The Central Bank of Malta’s
First Fifty Years:
A Solid Foundation for the Future

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List of abbreviations

EC       European Community
EEC      European Economic Community
ECB      European Central Bank
EMU      Economic and Monetary Union
ERM      Exchange Rate Mechanism
ESCB     European System of Central Banks
EU       European Union
FDI      foreign direct investment
GDP      gross domestic product
GVA      gross value added
IMF      International Monetary Fund
MFSA     Malta Financial Services Authority
MGS      Malta Government Stock
MRO      main refinancing operation
MSE      Malta Stock Exchange
NFC      non-financial corporation
TARGET   Trans-European Automated Real-time Gross Settlement Express
         Transfer system
UK       United Kingdom
ULC      unit labour costs
US       United States
# CONTENTS

GOVERNOR’S INTRODUCTION 7

FOREWORD 9

## I  ECONOMIC DEVELOPMENTS IN THE LAST 50 YEARS 15

1. Economic growth, business cycle and structural changes 17
   Box 1: The international environment 25

2. Prices and costs 29

3. Labour market developments 35

4. The external sector 45
   Box 2: The tourism sector 49
   Box 3: Exchange rate policy 58

5. The role of government 65

6. The financial system 73
   Box 4: A review of monetary policy in Malta 79
   Box 5: The evolution of banking in Malta 92

## II  THE CENTRAL BANK OF MALTA’S OPERATIONS AND HISTORY 111

7. A brief history of the Central Bank of Malta 113
   Box 6: Malta’s currency notes and coins 138

BIBLIOGRAPHY 167

ABOUT THE CONTRIBUTORS 177
GOVERNOR’S INTRODUCTION

This year marks the fiftieth anniversary of the Central Bank of Malta. This publication is one of a series of events organised specifically to commemorate this important milestone.

The notion of a central bank for the Maltese Islands was promoted in 1964 by a United Nations team of experts following a mission in Malta intended to study the problems associated with the restructuring of the Maltese economy in view of the planned closure of the British military bases. Within this context, the establishment of the Central Bank of Malta was intended to fill an important gap in the country’s financial infrastructure, especially in respect to the advice to Government on economic, financial and monetary matters. Since then, this institution and indeed, the Maltese economy as a whole, have changed beyond recognition. However, it is by better understanding the past that we can identify key lessons from which to build a solid foundation for our future.

Over the last fifty years, the role of the Central Bank of Malta has evolved from managing a monetary and exchange rate policy based on a currency peg, to membership in the euro area. Throughout this period, the Bank has played a key and, in some instances, pioneering role in supporting and modernizing the country’s financial infrastructure. From the establishment of the Clearing House in the early 1970s, its role as a market-maker in government securities, to the investment in the payment system infrastructure, the Central Bank of Malta has helped shape the payment and financial system, often prompted by a dramatic increase in payment volumes and by the advent of new technologies.

The Maltese economy has undergone an even more radical overhaul. It has shifted from one that was heavily dependent on British military expenditure to an increasingly diversified and service-oriented one. Diversification towards new industries and markets, as well as specific niches within established ones, such as banking services, tourism and manufacturing, has increased the flexibility and resilience of the economy. Membership of the European Union acted as a catalyst for reform, a process that was further intensified with the adoption of the single currency in 2008. Rapid growth has increased the demand for labour, which in turn accommodated the secular rise in the female participation rate and an inflow of foreign workers. Increased migratory
flows, which are especially concentrated on both ends of the skill spectrum, facilitated the growth momentum by allowing firms to overcome both labour and skill shortages.

Despite this economic success, which few, if any, had predicted at the time of independence, the country cannot rest on its laurels. Rapid economic and population growth will inevitably bring new challenges. The inflow of foreign workers will accelerate the increasingly cosmopolitan nature of the Maltese economy and, in addition to its macroeconomic impact, including its effects on the housing market, will continue to exert profound implications on Maltese society. Urbanisation and population growth will also present environmental and infrastructural challenges, which require adequate planning and investment for the benefit of future generations. All of this comes at a time when the considerable economic progress in Malta relative to other EU Member States will make it increasingly likely that Malta will have to rely less on EU funding. This highlights the importance of continuing to build adequate fiscal buffers and to invest in administrative and institutional capacity to make better use of the country’s resources. Finally, fast economic growth generates and will continue to generate social, cultural and political changes that may or may not contribute to the sustainability of Malta’s evolving development model. Care must be taken to contain inequality firstly because it is socially unjust and, secondly, to avoid the experience of other countries where rising inequality fuels resistance to any change and encourages populism. Policies that facilitate the accumulation of human capital, reduce labour market dualism, incentivise work effort rather than excessive reliance on social benefits, and promote the integration of migrants will achieve the double dividend of reducing inequality and at the same time boosting long-run growth.

Dr Mario Vella
Every year the Central Bank of Malta publishes an Annual Report where it reviews its operations and analyses economic and financial developments during that year. To commemorate the fiftieth anniversary since its establishment, the Bank wishes to provide the public with a similar account, spanning a period of fifty years. This publication attempts to develop a longer-term perspective of the fundamental changes that transformed Malta’s economic and financial landscape during this period and, in conjunction, the changing role of the Central Bank of Malta since its inception.

The first part of this publication gives an overview of the Maltese economy and the financial system, outlining trends and structural changes over the past five decades. Such a comprehensive assessment has inevitably built on past research and analysis conducted by the Bank’s economists, which have studied and documented the structural changes and transformation of the Maltese economy. Of particular importance was the development of an annual historical database containing key Maltese macroeconomic indicators dating back to the 1960s, which has been made available online and is used regularly for academic and policy purposes. This database covers more than 150 variables and was designed to enable researchers to study economic performance before 1995, the earliest year for which consistent official statistics are currently available. This helps put the country’s recent economic performance within a wider historical perspective. In the same vein, the two research publications launched by the Central Bank of Malta in 2016 and 2017 also deserve a special mention. The first publication focused on the changing structural characteristics of the Maltese economy, particularly following European Union (EU) membership in 2004, while

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the second one addressed the extent to which the recent trends and growth rates can be sustained over the next decades.

The picture that emerges from this analysis is that of a nation that has benefitted from an extraordinary rate of economic growth and a significant reduction in volatility despite its limited resources. This was not a foregone conclusion at the time of the country’s adoption of an export and foreign direct investment (FDI)-led development model in 1959 or of its independence in 1964, and few experts, if any, were predicting such a success. At the time, mass outward migration was encouraged both to contain population growth and avoid heavy unemployment. Instead the Maltese economy managed to develop alternative sources of employment that made up for the loss of activity from Britain’s expenditure in its Maltese bases, which before their dismantling accounted for over a quarter of total employment. The structure of the Maltese economy transformed from a fortress economy to a much diversified and fairly independent set of industries mainly geared towards foreign demand. After the first stage of economic transformation, preparations for EU membership acted as the catalyst for further reform, ushering in a period of structural adjustment that included price deregulation, privatization, as well as financial and trade liberalization.

Since EU accession, the country has further diversified its economic structure, both towards new sectors as well as in specific niches within established ones, thus increasing its flexibility and resilience to industry-specific shocks. Besides the traditional sectors of tourism, retailing and banking, the services industry expanded to include higher value added activities generated by financial and professional services, maritime activities, back-office administration, information technology and gaming. The shift towards export-oriented services has led to a radical improvement in the country’s current account position, from one of persistent deficits to a surplus position. It has also increased the demand for labour, which in turn, accommodated the increase in the female participation rate and necessitated an inflow of foreign labour.

The Maltese economy rebounded quickly from the global financial crisis and was able to absorb the impact of the European sovereign debt crisis in 2012. Thus at the end of 2016, Malta’s gross domestic product (GDP) stood at around 40% above its pre-crisis level in 2008, by far one of the best performers among its European peers. Growth was job-rich and the number of registered unemployed declined
to historical lows. Strong economic activity has led to a significant improvement in the government’s fiscal position, with positive effects on the debt-to-GDP ratio.

The overall conclusion of this analysis is that viewed against the background of the last fifty years, Malta’s positive economic performance in recent years does not appear to be very much out of line, and its pace of growth is not overly due to transitory factors. In particular, some of the most striking differences observed in economic growth in recent years compared to those in the past were that such growth was achieved without reliance on controls but within a context of an open economy in a globalised world, and without reliance on an overly expansionary fiscal policy and rising public debt. Indeed, the shift from twin fiscal and external deficits into a surplus position in both and an economic framework built on openness to international competition suggest that such growth has been driven by strong underlying economic fundamentals.

The second part of the publication reviews the evolution of the Bank’s operations since its inception. The Central Bank of Malta has played a key role in several important events, including the liberalization of the financial services sector in the 1990s, Malta’s preparation for EU membership in 2004 and the adoption of the euro in 2008. Its operational history can be divided in three main periods, reflecting the Bank’s evolution from an organisation carrying out central banking functions in the context of Malta’s fixed exchange rate regime, to an institution becoming an integral part of the Eurosystem.

The first period covers the period from 1968 until the early 1990s. The establishment of the Central Bank of Malta filled a major institutional gap within the domestic banking structure, bringing together into one institution a number of closely related functions that had hitherto been performed independently by a number of different Governmental units. During this initial period the Bank was mainly focused on the implementation of exchange rate policy, the management of the country’s reserves, the supervision of the banking system, the issue of currency and the provision of banking services to the government, public sector organisations and banks.

At the time of the Bank’s establishment in 1968, the Maltese currency was pegged to the British pound. The Bank’s role in the implementation of exchange rate policy assumed particular significance in July 1972 when, following the
breakdown of the Bretton Woods system in August 1971, the direct one-for-one link with sterling was discontinued. Consequently, the Bank started determining the exchange rate of the Maltese pound on the basis of a mechanism which pegged the pound – renamed as the Maltese Lira in 1973 – to a trade-weighted basket of currencies reflecting Malta’s trading patterns. At the time the main objective of exchange rate policy was to control imported inflation without hindering Malta’s competitiveness as an exporter of manufactures, a tourist location and a host for export-orientated FDI.

Over the years, the Bank played a key role in supporting, and eventually modernizing, the country’s financial and payments infrastructure. Key milestones included the setting-up of the Clearing House in 1971, the establishment of links with the Society for World-Wide Interbank Financial Telecommunications (SWIFT) in 1990 and the establishment of the MaRIS payment system in 2002, which was the first step in the integration of the Maltese payment system with other cross-border payment systems. Furthermore, the Bank has been acting as market-maker for Malta Government securities since its foundation, thus enhancing the liquidity of these securities and contributing significantly to the development of the domestic money and capital markets. Probably as a result of this experience the Central Bank of Malta was a pioneer in recognising the need for a stock exchange in Malta.

The second period considered – between 1994 until the adoption of the euro in 2008 – was characterised by the liberalisation of the financial sector, the abolition of exchange controls, the standardisation of banking regulations and an independent role for the central bank. Among the most important changes was the transfer of power to the Bank to determine the entire structure of bank interest rates, a responsibility that was previously shared with the Minister for Finance.

Preparatory work related to Malta’s EU membership bid had already started towards the end of the 1990s and staff at the Bank prepared several reports in connection with membership negotiations. These efforts were intensified in the early 2000s, when the Bank participated actively in the screening process that the European Commission conducted on Malta as a prerequisite to negotiations on EU membership and collaborated closely with the European Central Bank (ECB) on matters of common interest. Changes to the Central Bank of Malta Act in 2002 and developments in the EU accession process were key factors
that influenced the Bank’s policies, internal organisation and operations during this period.

An important development during this phase was the transfer of the banking supervision function to the Malta Financial Services Authority (MFSA) on 1 January 2002. Still, the Central Bank of Malta remained statutorily responsible for the overall stability of the financial system, assuming the role of a macro-prudential authority.

Following Malta’s accession to the EU in 2004, the Central Bank of Malta became a member of the European System of Central Banks (ESCB) and took up a shareholding in the subscribed capital of the ECB. By the end of 2004, officials from the Bank were sitting on 47 such committees, working groups and task forces. Links with the ECB deepened across the entire range of the Bank’s operations, including statistics, currency, market operations, information technology and payment and settlement systems.

The third period encompasses the years after euro adoption on 1 January 2008, when the Central Bank of Malta became a member of the Eurosystem and became fully-integrated in the decision-making bodies of the ECB. The Governor of the Central Bank of Malta became a member of the Governing Council, which is the main decision-making body of the ECB responsible for the formulation of the single monetary policy for the euro area. The Central Bank of Malta remained responsible for ensuring the stability of the domestic financial system, including the formulation and implementation of macro-prudential policy. At the domestic level, the Bank collaborates closely with the MFSA on financial stability issues and, where relevant, with the Ministry for Finance. Furthermore, the ongoing integration of European financial markets has continued to strengthen the need for further co-operation at the EU level in the area of cross-border financial stability. The Bank contributes to the maintenance of financial stability within the euro area and the EU through its participation in the European Systemic Risk Board and the European Banking Association and participates as an observer in the Supervisory Board of the ECB.

Membership of the euro area necessitated the integration and modernisation of the Bank’s infrastructure spanning a number of operations. The domestic payment system was replaced by TARGET2. The Bank was also among the first
institutions to join the TARGET2-Securities, as well as being actively involved in the preparations leading to the launch of the Single Euro Payments Area (SEPA) project. Participation in the Eurosystem has widened the Bank’s range of activities and provided an opportunity to enhance its technical expertise. At the same time, the Bank also continues to maintain strong relations with other international institutions such as the European Commission, the International Monetary Fund (IMF), the World Bank, the European Bank for Reconstruction and Development and the Asian Infrastructure Investment Bank.

Each year, the Central Bank of Malta hosts a number of ESCB committees or working group meetings in Malta. Among these events, the Bank hosted the first ECB Governing Council meeting in Malta on 22 October 2015, chaired by President Mario Draghi. That year was also the first time that European Cultural Days of the ECB were dedicated to Malta.

To conclude, this publication is intended to contribute to a comprehensive overview of the transformation of the Maltese economy and the Central Bank of Malta over the last fifty years. The central theme is one of consistent change, flexibility in the adaptation to new challenges and ongoing investment and modernisation of existing infrastructure. All these ingredients allowed both the economy and the Bank to benefit from new opportunities, such as those associated with EU membership and the adoption of the euro, and will continue to be key to address the challenges in the years ahead.

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PART I

ECONOMIC DEVELOPMENTS IN THE LAST 50 YEARS
1. ECONOMIC GROWTH, BUSINESS CYCLE AND STRUCTURAL CHANGES

The Maltese economy has experienced remarkable growth over the last half-century, managing to achieve an annual average growth rate of more than 5% in the first three decades after independence.¹ This rapid pace of economic growth contrasts significantly with the more sombre outlook that was predicted at the time of independence, when a United Nations study recommended mass emigration as “the only feasible solution in the long run” (Stolper et al., 1964).²

Indeed, alternative sources of employment were quickly developed that made up for the excessive reliance on the British military base, which before its rundown had accounted for over a quarter of total employment. The structure of the Maltese economy transformed dramatically in the first three decades after independence from a fortress economy that depended crucially on the United Kingdom’s (UK) military budget to a much diversified and fairly independent set of industries, mostly geared for foreign demand. Starting in the mid-1990s preparations for EU membership acted as the catalyst for further change, ushering in a period of structural adjustment that included price deregulation, privatization, as well as financial and trade liberalization. The role of the state evolved from one that sought to occupy the ‘commanding heights’ of the economy and promoted policies aimed to support infant industries to supporting freer trade and capital movements as the economy matured, although the Maltese state has continued to play a relatively more active role, typical of small open economies. Furthermore, since the mid-1990s the financial system evolved into one where access to finance for households was easier and began to have a more direct role in influencing economic growth.

