839 |
| Forward foreign exchange contracts | **(442)** | (1,038) | 596 |
| Other interest income | **47** | 88 | (41) |
| **Total** | **78,377** | 86,093 | (7,716) |

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 MRO rate. 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 ended 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.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Government accounts | | | |
| - In euro | **951** | 1,566 | (615) |
| - In foreign currency | **34** | 270 | (236) |
| Other customer accounts | | | |
| - In euro | **120** | 131 | (11) |
| - In foreign currency | **123** | 117 | 6 |
| Monetary policy operations | | | |
| - Minimum reserves | **1,264** | 2,144 | (880) |
| - Overnight deposits | **-** | 859 | (859) |
| - Fixed-term deposits | **303** | 12 | 291 |
| - Deposits related to margin calls | **-** | 10 | (10) |
| Intra-Eurosystem liabilities | | | |
| - TARGET2 balances | **20** | 6,028 | (6,008) |
| Other interest expense | **2,160** | 154 | 2,006 |
| **Total** | **4,975** | 11,291 | (6,316) |

## 2 Net result of financial operations, write-downs and risk provisions

### 2.1 Realised gains/losses arising from financial operations

This item includes realised gains and losses arising from transactions leading to reductions in foreign currency positions and disposals of financial instruments, mainly debt securities.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Net gains/losses on disposal of financial instruments | **12,821** | 15,326 | (2,505) |
| Net gains/losses on foreign currency positions | **(65)** | 963 | (1,028) |
| **Total** | **12,756** | 16,289 | (3,533) |

### 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.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Write-downs on debt securities | **4,461** | 4,045 | 416 |
| Write-downs on foreign currency positions | **4,557** | 50 | 4,507 |
| **Total** | **9,018** | 4,095 | 4,923 |

### 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 2013 the Bank received €382,434 (2012: €68,769) representing its relative share of the ECB's distributable remaining profits for 2012 in proportion to the Bank's subscribed capital key (see note 4 'Capital key' in the general notes to the financial statements).

Also included under this caption is the amount due to the Bank with respect to the ECB's interim profit distribution totalling €1,250,399 (2012: €519,025), (see note 7 'ECB profit distribution' in the general notes to the financial statements).

Income from equity shares and participating interest also reflects the increase in the relative share of the Bank in the net equity of the ECB as at 31 December 2013 due to the ECB's capital key changes (see note A9.1 'Participating interest in the ECB' in the notes to the balance sheet).

## 5 Net result of pooling of monetary income

This item contains the net result of pooling of monetary income for 2013 amounting to an expense of €761,238 as against an income of €783,184 in 2012; and the Bank's share of the reversal in full of the outstanding Eurosystem provisions against losses arising from monetary policy operations of €276,644 (2012: decrease in provision of €570,244) (see note L13 'Provisions' in the notes to the balance sheet). The net expense shown in this item amounted to €484,594 as against a net income amounting to €1,353,428 in 2012.

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 ECB capital key. The pooling and reallocation of monetary income to NCBs leads to certain net reallocation effects. One reason is that the yields earned on certain earmarkable assets and the interest expense paid on certain liability base items may differ to a varying degree among the Eurosystem NCBs. In addition, usually each Eurosystem NCB's share of earmarkable assets and in the liability base deviates from its share in the subscribed capital of the ECB. The net result arising from the calculation of monetary income is a payment (as opposed to a receipt in 2012) by the Bank which is the difference between the net monetary income pooled amounting to €15,906,678 (2012: €20,436,935) and the amount redistributed of €15,133,248 (2012: €21,140,102). A net income of €12,192 (2012: €80,016) was received for previous years' adjustment.