“Growth was quite robust during the late 1960s and 1970s averaging 10% per annum”

Chart 1 shows real GDP growth over the period 1968 to 2016. Growth was quite robust during the late 1960s and 1970s averaging 10% per annum, before

¹ Alesina and Spolaore (2003) noted Malta’s high rate of annual average economic growth is matched or exceeded by only six countries in the world, namely the Asian tigers and Botswana.
² Balogh and Seers (1955) disagreed. Their view eventually prevailed. In fact it led to the promulgation of the Aids to Industries Ordinance of 1959 (Vella, 1994) and to what Brincat (2009) calls the Maltese model of economic development.
slowing down to 1% in the early 1980s. This in part reflected the impact on exporters and the tourism industry of the international recession, especially in the UK, of the early 1980s and the second oil price shock, combined with some impact of the final dismantling of the military bases in 1979. Malta’s economy was still not very diversified at the time, and was hit hard by industry-specific shocks. A prime example was the drop in tourist arrivals from 0.7 million in 1981 to 0.5 million in 1982, mostly reflecting the high concentration on the UK market at the time. Furthermore, prolonged policies aimed at assisting infant industries and to seek scale economies, through import substitution and the bulk buying of basic consumer goods, created a number of distortions that eventually weakened the economy’s capacity to generate sustained growth. Some industries were heavily reliant on high protectionist barriers, which insulated domestic operators from the long term beneficial effects of competition. In fact, the European Commission’s response in 1993 to Malta’s application to EU membership had been highly critical, concluding that “the adoption of the acquis communautaire … depends on a thoroughgoing overhaul of the Maltese economy’s regulatory and operational systems” (European Commission, 1993).

The economic reforms enacted in the mid-1990s contributed to the second phase of economic diversification with focus increasingly directed on services and led to growth accelerating once more. However, some of the reforms, such as the final dismantling of trade restrictions, initially had negative impacts on employment.
Furthermore the need for fiscal consolidation, combined with enduring vulnerabilities that were exposed in the early 2000s by heightened competitive pressures from emerging economies and by two major external shocks (the bursting of the dot.com bubble and the events of 9/11) contributed to reduce economic growth significantly. More recently the third wave of economic diversification, namely the emergence of new export-oriented services sectors that followed EU membership coupled with policies aimed at increasing flexibility in product and labour markets, has led to a return to growth rates unseen since the late 1980s.

From a longer-term perspective, in addition to the regular business cycle fluctuations, GDP growth in Malta was on a downward trend from the late 1980s until the early years after the global crisis of 2009. Between 1985 and 2000, real GDP growth averaged 5.2% per annum but declined to 2.0% in the decade between 2001 and 2011. Malta’s economic growth increased significantly after the crisis, averaging 5.6% between 2012 and 2016. At the end of 2016, Malta’s GDP stood more than 40% above its pre-crisis level in 2008, one of the best performances in the EU. This enabled the country to gradually narrow its income gap vis-à-vis the rest of the EU, rising from around 80% of the EU average at accession to 96% in 2016.

Chart 2 plots GDP per capita, both in nominal and real terms, since the early 1960s. During this period, real GDP per capita fell in only four years – 1983,
2001, 2004 and 2009 – while in nominal terms it contracted only in 1983 and 2009. Since 1960, the conditions of the average Maltese improved by around 55 times, in nominal terms. If the effect of rising prices is considered, the GDP per capita has improved by 12 times.

Chart 3 focuses on the fundamental supply-side factors that drive economic growth in the long-run, namely the accumulation of capital stock, developments in the labour input and advances in technological progress. This is of key importance to policy makers because living standards, as measured by income per capita, are very closely tied to long-run growth.

Differences between real and potential GDP, defined as the sustainable level of output that can be achieved without leading to distortions in factor inputs and a corresponding increase in inflationary pressures, provides an indication of business cycle fluctuations. The estimates of the output gap in Chart 3 indicate that the economic cycle in Malta was very pronounced and long when the country was in its initial stage of economic development.

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3 For a detailed description of this approach applied to Malta, refer to Grech and Micallef (2014) and Micallef and Ellul (2016). A long time series of the output gap across time can also be found in Central Bank of Malta (2006).
Economic growth during the late 1970s was sharply driven by a strong rise in the capital stock, largely reflecting the growth in manufacturing activity at that time, much of it FDI financed. By 1980 the stock of capital was three times its size in 1970, which, in turn, contributed significantly to the increase in total factor productivity. Investment declined in the early 1980s, particularly in the public sector, while total factor productivity stalled. The resulting period of stagnation was followed by a boom in the early 1990s leading to an improvement in potential growth. Although capital investment was still a main source of this expansion, a pick-up in employment and total factor productivity also contributed to the country’s supply potential. Growth in employment decelerated in the second half of the 1990s, while that of the capital stock declined significantly in the early 2000s. More broadly, potential output growth in Malta slowed down significantly in the 2000s, with growth averaging slightly more than 2%, which was considerably lower than the growth rates achieved in earlier decades.

In sharp contrast to the experience in other European countries, however, the Maltese economy recovered strongly after the 2009 recession, with this growth being also reflected in the economy’s supply potential. The Bank’s estimates of potential GDP growth exceeded 6.0% since 2015, pushing the growth rate to levels last seen in the early 1980s.

All three categories of factor inputs to potential GDP contributed to the strong recovery after the crisis. The increase in the contribution of the capital stock reflects significant investment in the energy sector and the high absorption rate of EU funds at the end of the 2007-2013 financing programme. As for the labour component, a sharp increase in the female participation rate and inflows of foreign workers were the main drivers behind the increase in contribution of this factor input, which reversed the adverse impact of population ageing. Structural reforms in labour and product markets, as well as the investment in the country’s capital stock, both physical and human, largely underpinned the improvements registered in total factor productivity.

**The changing structure of the Maltese economy**

The structure of the Maltese economy has evolved considerably over the past five decades (see Table 1). The share of the agricultural sector stood at around

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4 See Grech (2000) for a discussion of public and private investment trends during this period.
7.4% of gross value added (GVA) in 1970 but this had already halved by the
1980s. It continued to decline in the subsequent decades, standing at around
2.3% at the time of EU membership in 2004 and dropped to below 2% towards
the end of the last decade.

“The structure of the Maltese economy has evolved considerably over the past five decades”

The industrial sector accounted for more than a third of the country’s GVA in
the 1970s and 1980s. Manufacturers were initially attracted by Malta’s relatively
low cost production base, but as wages increased, the manufacturing sector
gradually developed into one producing higher value added products. The
shift away from large labour-intensive industries to relatively smaller but more
skilled and technologically-intensive manufacturing reduced its share in total
employment. As a result Maltese manufacturing industry’s share of GVA declined
below 30% by the late 1990s. At the time of the global financial crisis in 2009,
this had dropped to slightly above 20%. The decline in the share of industry
in recent decades is primarily relative, being the result of the appearance of a
large swathe of new service operators rather than the shrinking of manufacturing
activity per se. The manufacturing sector is highly heterogeneous consisting of
high value added industries while others have been in decline after relocating to
lower cost destinations in the face of increased global competition. However, the
manufacturing sector still continues to attract significant inflows of FDI and has
considerable links to other sectors of the economy, including through outsourcing
to specialized service providers.

Malta has traditionally had a large services sector. Historically, this was explained
by the presence of the British naval base, which necessitated several ancillary

<table>
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<tr>
<th>Table 1</th>
<th>SHARE OF GROSS VALUE ADDED BY BROAD ECONOMIC SECTOR</th>
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<td>Industry</td>
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<td>Services</td>
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Source: Central Bank of Malta historical database.
services and resulted in a very good infrastructure. In fact, an 1892 report to the United States (US) Congress by its Consul notes that “facilities exist here for receiving, storing and distributing cargoes … that no other port in this part of the world possesses…the markets of the countries that press so closely around this busy and advantageous port offer now, more than they ever have done before attractions for the exporters of western goods and productions” (Worthington, 1892).

The opportunities foreseen in the 1890s during the first era of globalization are still present today, though since EU accession emphasis has shifted to export-oriented services. Growth in the services sector surged on the back of liberalisation measures, the higher availability of better educated labour resources and a targeted strategy to attract FDI. In fact, besides the traditional areas of tourism, education, health, retailing and banking activities, the services industry expanded to include higher value-added and export-oriented activities (see Table 2). These include activities by the financial services sector, specialised forms of tourism – such as language schools and dive centres,

Table 2
SHARE OF GROSS VALUE ADDED BY DETAILED INDUSTRY BREAKDOWN

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Source: Eurostat.

Consiglio (2006) documents the rise of the Maltese banking sector under British colonial rule. On the other hand, Chircop (1997) documents that colonial rule also impacted negatively on some sectors.
maritime activity, professional services, back-office administration, information technology and gaming. In fact, computer programming, professional services and administrative support accounted for over a quarter of the increase in value-added since EU accession. At the same time, the arts, entertainment and recreation sector saw its share of total value added increase from 3.7% to 13.5%.

The new services sectors have transformed the Maltese economy in many different ways. As shown in Table 3, Malta has become a net exporter in recent years. Exports of goods and services have consistently exceeded imports after 2010, mostly thanks to the sharp rise in exports of services. This contrasts sharply with the double-digit trade deficits that characterised the Maltese external sector till the mid-1990s. The shift from a trade deficit to a surplus is to a large extent mirrored in the decline in the private consumption-to-GDP ratio. The decline in the private consumption ratio has to be interpreted with caution. Private consumption in 2016, even after taking into account of price changes, is ten times higher than it was at the time of the country’s independence. However, given the small size of the domestic market, sustainable economic growth needs to be increasingly dependent on net exports. Recognition of this fundamental fact of economic life has been central to Maltese economic policy since at least 1959. Public consumption and investment have broadly fluctuated around their long-term averages of 17% and 20%, respectively.

| Table 3 |
| SHARE OF GROSS DOMESTIC PRODUCT BY NOMINAL EXPENDITURE CATEGORY (NOMINAL) |
| (per cent) |
|---|---|---|---|---|---|
| Private consumption | 77 | 64 | 62 | 63 | 58 | 48 |
| Government consumption | 17 | 14 | 15 | 18 | 19 | 17 |
| Gross fixed capital formation | 22 | 17 | 24 | 22 | 21 | 24 |
| Net exports | -33 | 0 | -10 | -7 | -1 | 11 |

Source: Central Bank of Malta historical database.
As a small and open economy, Malta is significantly affected by economic and price developments in its main trading partners and in international commodity prices. This Box provides an overview of the most significant international economic and financial developments over the past fifty years.

Following the end of the Second World War, advanced economies enjoyed a long period of economic growth that spanned almost three decades. This long period of economic expansion came to an end in the 1970s, with the breakdown of the Bretton Woods monetary system in 1971 and a recession in much of the developed world in the early-to-mid 1970s following the first oil shock (see Chart A).

The 1970s were characterised by two oil price shocks – in 1973-74 and 1978-79 – both associated with events in the Middle East (see Chart B). This led to a period of ‘stagflation’, with unemployment and inflation rising together. The monetary easing by most central banks to counter the rising unemployment led to further increases in inflation, ultimately resulting in a wage/price spiral. In 1979, Federal Reserve Chairman Paul Volcker announced new measures to rein in inflation in the US. As a result of
the new focus by the Federal Reserve to combat inflation, which led to restrictive targets for the money supply, the federal funds rate reached record highs in the early 1980s. As shown in Chart C, short term interest rates also increased significantly in the UK and in the European countries that nowadays constitute the euro area. Tight monetary policy led to a recession in the early 1980s but was successful in controlling and reducing inflationary pressures.
The period between mid-1980s to 2007 was one of relative macroeconomic stability in advanced economies, which is widely referred to as the period of ‘Great Moderation’. During this period episodes of financial stress were mainly concentrated in developing economies. Some examples include the Latin American debt crisis of the 1980s, the Asian financial crisis in 1997, as well as financial crises in Mexico, Russia, Brazil and Argentina. However, advanced economies were not immune to crises either. Tensions in the European foreign exchange markets culminated in the British Pound and the Italian Lira eventually withdrawing from the Exchange Rate Mechanism (ERM) in September 1992.

At the turn of the new millennium, economic activity in the advanced economies slowed down again following the burst of the dot.com bubble in the early 2000s and the terrorist attacks in the US on 11 September 2001.

The world economy expanded rapidly in the years before the financial crisis of 2009, in an overall low inflation environment and stable macroeconomic environment as a whole. This period was also characterised, however, by a significant build-up of imbalances at various levels in the global economy and rapid innovation in financial markets, which led to an under-pricing of risk. Due to the interconnectedness of world economies from trade linkages and financial markets, distress in the US sub-prime mortgage market quickly spread to the wider economy, eventually leading to the global economic and financial crisis of 2009. During the global crisis, resolute and co-ordinated action by policy-makers in the form of looser monetary and fiscal policies helped to avoid a repeat of the economic policy disaster of the 1930s Great Depression. In some euro area countries, however, the rapid build-up of public debt and the linkages between governments and the banking sector led to renewed pressures on the European economic and monetary union (EMU) during the European sovereign debt crisis of 2012. Additional monetary easing by the ECB, including reducing short-term interest rates to zero and a number of unconventional monetary policy measures, was instrumental in restoring confidence and ease tensions in financial markets.
2. PRICES AND COSTS

The degree of price movements has evolved over time in a similar fashion to the moderation in the volatility of economic activity in Malta. Retail price inflation was on average, high and volatile in the 1970s and early 1980s, partly reflecting the effects of oil price shocks during this period and global inflation. The peak in inflation was registered in 1980, with retail price inflation reaching 15.8%, while the GDP deflator increased by 12.4% (see Chart 4). The situation changed drastically by 1983, with declines being registered in both indices. The sudden drop in inflation in the early 1980s was due to a series of price controls, which were enacted to rein in inflation, particularly in household staples. Wage controls coupled with an economic downturn also contributed to this abrupt correction.

"The sudden drop in inflation in the early 1980s was due to a series of price controls"

In the decade between 1986 and 1995, retail price inflation averaged 3.2%. At first, changes in the GDP deflator were more muted, but following the 1992 devaluation of the Maltese lira, these rose above 4% for some years. Subsequently, the Maltese economy generated moderate inflation, which fluctuated around the average of 2.4% between 1990 and 2016. Changes in the GDP deflator were somewhat more pronounced, averaging around 2.6% during
the same period. This stabilisation of inflation also mirrored developments in advanced economies due to the high import content of domestic consumption.

Since the adoption of the euro, retail price inflation has averaged 1.8%, though it rose to over 4% in 2008 following the surge in the administered price of energy. In 2014, however, on account of the reversal in utility prices, it fell to the lowest rate observed since the mid-1980s. Changes in the GDP deflator have remained closer to their long-run average since the early-1990s of 2.6%.

Chart 5 suggests that Malta’s terms of trade – defined as the ratio between the price of exports to the price of imports – worsened significantly in the late 1970s and early 1980s, possibly due to the oil price shocks. Oil prices tended to have quite large impacts on the Maltese economy as electricity generation and water production during this period were almost entirely dependent on fossil fuels, while manufacturing and tourism activity, which are both highly energy intensive, constituted a large share in economic activity. In the late 1980s the terms of trade improved considerably as the price of exports grew more sharply than that of imports. The 1992 devaluation of the Maltese lira reversed this process and the terms of trade started once again to deteriorate, falling to their lowest point in 1998. Thereafter, Malta’s terms of trade have been on a persistent slightly upward trend, rising by about 4% over the last fifteen years. This may be attributed to
the substantial increase in the price of exports of services throughout the period, which was partly offset by the fall in the price of exports of goods on account of falling semiconductor prices.

Turning back to consumer prices, the sources of price changes have shifted considerably over time. Table 4 shows that food price inflation was relatively low in the 1960s and 1980s but quite high in the 2000s and, especially, in the 1970s. Likewise, prices for transport and communications were lower in the 2000s when compared with those recorded in the 1970s and the 1990s.

<table>
<thead>
<tr>
<th>Table 4</th>
<th>RELATIVE WEIGHTS AND INFLATION OF RPI SUB-INDICES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(per cent)</td>
</tr>
<tr>
<td><strong>Food</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>18</td>
</tr>
<tr>
<td>Weight of sub-index</td>
<td>42</td>
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<tr>
<td><strong>Beverages &amp; tobacco</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>67</td>
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<tr>
<td>Weight of sub-index</td>
<td>9</td>
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<tr>
<td><strong>Clothing &amp; footwear</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>10</td>
</tr>
<tr>
<td>Weight of sub-index</td>
<td>13</td>
</tr>
<tr>
<td><strong>Housing</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>10</td>
</tr>
<tr>
<td>Weight of sub-index</td>
<td>3</td>
</tr>
<tr>
<td><strong>Water, electricity, gas &amp; fuels</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>-7</td>
</tr>
<tr>
<td>Weight of sub-index</td>
<td>3</td>
</tr>
<tr>
<td><strong>Household equipment &amp; maintenance</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>10</td>
</tr>
<tr>
<td>Weight of sub-index</td>
<td>6</td>
</tr>
<tr>
<td><strong>Transport &amp; communication</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>18</td>
</tr>
<tr>
<td>Weight of sub-index</td>
<td>10</td>
</tr>
<tr>
<td><strong>Personal care &amp; health</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>25</td>
</tr>
<tr>
<td>Weight of sub-index</td>
<td>5</td>
</tr>
<tr>
<td><strong>Recreation &amp; culture</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>25</td>
</tr>
<tr>
<td>Weight of sub-index</td>
<td>5</td>
</tr>
<tr>
<td><strong>Other goods &amp; services</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation over period</td>
<td>12</td>
</tr>
<tr>
<td>Weight of sub-index</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Authors' calculations.
Prices of water, electricity, gas and fuels tended to remain quite stable, except for sharp jumps in the 1970s and 2000s. Inflation in this sub-index was subdued and turned negative over the past years due to the decline in utility tariffs. Meanwhile, inflation in the beverage and tobacco sub-index, which is significantly impacted by changes in taxation on these products, was quite strong throughout the period, though it appears to have slowed down in more recent years.

A clear break in trend is evident in inflation of prices of clothing and footwear items, recreation and culture services and household equipment and maintenance services, with price changes in recent decades being much more muted, or even turning negative over the past years, probably reflecting greater competition in these sectors following EU accession and later with the emergence of internet shopping.

Another interesting feature that emerges from Table 4 is the considerable change in consumption patterns of Maltese households. Whereas between the 1960s and 1980s, food items comprised 42% of the typical consumption basket, after 2010 their importance had dropped by half, reflecting the impact of rising incomes over time which typically reduces the share of food in consumption. By contrast, transport and communication services witnessed a significant increase in their importance in consumption. There was also a strong rise in the share of expenditure going to other types of services, notably personal care and health together with recreation and culture, which is again typical of higher levels of economic development. Conversely the relative importance of beverages, tobacco, clothing and footwear fell. This implies that an ever-growing component of the retail price index is services, which usually entails a higher degree of local value added, and relatively less imported goods. This implies that the role of domestic costs in determining overall price changes may be rising.

One way of assessing trends in domestic costs is by looking at unit labour costs (ULC). Chart 6 depicts the growth in compensation per employee and compares it with developments in aggregate labour productivity. The two variables together determine the trend in ULCs. As expected in a fast growing economy, ULCs have increased substantially over time. Overall, ULCs have grown on average by 2.5% per annum since 1970.

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6 An increase (decrease) in ULCs implies a rise (fall) in the labour costs of production relative to productivity, and hence a loss (gain) of competitiveness.
Growth in ULCs was inconsistent over time. The relatively higher rate of economic growth and global inflation in the 1970s might have led to a faster rise in wages and consequently a much sharper expansion in ULCs. The introduction of price and wage controls, coupled with the slowdown in economic activity, led to a sharp decline in labour productivity, wages and ULCs in the mid-1980s. Up to the late-1980s they remained relatively stable as the growth in employment income per worker and productivity tended to offset each other. By contrast, labour costs grew persistently at a higher rate than productivity during the first half of the 1990s. During this period labour costs grew, on average, by 8.4% per annum, while real output per person employed expanded by just 3.6% per annum. In part, this was triggered as an aftermath of the 1992 devaluation of the Maltese lira, with the wage indexation mechanism introduced in 1990 (which over time has become increasingly partial with the rise in incomes) ensuring that that wage growth shadowed inflation, albeit with a lag due to the backward-looking mechanism. Consequently, ULCs averaged 4.7% in the first half of the 1990s.

During the second half of the 1990s, growth in average labour costs decelerated somewhat, reflecting lower price inflation, though it continued to outstrip the gains in productivity. In the 2000-2010 period, growth in ULC accelerated on the back of a decelerating real output per worker, while nominal wage growth remained broadly stable at around 3.9%.
These developments in ULCs should however be interpreted with some caution in the context of the structural shift towards the services sector. Thus, whereas the services sector remains dependent on a higher level of labour input, manufacturing has become less labour intensive and increasingly shifted to more automated processes that increase labour productivity. These sectoral shifts can lead to composition effects that affect Malta’s aggregate ULC index, irrespective of the developments in cost competitiveness at a sector level (Rapa, 2016).

“In These sectoral shifts can lead to composition effects that affect Malta’s aggregate ULC index”

In recent years, the increase in labour productivity surpassed the growth in nominal wages per worker, leading to a decline in ULCs. The reversal in ULCs is the result of the pro-cyclicality of labour productivity, following a period of strong economic expansion, combined with the sharp increase in the supply of labour. The latter was buoyed by an inflow of foreign workers and a secular increase in the female participation rate, which also helped keep wage growth in check despite historically low unemployment.
3. LABOUR MARKET DEVELOPMENTS

Over the past fifty years the Maltese labour market has been shaped by significant transitions that affected the country’s demographic and social fabric. For most of its history, Malta has experienced considerable emigration. Around 150,000 Maltese, representing half the population recorded in the 1948 census, sought temporary and permanent settlement abroad between 1948 and 1975, benefitting from the moral and financial support given by various countries that received Maltese emigrants (Delia, 2002). In the first decade after independence the Maltese population fell by 7%, or 21,000 persons. Emigration limited population growth and heavy unemployment during the gradual transition of the Maltese economy away from military services.

“Emigration limited population growth and heavy unemployment during the gradual transition of the Maltese economy away from military services”

However, in the face of tighter controls from recipient countries, reliance on emigration to ease unemployment started to diminish. In this context, the 1981-1985 development plan was devised such that: “while retaining majority control in vital areas of the economy which are currently held by the public sector, the government will in the years ahead gradually seek to encourage private sector interests to participate in some of these areas. This will release public capital for further investments in new productive ventures to generate more growth” (Government of Malta, 1981:65).

This process accelerated in the late 1980s and early 1990s with economic and financial liberalisation measures that helped to revive investment growth. This provided the background for the subsequent rapid expansion of the Maltese economy, which led to a growing demand for labour. In fact, emigration flows started to be reversed in the 1980s and 1990s. Moreover starting in the late 2000s, immigration from both EU and non-EU countries has contributed further to the shaping of population dynamics (Grech, 2015). Since EU accession, the Maltese population has grown by 10% such that by the beginning of 2017, it exceeded 460,000 persons. Whereas, in the 1990s less than 2.5% of the
population residing in Malta were foreign citizens, twenty years later this proportion rose, standing at 11.8% in 2016.

Besides migration flows, population dynamics have been affected by other factors. One of these is the age structure of the Maltese population, which shows a consistent fall in proportion of younger people (see Chart 7). This is attributable to a declining birth rate. While in 1960 there were around six young people for each elderly person, the rate of growth of the elderly has outstripped that of the younger since 2012. Although this decline in the younger population cohort will undoubtedly affect economic growth negatively in the future, at the moment Malta is experiencing one of the highest proportions of working age population in its history. This demographic dividend underpins the cycle of economic growth in Malta. In the 1970s, the proportion of the working age population rose by 5 percentage points and this coincided with a pronounced acceleration in economic growth. This was followed by a relative decline in the working age population in the 1980s, which was characterised by a period of weak economic growth. Then in the 1990s the resurgence in the growth of the size of the working age population coincided with resumed economic growth. The story since EU accession is clearer as most migrants came to Malta seeking work in its growing economy.

![Chart 7: Age Structure of the Maltese Population](chart7.png)

Sources: NSO; authors' calculations.
Besides the demographic dividend, the Maltese labour market was also affected by a transformation in the role of women in society (Baldacchino & Sultana, 1994). Rising education levels combined with changing social norms contributed towards increased formal labour market activity by women.

“The Maltese labour market was also affected by a transformation in the role of women in society”

Chart 8 shows that, except for recent years, male participation rates have been falling consistently even though they remain amongst the highest in Europe. This long-term decline mainly reflects the expansion of post-secondary education. On the other hand, though female participation in post-secondary education has also risen spectacularly, this has not dampened the trend rise in formal labour participation.

In post-independence years, female participation rose significantly on account of higher public employment and the rapid expansion of sectors such as textile manufacturing. The weak growth of the 1980s affected female workers much more sharply than their male counterparts, with a relatively larger drop in participation rates. Whereas participation rates resumed their upward trend from the late 1980s, the trend accelerated drastically since the mid-2000s.

Source: Central Bank of Malta historical database.
Changing social norms have contributed to the significant changes in participation rates over time. It was customary for the female participation rate in Malta to peak in the early 20s and decrease sharply thereafter as women dropped out of the labour force after childbirth. More recently, the peak in female participation rate is being reached in the late 20s. Furthermore, despite a dip in later years due to child-bearing, females are choosing not to drop out of the labour force causing participation rates to remain higher compared with a decade ago. At 62.6% in 2016, however, the female participation rate still remains one of the lowest in the EU.

The increase in female employment since the late-2000s has been facilitated by a number of government initiatives. These measures include back-to-work fiscal incentives for women, new tax computations, an increase in maternity and adoption leave and other family-friendly measures (particularly in the public sector), tax credits for employed, and exemptions from means-testing for income earned by women working part-time. Childcare facilities were made more available and affordable. A number of public child care centres were introduced and their operational hours extended to be more effective for working parents. The introduction of after-school care services in a number of schools also helped to bridge the gap between day school and regular working hours of parents in employment. Other initiatives were targeted to provide care for children before schools’ official opening hours to allow additional flexibility to working parents.

"Immigration has contributed greatly to accommodate the rising demand for labour in Malta"

The sharp inflow of foreign workers after EU membership has been a key contributor to the increase in the supply of labour in Malta. The number of foreigners in the workforce increased from around 2,700 at the time of EU accession to 36,500 at the end of 2016. Most of this increase took place after 2010 (see Chart 9). This impressive growth was principally fuelled by EU citizens, with their number rising from slightly above 1,100 in 2004 to 26,300 by 2016. Immigration has contributed greatly to accommodate the rising demand for labour in Malta.

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7 Micallef (2015a) finds that slightly less than half of the increase in the female participation rate between 2008 and 2014 may be attributed to labour market reforms, which are estimated to have augmented the country’s potential output growth by 0.3 percentage point per annum over the six years to 2015.
While demand for foreign workers has grown across all occupations, foreigners are especially concentrated at both ends of the skills spectrum.

The shift in the gender profile of employment coincided with a change in the prevalence of part-time employment. Whereas by the end of the 1960s those working exclusively part-time job were equivalent to 1% of the labour force, in the 1990s there was a surge in this type of employment, particularly amongst women. This trend continued in the 2000s and the early 2010s, such that by 2016 those working exclusively part-time were equivalent to almost 20% of the work force. At the same time, there has also been quite a significant rise in those who work part-time besides their full-time employment, from 1% of the labour force at the end of the 1960s to 13% in 2016.

Table 5 shows that since 1960 the Maltese economy has created an additional 84,000 full-time jobs, 57% of which went to women. Job creation was broadly split between full and part-timers. Females accounted for almost all the increase in full-time employment and to around two-thirds of the increase in part-time employment. The rising female labour participation rate means that certain activities that were previously conducted informally by housekeepers are now being serviced by the formal economy, such that in 2004 there were about 3,300 workers in residential care services, but more than 6,700 workers by 2016, a tenth of all employment growth.
The fastest rate of job creation was recorded after 2010. A robust labour market has led to a significant rise in the number of employed males to the extent that the increase in half a decade amounted to the entire increase registered in the previous two decades. For women, the pace of job creation was also the highest ever registered, though not to the extent of the acceleration seen for men. With regards to part-time employment, however, there are no indications of any particular acceleration after 2010 compared with the preceding decade. In contrast, the growth in the number of those working part-time in addition to their full-time job decelerated.

The sectoral distribution of employment over time has changed in line with the structural changes in the economy, broadly mirroring those in gross value added (see Table 6). The relative importance of agriculture and industry has steadily declined, particularly after the surge in services activity that followed EU accession. The declines in relative employment shares are noticeably more pronounced than those in relative value added shares. This suggests that over time, firms in agriculture and fisheries and in industry have become more capital intensive and increased the productivity of their labour force.
The intra-sectoral composition of activity also changed substantially. For instance, whereas in the early 1980s those employed in the manufacture of clothing and footwear constituted 17% of all industrial workers, in 2016 their share had fallen to around 3%. In absolute terms, by 2016 employment in clothing and footwear manufacturing fell to a fraction of its level three decades earlier. Similarly, the share of workers in the tourism industry out of total employment in services has declined from 11.5% in the early 1980s to around 7.9% in 2016. This occurred despite the fact that in absolute numbers, employment in tourism rose by half during the last thirty years. However this growth was outstripped by the sharper rise in employment in other services sub-sectors such as remote gaming, professional services and administrative support services.

The unemployment rate has fluctuated considerably over the past five decades. Both the administrative or registered unemployment rate and the measure based on the Labour Force Survey definition show very similar trends, though the latter always exceeds the former as it has a broader scope. Following the second oil price shock, unemployment in Malta remained relatively high up to the mid-1980s. However, economic growth in the late 1980s, together with a sharp rise in public sector employment, helped reduce Malta’s unemployment rate. Unemployment fell until 1995, before rising slightly during the restructuring period which preceded EU accession. This trend continued until the early 2000s. Thereafter, the unemployment rate has been on a downward trend, except for two years as a result of the 2008 financial crisis, when it still remained below the levels seen between 2001 and 2003. In recent years, Malta has registered one of the lowest unemployment rates in the euro area despite the sharp increase in the participation rate.

Similarly to GDP growth and price inflation, the labour market has increasingly become less volatile in Malta over time. This could reflect the increased reliance on skilled labour, which firms are less prone to fire in bad times (Micallef, 2015b). The application of a standard HP-filter to distinguish between cyclical and structural movements shows that structural unemployment fell in the first decade after independence, before rising sharply during the 1980s recession (see Chart 10).8 This was followed by a decade-long drop till 1995, after which

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8 The structural unemployment rate is also referred to as the non-accelerating inflation rate of unemployment or NAIRU.
there was a slight rise during the economic restructuring that preceded EU accession. In more recent years, the structural unemployment rate in Malta appears to have declined considerably in stark contrast with developments in the rest of the euro area. In fact, the economic and financial crisis of 2009 had no permanent impact on the domestic NAIRU, making Malta one of only a few countries in the EU that have actually experienced a decline in NAIRU compared to its pre-crisis level.