## 6 Other income

Other income includes an amount of €4,000,000 (2012: €3,000,000), relating to the balance of unredeemed Maltese lira fifth series currency notes, which as at 31 December 2013 amounted to the equivalent of €42,770,324 (2012: €44,636,177). 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.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Staff salaries | **8,437** | 7,856 | 581 |
| Other staff costs | **837** | 902 | (65) |
| Training, welfare and other related expenditure | **681** | 847 | (166) |
| **Total** | **9,955** | 9,605 | 350 |

The full-time equivalent average number of staff employed by the bank during the year was as follows:

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **Number** | Number | Number |
| Governors | **2** | 2 | - |
| Director General | **1** | 1 | - |
| Divisional Directors | **5** | 5 | - |
| Heads and executives | **103** | 97 | 6 |
| Supervisory and clerical staff | **176** | 164 | 12 |
| Non-clerical staff | **34** | 35 | (1) |
| **Total** | **321** | 304 | 17 |

## 8 Administrative expenses

This item consists of operating expenditure incurred by the Bank.

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Market information and communication expenses | **626** | 710 | (84) |
| Other administrative expenditure | **4,447** | 4,153 | 294 |
| **Total** | **5,073** | 4,863 | 210 |

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 €78,500 (2012: €76,000).

Compensation to the members of the Board of Directors for the financial year under review amounted to €160,195 (2012: €159,807). 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 €342,950,000 (2012: €434,398,194) involving the forward deals of euro against the forward purchase or sale of other currencies and SDR44,640,000 (2012: SDR43,000,000) in a forward deal of SDR against euro.

### (b) Contingent liabilities and commitments

| | **2013** | 2012 | Change |
|---|---|---|---|
| | **€'000** | €'000 | €'000 |
| Contingent liabilities | | | |
| Guarantees and letters of credit | **218** | 599 | (381) |
| Financial commitments | | | |
| Repayment of foreign loans on behalf of the Government | **30** | 89 | (59) |
| **Total** | **248** | 688 | (440) |

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 amount to €20,985,100 (2012: €6,862,000) are spread up to 2016 and relate mainly to the building of the new extension and investment in the new IT infrastructure.

### (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 €11,533,232 (2012: €12,311,396) 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 2013, demonetised Maltese lira currency notes presented for redemption amounted to €1,865,853 (2012: €2,039,688). At 31 December 2013, the value of unpresented demonetised currency notes amounted to €42,770,324 (2012: €44,636,177).

### (f) Investment securities pledged as collateral

As at 31 December 2013, 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 €69,000,000 (2012: US$95,000,000 or approximately €72,000,000). No amounts were borrowed under these facilities at the balance sheet dates.

### (g) Assets held in custody

As at 31 December 2013, assets held in custody by the Bank in terms of the Insurance Business Act (Cap. 403) amounted to €28,368,792 (2012: €31,455,062).

### (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 2013, the Investor and Depositor Compensation Schemes had deposits of €54,429 (2012: €48,925) and €866,577 (2012: €694,710) 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 | Total €'000 |
|---|---|---|---|---|
| **Cash and balances with banks** | | | | **11,644** |
| **Gold balances** | | | | **12,517** |
| **Placements with banks by exposure country:** | | | | |
| Denmark | 30,000 | - | - | **30,000** |
| France | 15,000 | - | 29,730 | **44,730** |
| Great Britian | - | 5,997 | 18,128 | **24,125** |
| Japan | 30,000 | - | - | **30,000** |
| Switzerland | 60,000 | - | - | **60,000** |
| | **135,000** | **5,997** | **47,858** | **188,855** |
| **Securities by issuer category:** | | | | |
| Government | 1,191,511 | - | 27,037 | **1,218,548** |
| Insurance | 2,131 | - | - | **2,131** |
| Monetary financial institutions | 864,745 | - | 219,529 | **1,084,274** |
| Other financial institutions | 194,224 | - | 69,324 | **263,548** |
| Non-financial institutions | 47,205 | - | 10,394 | **57,599** |
| Supranational | 14,610 | - | 9,327 | **23,937** |
| | **2,314,426** | **-** | **335,611** | **2,650,037** |
| **Claims on the International Monetary Fund** | | | | **157,759** |
| **Participating interest in the European Central Bank** | | | | **15,367** |
| **Transfer of Foreign Reserves to the European Central Bank** | | | | **36,799** |
| **Fixed Income Investment Funds** | | | | **252,283** |
| **Other Foreign Currency Assets** | | | | **346** |
| **Total Investments** | | | | **3,325,607** |