Temporary and targeted assistance to manufacturing and tourism firms in difficulties, as well as flexibility in the labour market through reductions in the number of working hours helped to reduce the impact of the 2009 recession on unemployment levels. This approach was deemed more appropriate than a broad-based fiscal stimulus package that, in a small and open economy, would have mostly leaked abroad through imports. The introduction of reforms that were specifically targeted to reduce the share of the long-term unemployed, such as the introduction of the in-work benefit and tapering of social benefits, together with lower taxes on labour, also seem to have had a permanent effect on structural unemployment. Furthermore, prudent economic policies and flexible labour market institutions helped to increase the resilience of the labour market. For instance, wage-bargaining at firm level helped to contain wage pressures.
There is a clear relationship between developments in unemployment and the evolution of economic activity, in line with Okun’s law. Regressing changes in unemployment on changes in GDP yields a statistically significant relationship. Results indicate that the short-run Okun’s coefficient is around 0.1, while the long-run coefficient stands at 0.2 (Micallef, 2017). The size of Okun’s coefficient in Malta, however, is relatively low compared to other euro area economies. Labour hoarding is partly responsible for the low responsiveness of unemployment to economic activity with firms opting to vary the utilisation rate of labour during a period of temporary weak demand, instead of firing workers. However, due to the small size of the country, a relatively larger share of public sector employment, which tends to be more sheltered from developments in the real economy, is also likely to be a contributing factor to the low coefficient.

“The flattening of the Phillips curve is a phenomenon common to most developed countries”

Chart 11 shows that Maltese data on inflation and unemployment also displays a negative relationship, more commonly known as the Phillips curve. Higher levels of unemployment are associated with low or negative inflation rates, and vice versa. However the Phillips curve in Malta is quite flat, which suggests that the...
output gap plays a relatively small role in determining inflationary pressures. This implies that lower unemployment should be less inflationary in Malta than in other countries. The flattening of the Phillips curve is a phenomenon common to most developed countries, with economic literature suggesting it reflects the effects of globalisation (Iakova, 2007). Increased competition from abroad, together with rising shares of foreign labour weakens pressures for price rises. In Malta, these effects may have been accentuated by EU accession and increased penetration of internet shopping (Gatt, 2016).
4. THE EXTERNAL SECTOR

The Maltese economy ranks among the most open economies in the world. At independence, exports and imports were already equivalent to 165% of GDP. They then rose to over 200% during the 1970s and the 1980s, before growing even further to around 250% in the following decade. Following EU accession, the openness of the Maltese economy has been accentuated, to the extent that exports and imports together have exceeded by three times GDP.

“The Maltese economy ranks among the most open economies in the world”

In the 1960s world trade increased at a faster rate than in the preceding ten years, with virtually all the principal trading countries and trading blocs enjoying high export growth. Malta’s experience mirrored that of its trading partners. Its trade gap widened greatly in the 1960s in response to economic development and a rising standard of living. Malta’s imports picked up in the late sixties, but the rate of increase in Malta’s total exports was greater than that for imports in most of the preceding ten years.

The growth of Maltese exports, which had been on an upward trend since the introduction of the Aids to Industries Ordinance in 1959, accelerated during the 1970s, as foreign investors were additionally attracted to Malta by preferential access to the European Community (EC), which at the time was Malta’s largest export market. In fact, Malta’s formal relations with the then European Economic Community (EEC) commenced in December 1970 with the signature of an Association Agreement with the EEC that entered into force on 1 April 1971 and under whose terms most Maltese manufacturing exports (the most significant exception being processed agricultural products, foods and beverages) initially enjoyed a 70% reduction on the Community’s external tariff, subject to rules of origin. Access for most manufactured goods became duty free in 1977.

Frequently amended, the agreement continued to regulate trade between Malta and the EEC\EC\EU up to Malta’s accession to the EU on 1 May 2004. Partly as a result of the agreement the role of FDI in export creation, which was already prominent by the time of the Association Agreement’s entry into
force, continued to grow in the 1970s and 1980s. Brincat (2008) states that, in 1971, larger foreign-controlled manufacturers employed some 5,800 persons and accounted for 73% of total domestic exports; by 1986 employment in larger foreign-controlled enterprises had grown to almost 11,500, and their share of domestic exports to 86% (this had risen to 92% by 2000). This view of the Association Agreements as catalyst is supported by Pomfret (1997), who also notes that the growth of Malta’s manufactured exports in the 1970s occurred in sectors that were covered by the Association Agreement, and was concentrated in a small number of products suited to subcontracting or assembly operations by subsidiaries of multinational enterprises. Pomfret (1997), whose analysis is focused on the wearing apparel industry (Malta’s biggest manufacturing sector in the 1970s) suggests that the combination of geographical proximity with trade preferences strengthened Malta’s attraction as a base from which to serve markets in the EC, when compared to other locations where wages were as low, providing producers located in Malta with a competitive edge. However, Maltese entrepreneurs acting alone had not been able to fully exploit these advantages - thus the importance of foreign shareholding, even though capital itself had not been a serious constraint on Maltese economic development.

Thus, although exports have tended to grow in line with foreign demand over time, as shown in Chart 12, the link between demand and supply was maintained.

**Chart 12**

**MALTESE EXPORTS: WORLD DEMAND AND REAL EXCHANGE RATE**

*(index 2010 = 100)*

Source: Central Bank of Malta historical database.
principally by FDI. In the early 1980s Malta’s real effective exchange rate was high, which adversely affected exports. After the recession of the early 1980s following the second oil shock, export growth started to pick up again during the mid-1980s. Exports were also boosted by more competitive prices as the real effective exchange rate declined, although they mostly mirrored the rise in foreign demand.

However in the early 2000s, with the rise in globalisation Malta’s export performance deteriorated as a number of low-cost manufacturing firms, particularly in the textiles sector, relocated to emerging market economies. At the same time, imports of consumer goods rose following the removal of remaining trade protective barriers ahead of EU accession. Furthermore, some sectors of the manufacturing industry, in particular the semi-conductor industry, the largest exporting sector at that time, were affected negatively by the bursting of the dot.com bubble. These years also saw a worsening of the real effective exchange rate. In the second half of the 2000s, mirroring the significant rise in world trade prior to the financial crisis, export activity rebounded strongly, mostly on account of the emergence of services. The onset of the financial crisis resulted in a sharp drop in world trade and therefore lower demand for exports of goods. After the crisis, an improved real effective exchange rate and recovery in foreign demand pushed Maltese exports upwards, though these remained largely underpinned by continued expansion in activity in services.

The EU has been Malta’s main export partner for most of the post-independence period, accounting for more than two-thirds of Malta’s exports between 1970 and 1995 (see Chart 13). Peaking at 81% in 1991, this share fell to just over half in the years preceding EU accession and now makes up less than a third of Malta’s exports. In 2016 exports to EU countries and to North and Central American nations were just above their 1995 level, however, exports to Asian countries were four and a half times higher. Meanwhile, sales to other countries have multiplied by 22 times. However, external trade data for the post-2002 period need to be treated with caution since 55% of the increase in exports of goods during this period were generated by re-exports of fuels. Since 2003 exports of machinery and transport equipment have declined by a quarter. Price changes also account for a substantial part of these large movements. For instance, in
2017 the price of oil was almost double that in 2003, while semiconductor prices were almost a third lower.

Despite the boost provided by the emergence of fuel re-exports, the share of exports of goods as a proportion of GDP has been declining in line with the reduction in the relative importance of manufacturing. The rise in export-oriented services activity has also affected the relative share of exports. The post-EU accession period witnessed a spectacular rise in export-oriented services activities (see Chart 14). Although Malta has traditionally had a surplus in its trade in services, in recent years this has grown to an unprecedented level, which has led to the highest current account surpluses in the balance of payments in decades. Services exports have nearly doubled their share of GDP since 2004 mainly on the back of sectors such as gaming and financial services. Although their growth has decelerated over the past years, other emerging sectors such as computer programming and professional services are registering very strong growth.

Structural changes that have taken place in the Maltese economy over time have also impacted trends in imports. In the late 1980s trade liberalisation, the acceleration of private and public investment, and the growth of exports of goods and services, in particular electronic goods and tourism, led to a growth surge in
merchandise imports (IMF, 1995). However, as the share of services in Maltese output has risen significantly since 2010, the import intensities of consumption, investment and exports have declined (Grech and Rapa, 2016).

**Chart 14**

**THE RISE OF SERVICES EXPORTS**

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Exports of goods
Exports of services

Source: Eurostat.

**BOX 2: THE TOURISM SECTOR**

As early as 1959, as the authorities took the strategic decision to gradually diversify the Maltese economy away from its overwhelming reliance on the British military presence in Malta. Tourism, together with ship repair and manufacturing were identified as the major sources of economic growth and employment. The development of tourism in Malta had started in the late 1950s, with the Government initiating a programme of capital spending on improving access to beaches, together with promotion and advertising. Initial initiatives such as the setting-up of the Malta Government Tourist Board in 1958 led to moderate increases in the number of tourist arrivals. However, the adoption of a grants programme to encourage hotels in the mid-1960s, though more costly, was very successful.
From very modest beginnings in the early 1960s, the number of tourists that visited the Maltese islands quadrupled in the second half of the 1960s, as Malta established itself as a tourist destination in the Mediterranean (see Chart A). In contrast with significant growth in the number of visiting tourists during the 1970s, especially following the establishment of the national airline, tourist arrivals in the first half of the 1980s were hit by the second oil shock and the severe recession in the UK, which was a major source market for tourism in Malta at that time. Indeed, by 1984, the total number of tourists declined by about a third when compared with the high point reached in 1980. Earnings from tourism amounted to €261 million, equivalent to 25% of GDP in 1980, but fell in the following years, with revenue halving at one point.

Although this deceleration was also experienced by other Southern European countries, tourism in Malta was badly affected by the over-reliance on the British market and the appreciation of the Maltese lira. However, losses in the market were reversed by the end of the decade, partly because the authorities embarked on a diversification strategy.
in source markets for tourists, operators within the industry offered more competitive packages, and a dual exchange rate in respect of the British pound was introduced to reduce the impact of the Maltese lira appreciation.

“The number of tourists visiting the Maltese islands rose above the one million mark in 1992”

The number of tourists visiting the Maltese islands rose above the one million mark in 1992, but stagnated between 1994 and 2005. The advent of low cost airlines in the late 2000s significantly improved the connectivity of the Maltese islands to mainland Europe, leading to a renewed upward trend in tourist arrivals. Despite a reduction in tourist arrivals during the 2009 recession, the industry returned to strong growth, recording an average increase of 8.6% per annum between 2010 and 2017. During this period, the number of nights stayed rose by an average annual rate of 5%, while the average length of stay trended downwards, largely reflecting changing habits of tourists in preferring to increase their frequency of short-duration holidays during a year rather than taking fewer but longer holidays annually. These changing habits, however, help to improve the seasonal spread of tourists over a year. Overall expenditure, which includes spending on transport, accommodation, food, shopping and excursions, increased to close to €2.0 billion in 2017, up by 72% since 2010. Meanwhile, tourist spending per night rose by around 16% over the same period.

“In 2017, the number of visitors reached 2.3 million, around 60 times the amount of tourists who visited the Maltese islands in 1964”

In 2017, the number of visitors reached 2.3 million, around 60 times the amount of tourists who visited the Maltese islands in 1964. For the first time in 2013, gross earnings from tourism exceeded €1 billion, or 14% of GDP.
The contribution of tourism towards the Maltese economy may be split into three components: direct, indirect and induced. Figures for Malta issued by the World Travel and Tourism Council (WTCC) show that, in 2016, more than half of the total contribution was classified as direct contribution by the travel and tourism industry. This includes accommodation, transportation, recreation services, as well as domestic expenditure. Meanwhile, 35.3% of the total contribution is considered as indirect and includes purchases of goods and services of local sectors that deal with tourists, as well as capital investment and government spending directed towards the industry. Finally, the remaining 12.0% of the total contribution is induced by the wider impact of the spending of those employed within the industry. Cassar (2017) suggests that the accommodation and food services sector, including direct, indirect and induced effects, accounts for nearly 12% of total employment.

Over the years the tourism industry has changed considerably. At the outset, and for several years afterwards, the Maltese tourism industry relied on the UK as a source market, with as much as 72.6% of tourists being UK nationals during the 1960s (see Chart B). Although concentration on a single market was undesirable, change in the composition of tourists only started to be significant during the 1990s following the start of diversification strategies in the mid-1980s. These were spurred by the severe adverse impact of the UK recession on tourism in Malta in the early 1980s. Diversification became much more marked by the first decade of the new century, such that in the period between 2010 and 2016, the share of countries other than the UK, Italy and Germany, amounted to 46.3%, almost double the share of the 1970s. Nowadays, although at 29.6% visitors from the UK are still the largest source market, Italy and Germany collectively make up a quarter of arrivals. The ability to diversify the source market of tourists’ arrivals partly stems from the diversity of the Maltese product, but mostly is a result of increasing airline connectivity with a larger number of diverse source markets of tourists.

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1 For more detailed analysis of the contribution of travel and tourism to GDP refer to WTTC (2017).
Over time, the tourism industry in Malta has gradually shifted from package to non-package holidays, with the traditional tour operator business losing market power with the advent of bookings over the internet. Tourists are increasingly after authentic local experiences, paying increasing attention to price and value for money. Furthermore, the rising share of tourists staying in private accommodation, which stood at 43% in 2017, was made easier by online platforms.

Meanwhile, the number of cruise liner passengers that visited Malta rose to around 658,000 in 2017, more than double the amount recorded in 2004, and contributed to additional promotion of the country, apart from their direct expenditure in the Maltese economy.
The current account in the balance of payments measures the difference between a country’s exports and its imports. The current account had been generally in surplus up to the 1980s, as a positive income and services balance more than offset sizable deficits in the merchandise trade account (see Chart 15). During this period, any pressure on Malta’s external balance such as those experienced in the early 1980s was mitigated by import restrictions and export subsidies, while adjustments in the exchange rate were primarily relied upon to provide a stable nominal anchor for the economy by containing imported inflation (see Box 3). Current account deficits widened significantly from the mid-1990s and were a recurrent feature in the 2000s, reflecting both the impact of lifting of import controls, but also significant dissaving by government reflected in high fiscal deficits and rising public debt. Rapid growth in the net export of services since the mid-2000s, however, led to a reversal in trends in Malta’s current account. Balances on the income account remain slightly negative, reflecting the reliance on FDI whereby profits accrue to the foreign shareholders of such firms, in contrast with large positive balances registered in the 1970s and the 1980s, partly reflecting the payment of rent by the UK for its military base up to 1979 and official capital transfers, primarily from Italy during the 1980s.

The current account also reflects the gap between national savings and investment. According to this view, the current account surpluses that the
country recorded during the 1970s diametrically opposed the traditional view that developing countries run very high current account deficits (due to their initial heavy investment) and low savings on account of their low income (see Chart 16). In the first half of the 1970s, capital transfers from abroad, which were quite high during this period, financed government primary deficits and high levels of private investment.

The current account surpluses recorded between 1975 and 1978 were the result of large positive private saving gaps, which in turn reflected a hike in household saving, while the surpluses recorded between 1978 and 1982 reflected the considerable positive public savings gap which developed due to an improvement in government’s primary fiscal balance and the decrease in public capital expenditure.

"The 1970s and early 1980s were characterised by high current account surpluses"

The 1970s and early 1980s were characterised by high current account surpluses as savings, both public and private, consistently exceeded the investment rate. During this period the government sought to counter the effect of repeated revaluations of the Maltese lira by implementing controls on imports. Low interest rates were maintained and capital controls were introduced to limit
capital outflows. In this context Findlay & Wellisz (1993) described Malta as “an unusual case of fiscal conservatism coexisting with financial repression and rigid controls on capital movement and trade”. While tariff and non-tariff trade barriers were introduced to protect infant industries geared for the local market and limit imports, Maltese saving could not be channelled to purchase foreign financial assets through capital controls. Hence, the current account surpluses recorded during those years did not result in private sector holdings of foreign assets, but rather boosted the level of official reserves.

The current account position alternated between slight deficits and small surpluses during the 1983–1992 period, supported by significant official capital transfers from abroad. Compared to the earlier decade, the external situation changed significantly in the 1980s due to adverse international conditions that led to a decline in exports of goods and tourist activity, while a steadily deteriorating public saving gap also impacted on the deficit. The current account deficit increased to double digit levels in the mid-1990s, in part as a result of a sharp increase in the fiscal deficit. Similarly, private saving embarked on a downward trend in the late 1990s as personal income growth slowed, in part reflecting the initial impact of the restructuring of the Maltese economy that preceded the country’s EU membership. A number of sectors that had been previously shielded by tariff and non-tariff barriers needed to improve their competitiveness to survive, such that some firms wound down their activity while others restructured significantly their operations. The liberalisation of the financial sector and the end of widespread generous social housing schemes led to an increase in mortgage and consumer lending which also contributed to lowering the household savings rate.

A reversal of the downward trend in saving has occurred since the second half of the 2000s. Since 2006, with the exception of 2009, the national saving rate has been on a consistent upward path. Public saving has improved by around 5 percentage points of GDP since 2008. Corporate saving also increased significantly, largely due to a significant rise in the combined gross operating surplus of Maltese firms, which grew by €1.9 billion in the decade following 2006, more than double the increase in the decade preceding EU accession. Profits grew on the back of the emergence of new export-oriented services sectors combined with the impact of greater competition and restructuring of previously existing sectors. After 2012, robust economic growth and high employment levels have led to an increased disposable income. As a result, the household saving rate returned to the levels of the late 1990s.
Investment trends have over time mirrored those in saving. However, given the small size of the economy, these were often impacted by large one-off projects, as well as investment decisions made by foreign parents, mostly of local manufacturing firms. Private investment as a percentage of GDP was always higher than public investment throughout the years, with the largest differences occurring in the early 1980s. In fact, during most of the 1980s public investment was relatively low, and contrasted with the mid-1970s when public investment overtook that undertaken by the private sector, as a result of increased construction expenditure by the state. The rise in public investment resumed during the late 1980s and the 1990s.

Private investment was relatively stable during the first part of the 2000s, before picking up steadily in the second half, reaching levels last seen in the late 1990s. Subsequently, it gradually fell, halving by 2008 to its lowest historical level, reflecting the gradual decline in manufacturing investment. In recent years, there has been some recovery. For instance, in 2015, the emergence of aviation services, which is heavily capital intensive resulted in a sharp rise in the private investment ratio, whereas significant energy-related projects also boosted gross fixed capital formation in recent years. However, the gradual shift towards services, which are less capital intensive, has limited investment growth, particularly in machinery and equipment.

With the exception of 2002, Malta registered persistent current account deficits from the early 1990s up to 2011. Grech (2000) shows that the deterioration in the current account position reflected a steady decline in government saving that offset the impact of a lower investment ratio. Since 2009, however, Malta’s current account position improved by nearly 13 percentage points to 6.6% of GDP in 2016, by far the largest change amongst euro area countries. Grech and Rapa (2016) argue that this improvement in Malta’s current account position was not caused by cyclical demand factors, as lower oil prices and a better real exchange rate played only a minor part in explaining movements in imports and exports during this period. Rather, structural developments such as improving energy intensity and falling import content of the main GDP expenditure components were more important drivers. While in the past, Malta’s production was relatively more reliant on imports of capital goods, the surge in labour-intensive services sector, coupled with domestic population dynamics, has led to increased reliance on imports of labour.
BOX 3: EXCHANGE RATE POLICY

When the Central Bank of Malta was established in 1968, Malta had achieved its independence and still had a very strong trading relationship with Britain. At that time, the Maltese currency, known as the Malta pound, was fixed at par with pound sterling. Ellul (1997) explains that some form of fixed exchange rate was seen as the most appropriate arrangement for “a small, open economy with relatively underdeveloped financial markets” such as Malta. The rationale behind the fixed exchange rate was to reduce exchange rate volatility, in order to maintain confidence in the value of the Maltese currency, thus boosting foreign trade and investment.

In the 1960s, the international monetary system was based on the Bretton Woods System, introduced following the setting up of the IMF in 1944, whereby the US dollar was fixed to gold. All other currencies were then bound to the US dollar with a narrow fluctuation margin of 1% each side of the declared fixed parity. This system came under increasing pressure in the late 1960s as the US balance of payments deficit grew sharply, and broke down in August 1971 when the US authorities suspended convertibility of the US dollar into gold.

The collapse of the Bretton Woods System was accompanied by heavy downward pressure on sterling. Maintaining the binding relationship between the Maltese pound and the British pound would have implied a depreciation of the Maltese currency which, in turn, would have had domestic inflationary effects. To avoid such repercussions, in August 1971, the Maltese authorities broke the one-for-one peg with the pound sterling and pegged the Maltese currency at a 5% premium over sterling. This premium was eventually reduced to 2.5% in September 1971 as sterling recovered slightly. Further pressure on sterling forced the pound to float on the international markets in June 1972.

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1 The objective was to encourage the growth of world trade by maintaining stability in exchange rates and avoiding the system of competitive currency depreciations which had impacted the world economy negatively in the 1930s.
On 1 July 1972, the direct link with the British pound was discontinued. The Maltese authorities decided to peg the Maltese pound to a trade-weighted basket of seven currencies which, besides sterling, included the major continental European currencies. This decision was taken to insulate the Maltese lira from external pressures arising from binding relationships with a single foreign currency and to maintain domestic price stability (Spiteri, 1975). The choice of a basket of currencies also reflected a desire to increase the diversification of Malta’s international trade, and allow Malta’s economic policies to diverge from those of the United Kingdom.

“On 1 July 1972, the direct link with the British pound was discontinued”

Malta became one of the first countries to peg its currency to a basket rather than to a single major international currency (Ellul, 1998). The weights given to the currencies reflected Malta’s trading patterns. Both export and import patterns were included in the determination of the basket weights as the overriding objective of exchange rate policy was to strike the right balance between controlling imported inflation, by favouring hard currencies, and enhancing Malta’s export competitiveness. The emphasis placed on either of these two objectives tended to vary over time, depending on the state of the local economy and the prevailing economic priorities. Initially, the composition of the basket reflected the importance given by the Maltese authorities to contain imported inflation. Thus, in January 1974, the Malta pound formula was expanded to include the US dollar, which had gained in importance in Malta’s foreign trade as a result of the increase in oil prices following the OPEC price hike in December 1973. The composition of the currency basket thus became based on sterling, the continental European currencies and the US dollar.

“Both export and import patterns were included in the determination of the basket weights”

Several modifications to the currency basket were made over the years. In these revisions the weights of those currencies which were
expected to appreciate were increased, while the weights of those that were considered weak were correspondingly reduced (Caruana Galizia, 1989). In January 1979 the Malta pound formula was revised to take into account the depreciation of the US dollar and the prospective launching of the European Monetary System. A month later, the Japanese yen was included in the formula to bring the number of currencies in the basket at the time to nine.\(^2\)

The Malta pound was revalued three times between February 1979 and April 1980 to cushion the Maltese economy as much as possible against the damaging effects of imported inflation (Caruana Galizia, 1989).\(^3\) On April 28, 1980, however, the Maltese currency was devalued by 4.2% as the Maltese authorities were concerned that the strengthening of the currency could have adverse effects on Malta’s competitiveness.

In 1981 there were two subsequent revaluations – in March the Maltese pound was revalued by 0.5% while in May, it was revalued again by 3.7%. Moreover, the Italian lira and the Belgian franc were dropped from the basket and their weight was allotted to the stronger currencies (US dollar and the Japanese yen). This period was marked by an extremely high level of international inflationary pressures. Consequently there was a bias in favour of “harder” currencies in an attempt to combat imported inflation.

By the mid-1980s, inflationary pressures subsided and the main concern for the Maltese authorities was the slow pace of economic growth (Ellul, 1997). The importance of export competitiveness came to the fore and, consequently in 1985, the bias in favour of strong currencies was removed. At the same time, the composition of the currency basket was changed to reflect also foreign exchange earnings from tourism. At the same time, the Italian lira and the Belgian franc were reincorporated in the

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2 The currencies in the basket were the Deutsche mark, French franc, Swiss franc, Dutch guilder, Italian lira, Belgian franc, Pound sterling, US dollar and Japanese yen.

3 The Malta pound was revalued by 1.7% in February 1979 and by 1.1% and 4.3% in March and April 1980, respectively.
currency basket which resulted in a noticeable contraction in the weighting of the US dollar and Japanese yen. The formula was revised once again in 1987 to give due regard to the interests of all sectors in the economy, each sector duly weighted by its relative importance in Malta’s balance of payments. The basket, therefore, started to reflect much more closely Malta’s trading patterns. Another innovative feature was the inclusion of the Special Drawing Rights, for a brief period, in order to reflect transactions with countries that were not represented in the currency basket. In 1989, the number of component currencies was reduced to three: the US dollar, pound sterling and the European Currency Unit (ECU). The latter had replaced several European currencies and was assigned the biggest weight given the country’s strong trading links with the EU.

“In November 1992, the Central Bank of Malta devalued the Maltese lira by 10%”

The early 1990s were characterised by speculative attacks on some currencies in the ERM, especially the Italian lira and British pound. In November 1992, the Central Bank of Malta devalued the Maltese lira by 10%. This was intended to safeguard the competitiveness of the Maltese manufacturing and tourism industries in the wake of the pronounced currency turmoil in Europe that left several trading competitor currencies weaker.

Chart A shows the movements of the Maltese lira against some of the major currencies over three decades since 1968. Ellul (1998) believes that the exchange rate peg to a currency basket served the economy well as it contributed to exchange rate stability while, at the same time, toned down the extent of imported inflation. This stability, however, came at a cost. Unless capital controls are in place, maintaining a fixed exchange rate regime implies that that the government must relinquish the use of monetary policy for stabilization purposes (Obstfeld & Rogoff, 1995).4 5

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4 The Maltese pound was renamed as the Maltese lira in 1983 (Central Bank of Malta, 2013).
5 Because of the incompatibility between monetary policy autonomy, capital account liberalisation and a fixed exchange rate, known as the Trilemma, only two goals can be achieved simultaneously.
Malta’s success in operating a fixed exchange rate regime was partly owed to the presence of capital controls and the associated imperfect substitutability of Maltese for foreign financial assets (IMF, 1999). Controls on capital movements allowed the Maltese authorities to maintain a pegged exchange rate while simultaneously pursuing a domestic interest rate target. On the other hand, capital controls can weaken economies as they tend to reduce foreign investment and can increase financing costs for domestic firms. Controls also insulate markets from competition, and can be costly to enforce, besides leading to market-distorting activities by economic agents who seek to avoid them.

By the mid-1990s, Government was pursuing trade and financial sector liberalisation. Vassallo (1996) outlines the financial sector reforms that were implemented, and which were intended to make the Maltese financial system more market-oriented. These reforms led to a gradual liberalisation of interest rates and strengthened the Bank’s independence. Moreover, toward the end of 1994 Malta accepted the obligations arising from Article VIII of the IMF’s Articles of Agreement. As a result, current account transactions were freed from exchange controls while restrictions on capital movements were drastically reduced until
all exchange controls were abolished by the date of EU accession. It was increasingly recognized that, in the absence of capital controls, monetary policy had to be more actively oriented towards maintaining the peg (Vella, 2017).

The Central Bank of Malta used a variety of policy tools to maintain the exchange rate peg. Apart from intervening in the foreign exchange market, the Bank altered official interest rates, which were then transmitted to the retail bank lending and deposit rates. Open market operations were regularly used to influence liquidity in the banking system, thereby ensuring that short-term interest rates were in line with the Bank’s monetary policy stance.

As from January 1999, following the advent of the EMU, the ECU was replaced by the euro and the weights of the components of the Maltese lira basket were revised accordingly. The euro was assigned a weight at 56.8% in the currency basket while the US dollar and sterling were assigned equal weights of 21.6%. The euro’s weight increased further to 70% in 2002 in anticipation of EU membership, while those of the pound sterling and the US dollar were set at 20% and 10%, respectively. In May 2005, a year after Malta’s accession to the EU in May 2004, the Maltese lira started its participation in the ERM II with a central parity rate of EUR1=MTL0.4293. The authorities committed themselves to maintain the exchange rate at its central parity rate. The latter became the conversion rate between the Maltese lira and the euro when Malta adopted the euro in January 2008.

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6 ERM II is a fixed exchange rate mechanism, involving the adoption of a central exchange rate against the euro in agreement with the ECB. This rate is then allowed to fluctuate within a band with margins of up to +/-15%. The national currency is expected to remain within the fluctuation margins for at least two years, without resorting to devaluation against the euro. Accession to EMU is conditional on prior participation in ERM II.
5. THE ROLE OF GOVERNMENT

The State has traditionally taken a prominent role in the expenditure and income flows of the Maltese economy. Fiscal policy has served as the major economic stabilisation tool, given that for many years preceding euro adoption monetary policy had been focussed on preserving a sustainable level of external reserves to ensure credibility in the pegged exchange rate. However, excessive reliance on fiscal policy to support economic growth has also given rise to persistent budget deficits for a prolonged period of time, which led to an accumulation of national debt. This trend, however, has been recently reversed, as Government embarked on a strategy of implementing sound economic policies conducive to economic growth which enabled it to embark on a credible programme of fiscal consolidation, adhering with greater consistency to its fiscal targets.

“Fiscal policy has served as the major economic stabilisation tool”

The state of public finances in Malta has been partly influenced by the transformation of the government’s role in the economy. Starting in the late 1950s, the State had a very active role in the economy particularly as regards the provision of infrastructure and the promotion of export-led industrialisation, mostly through the promotion of FDI. This new role reflected the widespread recognition that British military expenditure had entered into irreversible decline, and was particularly marked from the early 1970s onwards, following the political decision to gradually end what remained of the British military presence in Malta, on which the Maltese economy continued to rely to an important extent. With the shift in activity away from services to the British military base to the gradual emergence of significant manufacturing exports and earnings from tourism in the 1960s (the first significant investments took place in this period), the government became directly involved in productive activities, particularly services (especially after the early 1970s) but also goods, albeit to a much lesser extent. Government policy resorted to import and capital controls and interest rate ceilings to support infant industries and at the same time protect the exchange rate peg. Nevertheless, up to the early 1980s fiscal policy remained prudent. At that time the government increased its savings in the Consolidated and Posterity Funds to the extent that up till 1982, public sector budget surpluses were a regular feature. During this period government continued to invest heavily in the promotion of
FDI, inflows of which continued to play a leading role in industrial development and the generation of exports.

However, after the recession of the early 1980s, when tourism and exports of manufactures were severely affected, fiscal policy was loosened considerably, mainly on the back of lower government revenue, which fell to around 30.3% of GDP in 1998 from 37.1% in 1981. The 1990s witnessed a transition to a more liberalised and market oriented economy, with the main thrust during this period being that of government gradually withdrawing from its role in direct production of goods and services. Despite this retrenchment in the role of the State, the fiscal balance deteriorated steadily throughout the 1990s, with public debt soaring. After EU membership, the government engaged in fiscal consolidation in its efforts to adopt the euro by 2008. After achieving the goal of euro adoption, fiscal consolidation stalled until 2012, after which the situation in public finances progressively strengthened, with public debt embarking a downward trend and a fiscal surplus was achieved in 2016.

**Sources of revenue**

For many years, the share of tax revenue in GDP fluctuated around 33%. This stability in the relative tax share complemented government’s efforts to raise non-tax revenue from other sources, primarily from a more direct involvement in production and the generation of income transfers from abroad (Delia, 2002). In turn these sources of government revenue supported more generous welfare programmes.

Such a policy was also set out in the 1973-1980 Development Plan for Malta which at the time had indicated that: “the state will not limit itself to a backing role, as it had done up to 1971. There will be greater government involvement in the productive sector, both in areas where the public interest warrants state control and in situations where the State has to act in default of private initiative” (Government of Malta, 1974:60). In addition, measures were to be taken “to ensure that productive run enterprises were to be run on an efficient and commercially profitable basis unless there is a compelling social reason why they should be subsidised”. Meanwhile, profits generated were planned to ease pressure on tax collection.
The reforms enacted in the late 1980s and early 1990s with the aim of re-dimensioning the role of the State in the production of goods and services, led to significant changes in the composition of the sources of government revenue, with the most significant transformation being the shift from non-tax to tax revenue (see Chart 17). Non-tax revenue as a percentage of GDP fell from an around 10.5% in the mid-1980s to around 4.2% in the early 2000s. The decline in non-tax revenue reflected changes in the composition of its main components, namely profits from public sector corporations, dividends from investments and Central Bank of Malta profits. For instance, inflows from public sector enterprises increased in the period between 1988 and 1994 but dropped in the years that followed. This drop reflected growing inefficiency in state-owned firms, which had to be largely subsidised, as well as the privatisation of some profit-making enterprises.

The share of Central Bank of Malta profits in total revenue nearly halved between 1987 and 2001. This reduction largely reflected the relative decline in the external reserve position of the Central Bank of Malta following the gradual trade liberalisation measures, as well as the highly expansionary fiscal stance that led to current account deficits in the balance of payments. The amount of reserves was allowed to drop from over 16 months of imports to less than six months.
Similarly, the inflows of foreign official grants, particularly from Italy, which were a major source of finance in the early 1980s, also decreased in importance as Malta geared its policy towards EU membership.

Whereas the share of non-tax revenue in GDP stabilised after 1998, tax revenue rose steadily from around 25.1% of GDP in 1998 to 32.0% in 2016. This growth may be attributed to two distinct phases. Following the introduction of the Pay-As-You-Earn system in 1973, the maximum income tax rate was reduced from 65% to 35% in 1990 so as to encourage less under declaration of income. The government’s shift in policy in the mid-1990s from taxing labour income to taxing consumption, led to a broadening of the tax base and the creation of a wider channel of tax revenue. Thus, in the period up to EU accession, the rise in tax revenue was driven by indirect taxes and reflected to a large extent the implementation of value added tax (VAT), which mainly substituted customs duties, accompanied by a period of strong economic growth. After EU accession, higher direct tax revenue reflected higher corporate taxation receipts that were generated by increased activity in the services sector. At the same time, the effective tax on labour income was gradually reduced, contributing to raise Malta’s labour participation rate from one of the lowest in the EU to a level that is close to the average.

The composition of public expenditure

Spending patterns have also changed over time. Traditionally, the reaction of governments to weak economic growth has been generally that of resorting to demand management policies, involving either an increase in public expenditure or, more infrequently, reductions in taxation. Recurrent expenditure rose over the years, while discretionary expenditure, such as that on capital projects, declined. Capital spending, which had surged to around 7% of GDP in the late 1980s/early 1990s, was halved in subsequent years. Spending on capital projects rose again in the mid-2000s on account of the completion of a new hospital. It then surged again between 2012 and 2015, partly reflecting significant energy-related projects and others financed by the 2007-2013 EU financing framework.

Meanwhile, the increase in recurrent expenditure reflected the expansion of Malta’s extensive welfare system, especially in respect of provision of health
and education services as well as pensions. Diversified assistance, in cash or in kind, had led to reliance on the State to the extent that in recent years a successful attempt was made to increase the incentives for citizens to enter the labour market and rely less on social benefits.

Spending on contributory benefits and personal emoluments also increased over time. Whereas most categories of expenditure declined as a percentage of GDP, contributory social security benefits rose steadily (see Table 7), with the exception of recent years.\(^9\)\(^,\)\(^10\) This upward trend was driven by the maturing of the pension system combined with the impact of population ageing. While outlays on personal emoluments were double the spending on contributory benefits in the 1980s, spending on these two items has converged in recent years.

<table>
<thead>
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<th>Table 7</th>
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<td>GOVERNMENT SPENDING AS A SHARE OF GROSS DOMESTIC PRODUCT</td>
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<td>(per cent)</td>
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<td></td>
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<tr>
<td>Personal emoluments</td>
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<tr>
<td>Contributory social security</td>
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<tr>
<td>Non-contributory social security</td>
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<tr>
<td>Public debt servicing</td>
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<tr>
<td>Other current expenditure</td>
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<td>Capital</td>
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The highly expansionary fiscal stance after 1990 led to growing debt servicing costs. These rose from around 1.0% of GDP in 1980 to 1.3% in 1990, and subsequently soared from 4% of GDP in 2000 to 7.7% by 2016. This reflected developments in gross debt,\(^11\) which relative to GDP, shot up from around 13% in 1980, peaking to 66% in 2011 before subsiding to 55% in 2016.

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\(^9\) A contributory social security scheme relates to a system where an employee or self-employed person pays a weekly contribution as laid down by the Social Security Act, so as to finance contingencies related to sickness and retirement.

\(^10\) Spending on non-contributory benefits, which are provided on the basis of a means-test, has declined over time. This reflects the introduction of an earnings-related pension scheme (national two-thirds pension) for employed and self-employed persons, which are classified as contributory schemes. In addition, rising living standards lessened reliance on certain benefits for leprosy, tuberculosis, milk grants, etc.

\(^11\) Gross debt held by Central Government excluding debt by extra-budgetary units and debt held by sinking funds.
The expansionary fiscal stance spanning over more than three decades after 1982 shows that this imbalance was one of a structural nature, driven by growing public expenditure that outpaced revenue irrespective of the economic cycle. In a study of a more recent period, Farrugia (2014) assessed two cyclically adjusted budget (CAB) estimation approaches for Malta in order to observe the underlying fiscal position net of automatic stabilisers and, hence, arrive at a fuller understanding of the extent and effectiveness of discretionary fiscal policy. Both approaches suggest that the main changes in the budget balance in Malta between 2000 and 2013 were a result of discretionary government policy rather than the economic cycle. Nonetheless, the cyclically adjusted balance improved somewhat during this period. Most of the improvement took place in the years immediately following Malta’s entry in the EU and the euro area, when the country was undergoing various fiscal measures in an effort for an early adoption of the Euro.

The fiscal position in recent years

Malta’s fiscal performance improved in the run-up to EU accession and the years that followed. Indirect taxes were raised, and tax administration was strengthened, while attempts were made to limit further increases in government employment. On-going fiscal consolidation efforts brought the deficit down to around 5.5% of GDP in the early 2000s from 9.1% of GDP in 1998 (see Chart 18). Nevertheless,
the fiscal deficit still remained well in excess of the limit required by the Stability and Growth Pact and in 2004 the European Commission opened the Excessive Deficit Procedure (EDP) for Malta.\textsuperscript{12}

Attempts at fiscal consolidation in a particularly weak growth environment had to focus on better expenditure management.\textsuperscript{13} At the time perhaps the greatest obstacle to the effective implementation of such an approach was the negative short-term economic impact that expenditure cuts were likely to entail. In this regard, the private sector was required to be in a position to take up the slack left by the State’s reduced role in the economy (Bonello, 2003). Additional fiscal consolidation measures consisted of a wide-ranging privatisation programme and the first stage of a pension reform. The restructuring of public enterprises led to a drop in personal emoluments and the contribution to government entities as a share of GDP between 2003 and 2007. At the same time, the economy was able to diversify into new sectors, boosting tax revenue from both higher employment and corporate profits. As a result, in 2007, the Council of Ministers had accepted the recommendation of the European Commission to abrogate the decision on the existence of an excessive deficit, which, together with other criteria, made Malta eligible to become part of the Eurosystem in 2008.

The onset of the global economic and financial crisis exposed the weakness of the economic governance framework of Europe’s EMU. Thus, after 2009, EU institutions and Member States had to undertake substantial efforts to strengthen the governance of EMU and sustain the credibility of the single currency project (Attard & Demarco, 2013).\textsuperscript{14} During this period, the economic downturn called for a fiscal response to support activity, with the government providing rapid and targeted support to companies with cash flow difficulties. However, despite the rapid recovery of the Maltese economy after the downturn in 2009, fiscal

\textsuperscript{12} The EDP is an action launched by the European Commission against any Member State that exceeds the budgetary deficit ceiling imposed the EU’s Stability and growth pact legislation.

\textsuperscript{13} In line with the Maastricht criteria which EU member states are required to meet certain criteria to enter the third stage of the EMU and adopt the euro as their currency: amongst others, the fiscal criterion requires that government debt relative to GDP must not exceed 60% (debt criterion) and the government deficit relative to GDP must not exceed 3% at the end of the preceding fiscal year (deficit criterion).

\textsuperscript{14} These included the setting up of financing mechanisms, like the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (ESM), the establishment of the European Semester to strengthen surveillance and co-ordination of economic and budgetary policies, as well as the enactment of the “golden fiscal rule” into national legislation which incorporates fiscal expenditure and public debt limits.
slippages emerged, and in 2009 an excessive deficit procedure was opened once again, until such a decision was abrogated in 2012.

Nonetheless, in 2013 the Council had once again opened an EDP after Malta had failed to meet its 2012 fiscal targets. In an effort to achieve the medium-term objective of achieving a balanced budget over the business cycle, Malta renewed its efforts to take effective action to correct its excessive deficit. The last EDP was abrogated in 2015, as European Commission forecasts indicated that the deficit was not projected to exceed the 3% of GDP threshold over the forecast horizon, and the debt ratio fulfilled the forward-looking element of the debt benchmark.\textsuperscript{15} Indeed, public finance statistics showed that in 2016 the government recorded a fiscal surplus in excess of 1.0% of GDP, the first surplus since the early 1980s. Though this reflected strong growth in revenue on the back of buoyant economic activity, the success of active labour market policies in reducing the share of social expenditure also played a significant role.

\textsuperscript{15} Refer to Council of the EU (2015).
6. THE FINANCIAL SYSTEM

The rapid development of the Maltese economy has led to substantial changes in the local financial system. Before the early 1990s, the Maltese financial sector was highly regulated by the Minister for Finance, both in terms of interest rate and capital controls (Azzopardi & Briguglio, 1993; Falzon, 1994). These controls were gradually removed and government’s role in the banking sector (including direct shareholding) was significantly curtailed. With the removal of capital controls, the Central Bank of Malta focused its operations on maintaining a credible exchange rate peg, while economic and financial sector liberalisation led to a significant rise in bank lending.\textsuperscript{16}

\textit{“Economic and financial sector liberalisation led to a significant rise in bank lending”}

Chart 19 displays the changes over time of two monetary aggregates: currency in circulation and broad money. The amount of currency in circulation in Malta expanded significantly since the 1960s and reached a historical peak in 2005. The increase was especially rapid in the 1970s given the high inflation prevailing

\textsuperscript{16} For Malta’s monetary policy framework prior to the adoption of the euro, see Grech (2003).
in this decade following the two oil price shocks. Compared to nominal GDP, currency in circulation rose through the early 1970s but was broadly flat between 1975 and 1985, before starting a gradual decline. A bank run in 1973 led to a rise in currency holdings as the public’s confidence in the banking system was badly shaken although by the end of 1974 confidence in the banking system had already been restored.17

The development of the local banking sector, together with financial liberalisation, led to a decline in currency demanded because of the increasing use of non-cash payments. In fact, the ratio nearly halved over the decade 1986 to 1995. Between 1996 and 2005 the ratio of currency in circulation to nominal GDP remained relatively stable, before falling again in 2007 in anticipation of euro adoption and the associated cash conversion process. Euro adoption led the stock of currency to fall by half as authorities sought to reduce the use of cash.18 Since then it has remained relatively constant. However, until recently holdings of currency were still very high in Malta when compared to other Western European countries (Grech, 2013).

An analysis of Maltese payment habits shows that despite substantial access to debit and credit cards, cash was the most popular payment channel, accounting for almost 90% of all transactions although for less than 55% of the total value of the transactions (Central Bank of Malta, 2014). In the last two decades, substantial progress has been made in the use of other forms of payment. For instance, payments through internet banking ranked second as a percentage of total transactions in terms of value. The use of cheques, which were very popular in the 1990s and accounted for about 75% of the value of retail payments in Malta in 1999, has gradually diminished (Central Bank of Malta, 1999; 2014). The use of cheques in Malta, however, still remains one of the highest among euro area countries.

17 Following a run on the National Bank of Malta Ltd., a substantial switching of bank deposits into cash was recorded (Central Bank of Malta Annual Report, 1974). Further historical details on this event are available in Consiglio (2006).

18 Entry into the euro area represents a break in series in the presentation of Maltese monetary statistics. As from January 2008, instead of showing monetary aggregates for Malta, the statistics represent the ‘Contribution of resident MFIs to the euro area monetary aggregates’. The Maltese contribution to the euro area monetary aggregates and counterparts represents a notional amount attributed to each national central bank (NCB) in the euro area according to the banknote allocation key, based on the NCB’s adjusted share in the paid-up capital of the ECB.
Broad money, which besides currency also includes bank deposits, as a share of GDP declined in the 1970s. While in absolute terms deposits more than doubled, GDP grew even faster. Following the weak economic growth of the 1980s, growth in broad money resumed rapidly on account of rising deposits. This increase in deposits has facilitated the reliance of domestic banks on a traditional banking business model, with their activities financed mainly by retail resident deposits rather than from wholesale markets. This approach, together with prudent lending practices, was a key factor in the resilience of the Maltese banking system during the most recent global financial crisis.

Mirroring the increase in deposits, lending to Maltese residents grew substantially especially from the mid-1980s onwards. From around 40% of GDP in 1986, the relative size of total loans to residents peaked at 130% by 2011. This is consistent with what happened in other countries, where financial liberalization led to increased financial depth and a higher credit-to-GDP ratio (Tornell et al., 2004; Bonfiglioli and Mendicino, 2004). Despite this increase, Maltese banks have remained prudent in their lending activities and, at 56%, Malta had the lowest loan-to-deposit ratio in the euro area at the end of 2016. In spite of the low interest-rate environment, the core domestic banks reported further growth in profits and the profitability of banks in Malta, as evidenced by their Return on Equity, which compares favourably with that of other euro area countries (ECB, 2017).

“Personal lending, mainly in the form of mortgages, accounts for a large share of the rise in credit”

Personal lending, mainly in the form of mortgages, accounts for a large share of the rise in credit. Lending for house purchases was negligible before the 1990s, at around 1% of GDP, because of generous social housing policies and incentives aimed at boosting home-ownership. As such incentives and provision of social housing was gradually re-diminished, mortgages increased rapidly after the mid-1990s and by the end of 2016 amounted to 42% of GDP (see Chart 20). Lending to construction and real estate firms also increased from around 2% of GDP in the 1980s to 29% in 2009. However, in recent years banks have reduced their exposure to these firms, making the banking system somewhat less exposed to the construction sector.
While for many years bank loans were the main source of debt finance to businesses resident in Malta, the trend was reversed after the financial crisis of 2009. The process of disintermediation has intensified in recent years (Darmanin, 2017). Bank loans to non-financial corporations (NFC) contracted by an annual average of 2.8% between 2012 and 2016.\(^\text{19}\) It is likely that this decline in NFC credit reflects a combination of both demand and supply factors (Micallef, 2015c; Darmanin, 2017). This process of disintermediation has resulted in a gradual shift in banks’ loan portfolios from NFCs towards households, with the share of the latter rising from 37% in 2005 to 51% in 2016 (see Chart 21).

The financial liberalisation of the 1990s has increased the role that banks play in the determination of household consumption (Grech, 2015). As at 1990, personal credit constituted less than 7% of total bank lending as banks dealt mostly with firms. Personal credit nowadays accounts for a much larger share of banks’ activity, with the main type of lending being mortgage credit.

The rise in mortgage lending coincided with a sharp rise in house prices. Falzon, Zammit & Camilleri (2005) argue that banks’ lending practices helped to accommodate demand. Nevertheless they note that in the 1980s mortgage

\(^{19}\) Loans to NFCs include also loans granted to sole proprietors, partnerships and non-profit institutions. Furthermore, the growth in bank loans to NFCs during this period was impacted by the reclassification of some loans owed by public NFCs to financial corporations.
lending had also been rising strongly (in absolute terms it quadrupled) while house prices had remained broadly stable. This reflected the fact that in that period Government offered various incentives to encourage home ownership (Demarco, 1995). For example, in the 1980s, numerous plots of land were distributed at no cost or at a very low price by the Housing Authority, thus relieving pressure off house prices. The winding-down of such programmes, which became limited to low-income cases, did little to dampen the attractiveness of home ownership for Maltese households, mainly because of lack of willingness of landlords to supply property for rent on account of market-unfriendly rent laws. In the 1990s house prices doubled, but this was exceeded by the rise observed in the three years prior to EU accession when house prices grew by 14% per annum on average. Another supporting factor at the time was the Investment Registration Schemes announced in the early 2000s. Growth in house prices gradually slowed down but remained positive until late 2007. Subsequently, house prices fell for the first time since the 1980s, accompanied by a fall in credit to the construction sector and lower growth in mortgage lending. Activity in the property market remained subdued till around 2012, after which the housing market started to recover.

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20 Even when rent legislation was reformed in 1995, landlords still remained reluctant to supply property for rent, especially to Maltese households, because of the lengthy and difficult process to eject tenants.

21 These schemes allowed residents with undeclared overseas assets to regularise their position. Many residents took advantage of these schemes and invested their assets in domestic property, once they repatriated their assets to Malta, given the low interest rate environment prevailing at the time.
The recovery in property prices since 2013 can be attributed to strong economic growth and historical low unemployment rates, which boosted disposable income. Household income has also benefitted from the increasing role played by the second-wage earner due to the increase in female participation in the labour market. Government policy also played an important role in stimulating the property sector. Policies that supported house prices include the exemption of stamp-duty for first-time buyers, the announcement of another investment registration scheme in 2014, and a reform to the Capital Gains Tax in 2015. The low interest rate environment is also likely to have played a role in supporting demand for property due to portfolio rebalancing by investors.

Social and demographic factors also exerted an impact on the housing market. In particular, the inflow of foreign workers has stimulated the demand for rented properties. Similarly, changing patterns in the tourism industry have also affected the property sector, with an increasing number of tourists opting to stay in private accommodations. This trend has been facilitated by online booking platforms. Both these factors have led to a sharp increase in demand for rental properties, which increased the attractiveness of property to investors, especially in view of a prolonged low interest rate environment.

“The home-ownership rate in Malta stood at 82% as at 2016”

The home-ownership rate in Malta stood at 82% as at 2016 and exceeds that of the EU, which stood around 72%. To an extent, however, the rising share of home ownership in Malta was also affected by the legacy of rent controls, introduced in the late 1940s, which led to supply shortages in the rental market. In an effort to stimulate the rental sector, the Government freed post-1995 rentals from rent controls, although the pre-1995 agreements remained governed by the old law, until 2009, when another rent reform brought to an end the right of occupiers to inherit the tenancy from existing tenants in such kind of properties.
The monetary policy objective of the Central Bank of Malta was initially set as the promotion of “the orderly and balanced development of Malta and a rising level of employment and income consistent with the maintenance of monetary stability in Malta and the external value of the currency”. Although the original Act of 1967 did not single out price stability as the primary objective of the Bank, since its inception, the Bank indirectly pursued this goal via the adoption of the exchange rate as a nominal anchor. Policymakers also clearly recognized that price stability is necessary to promote sustainable growth in employment and income, and to maintain the external value of the currency, though during the 1980s, such measures also included direct price and wage controls by the fiscal authorities.

Following amendments to the Central Bank of Malta Act, which entered into force on October 1, 2002, the primary objective of the Bank was defined as the maintenance of price stability.

“Comprehensive package of financial legislation that was enacted in 1994 to close the gap between international legislative standards and domestic ones”

Until the early 1990s, monetary policy played a relatively passive role as an instrument of economic policy and the system relied almost entirely on direct controls (Ellul, 1998). However, this changed by the mid-1990s when a much more active monetary policy was pursued, though this was in practice somewhat constrained by the fixed exchange rate policy and high degree of openness of the Maltese economy. This coincided with the comprehensive package of financial legislation that was enacted in 1994 to close the gap between international legislative standards and domestic ones. Consequently, the Central Bank of Malta embarked on a programme to develop an appropriate monetary policy operational framework. The focus was four-pronged aimed at introducing open market
operations, kick-starting the interbank market, revamping the Treasury Bill market and liberalising interest rates and exchange controls (Pullicino and Saliba, 2002).

Prior to these reforms, the Central Bank of Malta shared responsibility for the setting of interest rate policy with the Minister for Finance. While the Bank fixed deposit interest rates, it was the Minister for Finance who was responsible for setting maximum levels of bank lending rates, which differed depending on the category of the borrower. Interest rates were changed by means of administrative measures according to the state of the economy. Different rates were established by the Central Bank of Malta for current, savings and term deposits up to a maximum of 5% (see Chart A). These deposit rates remained constant throughout the 1970s and early 1980s. During the same period, bank lending rates were subject to a uniform ceiling of 8%. In 1982, following a period of inflationary pressures, which resulted in negative real interest rates, the Central Bank of Malta raised the discount rate by one percentage point to 6.5%. Simultaneously, the ceiling on one year term deposit rates was raised by 1 percentage point, to 6%. These increases were reversed in the second half of the 1980s because of a slowdown in economic growth. Despite the strict

**Chart A**

**LIMITS ON DEPOSIT AND LENDING RATES**

(per cent)

![Chart A](chart.png)

Source: Central Bank of Malta.
foreign exchange control in Malta, the prevailing low interest rate regimes resulted in leakages as savers sought higher rates of return from financial investments abroad (Tarling and Rhodes, 1989).

By the late 1980s, it was increasingly recognized that Malta’s rigid interest rate regime was hindering the growth of the financial sector as interest rates were not being allowed to play their proper role in the allocation of resources (Ellul, 1998). While businesses complained about credit rationing by the banking system, the banks countered that they were constrained by the ceilings on lending rates, which prevented them from charging adequate risk premia. In fact, during the 1980s, a large proportion of business investment was financed out of retained profits rather than by the banking system (Ellul, 1998).

The following decade was characterised by a shift away from direct controls and towards market-oriented tools of monetary policy. As a first step, in the 1990, credit institutions (then known as commercial banks) were obliged to open and maintain reserve deposits at the Central Bank of Malta equivalent to 5% of their deposit liabilities. This was intended as a monetary policy tool to signal the need to curtail excessive rapid credit growth. This was complemented by the commencement of stock exchange trading in 1992, whereby market forces began to influence bond prices and, consequently, longer-term interest rates. This added to the pressure to liberalise interest rates.

“The liberalisation of bank interest rates was carried out gradually in the first half of the 1990s”

The liberalisation of bank interest rates was carried out gradually in the first half of the 1990s as part of a wider process of financial sector liberalization that included the easing of exchange controls and the privatisation of banks. In July 1990, Malta formally applied to join the EU which further urged the process of liberalization (Azzopardi and Briguglio, 1993). In 1993, a single ceiling on bank lending rates was established instead of
the scale of interest rate ceilings that applied to different categories of borrowers. This ceiling was established at 3 percentage points above the Bank’s discount rate of 5.5%.\footnote{Different maxima were set in the case of loans granted for housing, for property development and for those loans granted in foreign currency.} While leaving the maximum statutory lending ceiling unchanged at 8.5%, this development signalled that, thereafter, bank lending rates were to be directly linked to the Bank’s central intervention rate. In 1994, the Central Bank of Malta liberalised deposit rates, with the exception of the minimum rate on savings and term deposits, which was set at 3%. This was intended to safeguard the interests of deposit-holders. This was possible following the amendment of the Central Bank of Malta Act in 1994, whereby the Bank’s role in monetary policy implementation was strengthened as it gained the authority to influence, or directly determine, the level of interest rates. Subsequently, in 1995, bank lending rates were liberalised.\footnote{Because of legal requirements, however, a ceiling on lending rates, equivalent to the minimum discount rate plus a stipulated margin, had to remain in place. An increase in the margin over the discount rate from 3 percentage points to 10 percentage points was considered sufficiently high to render the ceiling on lending rates ineffective.}

The amended Central Bank of Malta Act of 1994 also strengthened the independence of the Bank. The prohibition of monetary financing strengthened the ability of the Central Bank of Malta to control money supply. The Bank ceased to participate in the primary market for Treasury bills after March 1996, in line with its policy aim of limiting its direct lending to the Government. However, by this time the Central Bank of Malta was still purchasing Government stocks on the primary market, in part to replenish its holdings of such securities in view of its role as market maker in the secondary market.

Monetary policy was determined by the Bank’s Monetary Policy Council. The establishment of this Council was the first step towards pursuing a more active role in the implementation of monetary policy. Moreover, whereas prior to the reforms, the Central Bank of Malta had to resort solely to direct controls and reserve requirements to exert monetary
control, it could now pursue a policy that relies more on indirect methods. It was increasingly recognized that direct instruments of control, including the imposition of interest rate ceilings and limits on bank lending, were inefficient and tended to distort competition (Vassallo, 1994).

"Open market operations were the main tool used to implement monetary policy"

The three standard monetary policy instruments used during this period were open market operations, standing facilities and reserve requirements. Open market operations involved the purchases and sales of securities by the Central Bank of Malta to influence monetary conditions. Open market operations were the main tool used to implement monetary policy. The Central Bank of Malta conducted weekly auctions of repos and term deposits to inject or absorb liquidity as required. In most cases, given the structural liquidity surplus of the Maltese banking system, open market operations were intended to absorb excess liquidity. Reserve requirements stipulated a minimum percentage of deposit liabilities which the commercial banks must hold on deposit with the Central Bank of Malta. In Malta, reserve requirements were introduced in October 1990. Finally, the standing facilities were intended to provide and absorb overnight liquidity. Apart from repo operations, the Central Bank of Malta also executed foreign currency swaps against the Maltese Lira to influence money market activity, although on a less-regular basis.

The mid-1990s was a challenging period for the conduct of monetary policy because of price pressures in the economy and the relatively high rate of annual monetary growth, partly fuelled by extraordinary growth in credit (Ellul, 1998). To address the rapid increase in credit to both the Government and the private sector, the Central Bank of Malta used open market operations to tighten the stance of monetary policy and, consequently, ease the strains on the balance of payments and the drop in official external reserves.
Initially, the more active monetary policy took time to be effectively transmitted to retail rates as the banks and the economy as a whole had to adjust to the notion that interest rates should move in line with changes in monetary conditions (Ellul, 1998). However, as the money market developed further and the banks increased their familiarity with open market operations, the monetary policy transmission mechanism improved in its effectiveness and the Bank contributed to curb the excessive rates of domestic credit growth and to limit the outflow of external reserves through tighter monetary policy.

In the early 2000s, in the context of subdued inflation pressures and weak economic growth as a result of the downturn in the electronics and tourism industries, the Central Bank of Malta eased its monetary policy stance, with official interest rates falling from 4.75% in 2000 to 3.0% at the end of 2003 (see Chart B). The decision to ease the monetary policy stance was supported by further growth in net foreign assets and reductions in official interest rates abroad in response to low inflationary pressures arising from weak demand in Europe and in the US. In contrast with previous years, when the Central Bank of Malta used open market operations mainly to absorb liquidity from the banking system, during most of 2001 these...
instruments were used to inject liquidity. In the second half of 2001, the required reserve ratio was reduced by one percentage point to 4% of the banks’ deposit liabilities. This reduction in the required reserve ratio led to an increase in the liquidity available to the banks and was reflected in lower money market interest rates.

Amendments to the Central Bank of Malta Act in 2002 granted the Bank full independence in the formulation and implementation of monetary policy. The amendments formally established price stability as the primary objective of the Central Bank of Malta, while also promoting orderly and balanced economic development. It also introduced additional measures to safeguard the Central Bank’s independence at various levels and vested the responsibility of monetary policy decisions on the Governor. Another important change was the prohibition from purchasing debt instruments directly from the Government or from the public sector in general. The rationale behind the change was to ensure that the public sector bids for resources in the financial market to fund its borrowing requirements, thus contributing to a healthier financial environment. Until 1999, the Central Bank of Malta was still purchasing government securities on the primary market and it was only in 2000 that it refrained from doing so. Despite this, the Central Bank of Malta still acted as market maker in the secondary market to ensure adequate liquidity for Maltese government bonds.

2005 marked an important milestone in Malta’s monetary history with the participation of the Maltese Lira into the ERM II. Monetary policy decisions during the ERM II period, however, were still taken by the Central Bank of Malta. Following a decline in the Bank’s net foreign assets, brought about by the liberalisation of trade, a higher fuel import bill and increased capital outflows, the Bank raised the central intervention rate by 25 basis points to 3.25% in April 2005 (see Chart B). Monetary policy tightening continued in 2006 and 2007 with the official interest rate rising to 4.25% in May 2007, in response to a further decline in the Bank’s external reserves and a marked narrowing of interest rate differentials in favour of the Maltese lira. Official
interest rates remained unchanged until 28 December 2007, when the Bank lowered its central intervention rate to 4.00% to bring it in line with the minimum bid rate on the main refinancing operations (MRO) set by the ECB ahead of the adoption of the euro as its currency on 1 January 2008. At the same time, the Bank’s Monetary Policy Advisory Council was formally dissolved.

"Following euro adoption, monetary policy responsibility was transferred to the ECB"

Following euro adoption, monetary policy responsibility was transferred to the ECB, with the Governor of the Central Bank of Malta having a seat on the ECB’s Governing Council. However, the Central Bank of Malta still remained responsible for the domestic implementation of the monetary policy decisions taken by the Governing Council. At the same time, Maltese banks gained access to the Eurosystem facilities available to credit institutions in the euro area, while the ECB’s regulations on minimum reserve requirements entered into force. In particular, this entailed the lowering of the reserve requirement ratio from 4% of the reserve base to 2%, resulting in the release of additional funds into the banking system.

Following the economic and financial crisis that intensified in late 2008, the ECB reduced the interest rate on its main refinancing operations by 175 basis points to 2.5% in December 2008. By May 2009, the MRO rate was further reduced to 1.0%. Financial markets became increasingly concerned about the ability of some euro area countries, especially those in the periphery, to repay their excessive debts amid an environment of low economic growth. The resulting European sovereign debt crisis led

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3 Prior to the adoption of the euro, the central intervention rate in Malta was set at a premium compared with the rate on the MRO set by the ECB. In the run-up to euro adoption, the spread between the two gradually narrowed until the central intervention rate became equal to the MRO and official interest rates began being determined by the Governing Council of the ECB.
to the ECB to adopt additional exceptional policy measures, with official rates reduced to 0% in 2016.

Chart B shows that in the pre-crisis period, the weighted average deposit rate in Malta was always below the policy rate. After the crisis, however, the situation was reversed as the domestic deposit rates reacted more sluggishly to the exceptional monetary easing by the ECB. Micallef et al., (2016) document the decline in interest rate pass-through in bank deposit rates, which was also accompanied by a decline in pass-through in certain lending rates, especially to NFCs. The lower responsiveness of the retail deposit rates after the crisis compared to previous monetary cycles is partly attributed to the banks’ funding structure, in particular, their reliance on retail bank deposits for their funding.

Within the context of interest rates constrained by the effective lower zero bound, an impaired monetary transmission mechanism and persistently low inflation, the ECB complemented the standard monetary policy operations with other non-standard measures, including longer-term refinancing operations and asset purchase programmes.

Vella (2017) argues that monetary policy was crucial in preventing the shocks from both the financial crisis and, subsequently, the European sovereign debt crisis from having even more pronounced adverse consequences for the euro area as a whole. It must be acknowledged, however, that monetary policy on its own cannot achieve the full range of desirable economic outcomes. Only when it is accompanied by prudent fiscal policy and well-designed structural reforms can it lead to price stability while maintaining economic activity and employment levels close to their potential levels.
Money and capital markets

The market for government bonds took off in 1959, although at a relatively slow pace given that up to the mid-1980s more than half of Maltese Government debt was financed by loans from foreign institutions or governments. These loans were often offered at low interest rates as they were mainly granted for development purposes. Thus, the effective rate paid on Government debt started out low, averaging 3.5% in the 1980s. Since then, the share of foreign loans in total debt has declined substantially as outstanding obligations were repaid and Government made increasing use of domestic sources to finance its activities.

As a first step to develop the local money and capital markets, in 1969 the Central Bank of Malta announced its willingness to buy and sell Malta Government Treasury bills and Development Stocks. In practice, the Bank was a consistent net buyer of bills from the market. Moreover, the Bank was frequently the largest allottee of bills in the Government’s periodic tenders and, consequently, the amount of bills held by the Bank rose rapidly. Enthusiasm for Malta Government Treasury Bills by private sector banks was lacking because of the low rate of interest paid on such instruments which, at an average of 4.7% in 1969, was very much below the rates on similar short-term money market instruments abroad (Central Bank of Malta Annual Report, 1969). Moreover, up to the 1990s, the Government preferred to finance its funding requirements from alternative sources, including a short-term advance facility from the Central Bank of Malta (Pullicino and Saliba, 2002).

Starting in the early 1970s, however, interest in Treasury bills started to increase and commercial banks became more active participants in this market segment, in part also because of their need to maintain local liquidity ratios at more satisfactory levels under the terms of the Banking Act 1970. Moreover, tighter exchange control on capital movements in the 1970s increased the banks'...

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22 A number of interest-free foreign loans were also made available although their share in total debt was very low.

23 This was calculated by dividing the interest paid on government debt by type by outstanding debt by type.

24 For more information on the establishment of a market for Government Development Stocks, nowadays known as MGSs, refer to Central Bank of Malta (1969a).

25 At the end of 1969, the Central Bank held 48% of the total amount outstanding of Treasury Bills. This represents a marked change from the 20% in June 1969 and 17% at the end of 1968 (Central Bank of Malta Annual Report, 1969).
demand for Treasury Bills. Nonetheless, both the money market and capital market remained underdeveloped for several years.

It was only in 1995 that the money market was boosted following the Treasury’s decision to start holding weekly auctions of Treasury Bills, including during periods when it had a strong liquidity position. At the same time, a proper auctioning system was introduced with the Central Bank of Malta playing a dominant role to encourage the participation of banks and ensure that the discount yield on the Treasury Bills was market-determined. Apart from one month and three month bills, the tenor of bills was gradually increased to include six months, nine months and one year maturities. However, secondary market trading tended to be relatively thin because of the small number of market players.

“The commencement of trading on the MSE in January 1992 provided a boost to the development of a capital market in Malta”

The commencement of trading on the Malta Stock Exchange (MSE) in January 1992 provided a boost to the development of a capital market in Malta. It widened the range of financial products available to savers and increased the sources of finance available to borrowers. Nonetheless, activity on the stock exchange remains modest and low by international standards. Since its inception in the early 1990s, the growth in the number of listed companies on the MSE has been somewhat slow, with only 22 being listed on the official list at the end of 2017. Contributing factors to this slow growth in listings on the MSE include the small size of the Maltese economy, high proliferation of family-owned businesses that resist going public in order to retain control of their company, and preference towards bank credit (Pullicino and Saliba, 2002).

Turnover in the secondary market was strong in the period 1998 to 2000 when the market was dominated by a strong bullish sentiment, with 1999 being a record year for equity and turnover rising to 8.4% of GDP. During the same year, the MSE index grew by 170% year-on-year. However, in the subsequent three years, turnover fell sharply as equity prices trended sharply downwards in the wake of a combination of domestic and international factors. A widespread price correction took place across the Maltese equity market in 2001 and 2002 and this also coincided with the international bear market following the bursting of the dot.com bubble and the September 2001 terrorist attacks in the US. Following
the sharp correction in equity prices, investors turned their interest in favour of fixed income securities with the corporate bond market registering a growth in market turnover. Since then, equities' turnover as a share of GDP has remained low, highlighting the extremely thin trading conditions (see Table 8).

The fixed income market in Malta comprises both corporate and government bonds. The latter represents the bulk of the outstanding amount, standing at €5.2 billion at the end of 2016. Since the 1990s the Government has been borrowing consistently from the domestic market to finance its recurring budget deficits, although the need for such borrowings were reduced significantly since 2016 given the surplus recorded in that year. Domestic demand for primary market issues by the government has always been high and these bonds are often over-subscribed. Most government debt is held by Maltese residents and is denominated in local currency. At the end of 2017, there were 50 different Government bond issues outstanding, most of which had a fixed coupon.

In recent years, the Government has benefited from the prevailing low interest rate environment and issued longer-dated bonds with lower coupons resulting

<table>
<thead>
<tr>
<th>Table 8</th>
<th>SELECTED CAPITAL MARKET INDICATORS</th>
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<tr>
<td></td>
<td>(yearly averages)</td>
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<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Equities</strong></td>
<td></td>
</tr>
<tr>
<td>Number of deals</td>
<td>807</td>
</tr>
<tr>
<td>Market volume in millions</td>
<td>5</td>
</tr>
<tr>
<td>Market turnover in Euro millions</td>
<td>18</td>
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<tr>
<td>Turnover/GDP (%)</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>Corporate bonds</strong></td>
<td></td>
</tr>
<tr>
<td>Number of deals</td>
<td>97</td>
</tr>
<tr>
<td>Market volume in millions</td>
<td>0</td>
</tr>
<tr>
<td>Market turnover in Euro millions</td>
<td>1</td>
</tr>
<tr>
<td>Turnover/GDP (%)</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Government bonds</strong></td>
<td></td>
</tr>
<tr>
<td>Number of deals</td>
<td>1,573</td>
</tr>
<tr>
<td>Market volume in millions</td>
<td>27</td>
</tr>
<tr>
<td>Market turnover in Euro millions</td>
<td>65</td>
</tr>
<tr>
<td>Turnover/GDP (%)</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Sources: Malta Stock Exchange; authors’ calculations.
in an average effective interest rate of 4.7% between 2010 and 2016 (see Chart 22). The effective interest rate on government debt had risen steadily up to the early 2000s, reaching a peak of 6.5% in 1999, but fell in the run up to EU accession, and again in recent years as government bond yields in several countries responded to highly expansionary monetary policies pursued by key central banks. To offer a relatively attractive coupon, intended for investors in search of a higher return, the Treasury has tapped the longer end of the yield curve, with the longest-dated bond having a tenor of 25 years on date of issue. The non-bank public sector traditionally shows a marked preference for longer-dated bonds due to the higher coupon rate, while financial institutions tend to prefer a more balanced spread.

The Central Bank of Malta acts as a market-maker for MGSs in order to increase the liquidity of these securities. Notwithstanding this facility, turnover in the market for domestic government bonds remained relatively thin, reflecting the tendency of a large proportion of bondholders to retain most of their holdings until maturity. The MGS market hit a record year in 2014 in terms of turnover with €836.4 million worth of bonds changing hands during that year. The subsequent year was also positive for the MGS market, especially at the time of the announcement by the ECB of its quantitative easing programme, which led to a further sharp decline in yields.
The first corporate bond on the MSE was issued in 1994. The number of listed corporate bonds has been edging up gradually from two in 1995 to 56 in 2016. Market capitalisation, though growing, is still relatively modest. The relatively low level of outstanding corporate bonds suggests that the corporate sector still relies somewhat on bank financing. More recently, however, large corporations are increasingly resorting for capital market financing and shifting away from bank financing (Darmanin, 2017). However, smaller firms still face a number of barriers in accessing capital markets. In fact, the Survey on the Access to Finance of Enterprises (SAFE) shows that, as at 2016, almost 60% of SMEs in Malta believe that bank loans are an important source of finance for their firms, while only 5% of SMEs believe that debt securities are relevant. The establishment of the Malta Development Bank, which is expected to start its operations in 2018, was intended to address these concerns by focusing on lending to SMEs, as well as large-scale infrastructural projects.

**BOX 5: THE EVOLUTION OF BANKING IN MALTA**

The history of banking in Malta can be traced back to the advent of British rule in Malta when a number of banks started their operations as the Island’s strategic location made it a prosperous shipping station. One of the renowned banks was Barclays Bank DCO, which set up its operations in Malta prior to World War II and remained in the country till 1975. In 1975, it was replaced by Mid-Med Bank p.l.c., jointly owned by Barclays Bank DCO and the Government of Malta, with the latter obtaining shareholding of 60%. As at 1975, two other licenced commercial banks operated from Malta – Bank of Valletta (BOV) p.l.c. and Lombard Bank Malta p.l.c. The Government was the major shareholder of BOV p.l.c., with a shareholding of 60%, while also having a 25% share in Lombard Bank Malta p.l.c.

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1 For a more thorough overview of the evolution of the banking sector in Malta refer to Consiglio (2006).
2 Mid-Med Bank p.l.c. was the largest of the three licensed banks while Lombard Bank p.l.c. was the smallest. Apart from commercial banks, six non-commercial bank financial institutions operated in Malta as at 1975 with the Government Savings Bank being the largest.
3 BOV p.l.c., which started operating in March 1974, took over the assets and liabilities of the National Bank of Malta Ltd., which formed part of a group, the origins of which date back to 1809, following a run on the Bank. Subsequently, the public’s confidence in the banking system was badly shaken and for some time business remained comparatively slack. However, by the end of 1974 confidence had been fully restored as BOV p.l.c. established itself with the backing of public funds and the public gradually increased their banking transactions (Central Bank of Malta Annual Report, 1974).
In March 1979, Government purchased the remaining 40% shareholding in Mid-Med Bank p.l.c. belonging to Barclays Bank DCO, so that Mid-Med Bank p.l.c. became wholly owned by the Maltese Government. Moreover, in 1981, the Government bought 35% shareholding in Lombard Bank Malta p.l.c., thereby increasing its shareholding to 60%. With this transfer, the Government acquired majority representation in the Island’s three commercial banks.

The commercial banks sought to expand their range of services to the public in the 1980s. In 1989, following a considerable capital expenditure programme particularly in the field of computer technology, commercial banks introduced Automated Teller Machines (ATMs) in a number of branches. In 1990, APS Bank Ltd obtained the license to operate as a commercial bank, with the majority shareholding of this bank held by the Archdiocese of Malta and Gozo. Consequently, the number of commercial banks went up to four although the local banking system continued to be dominated by Mid-Med Bank p.l.c. and BOV p.l.c.

In April 1990, Lombard Bank p.l.c. became a public limited company and offered equity for sale to the public. The issue was five times oversubscribed and the government subsequently totally divested its shareholding. Thus, the two smaller commercial banks were both privately owned. In 1992, BOV p.l.c. became the first public company to be listed on the MSE while Mid-Med Bank p.l.c. and Lombard Bank p.l.c. soon followed in its steps.

“The 1990s was a period of significant change for the financial sector”

The 1990s was a period of significant change for the financial sector as Government pursued financial sector liberalisation. This was also a time when a strategic decision was taken to turn Malta into an international financial centre. A comprehensive package of legislation consisting of a number of new financial laws, as well as amendments to existing ones,
was enacted in 1994. This period was also characterised by the sale of Government’s shareholdings in banks in line with its policy of encouraging greater private sector involvement in the financial sector. In 1995 the Government reduced its shareholding in BOV p.l.c. to just over 25%, though retaining the right to appoint the chairperson of the board of directors. As a result of this development, Mid-Med Bank p.l.c. was the only one of the four deposit money banks in which the Government retained a majority shareholding by the end of that year. Eventually, Mid-Med Bank plc was sold to HSBC Bank Malta p.l.c. in 1999.

The commercial banks continued to expand the range of banking services offered in the 1990s, introducing new deposit and credit products and developing electronic banking systems and credit card schemes. The banks also entered into other areas in the financial services sector, through investments in subsidiary and associated companies operating in the insurance and venture capital fields. Moreover, in the mid-1990s, the first licences were granted to several foreign-owned banks, which operated mostly with non-residents.

Prior to financial sector liberalisation in the 1990s, the Maltese financial sector was highly regulated by the Ministry for Finance, both in terms of interest rate as well as capital controls. In the absence of money and capital markets, the banking sector dominated the financial system. However, the sector did not operate efficiently because of the rigid interest rate regime (Bonello, 2004a). As a result, banks were unable to adjust their pricing structure according to the perceived creditworthiness of borrowers, which led to credit rationing and large collateral requirements. The latter often took the form of real estate, as banks attached a high degree of importance to property as collateral, while relying to a lesser extent on the viability of projects (Bonello, 2004a). Consequently, savings could not be channelled effectively into productive private investment resulting in a misallocation of

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4 These included a new Banking Act, which replaced the 1970 Banking Act, a Financial Institutions Act, a Prevention of Money Laundering Act, an Insider Dealing Act, and a Professional Secrecy Act. The new 1994 Banking Act and the related Directives brought Malta’s legislation in terms of bank solvency, capital adequacy and large exposures in line with EU standards.
credit (Camilleri, 2001). This problem was exacerbated by the absence of a capital market.

The liberalisation of the economy and its exposure to market forces led to some distortions within banks’ balance sheets (Sammut, 2002; Bonello, 2004a). However, the deterioration in the asset quality of the Maltese banking sector, as evidenced by the rise in the level of loan provisions for bad debts, did not create significant strain on the banking sector. Financial liberalisation in Malta did not result in the credit booms and busts seen in other countries that liberalised quickly their banking sectors.

In the early 2000s, to fully prepare the financial sector for Malta’s accession to the EU, the banking system underwent various structural and legislative developments intended to enhance the services offered to customers and the environment in which the banks operate. A number of innovative products and delivery channels, such as equity-linked deposits and mobile and internet banking, were developed by the major banks. On 1 January 2002, the banking regulatory and supervisory function was transferred from the Central Bank of Malta to the then Malta Financial Services Centre (MFSC). Subsequently, on 1 October 2002 the MFSC became the MFSA and assumed its full regulatory and supervisory powers as the single regulator for all banking, investment and insurance businesses in Malta. While MFSA gained responsibility for micro-prudential supervision, the Central Bank of Malta remained responsible for ensuring stability of the entire financial system and assumes the role of a macro-prudential authority.

“The economic and financial crisis of 2009 had a limited impact on the domestic financial system”

The economic and financial crisis of 2009 had a limited impact on the domestic financial system and on the Maltese economy. The domestic banking system played a crucial role in preventing a more severe downturn in economic activity because of the prudent behaviour on the
part of banks in both asset and liability management. Maltese banks benefited from their traditional funding model based on intermediation between largely local retail depositors and borrowers. They were characterised by substantial liquidity, adequate capital and prudent lending policies. The Great Recession, as the 2008 crisis is commonly referred to, was followed by the European sovereign debt crisis in 2010. However, Malta’s banks remained largely unaffected by the euro-area crisis as securities held were of relatively high quality, and thus did not require any government assistance.

The Maltese banking system also includes non-core banks and international banks which rely mainly on wholesale funding and non-resident deposits. While particularly large compared to the size of the Maltese economy, these banks have limited, or negligible, links with the domestic economy. Thus, the risks to financial stability arising from these banks are rather low and the deleveraging of some of these banks in recent years had a negligible impact on the local economy (IMF, 2015).
Staff members in a celebrating mood, taken in the early seventies

The late governor Anthony P. Galdes touring the site at Binja Ġlormu Cassar in the company of Architect Professor Richard England and the then Minister for Finance the late George Bonello duPuis on 14 February 1992
Bank of Valletta officials presenting a memento to former governor the late Anthony P. Galdes on the occasion of the Bank’s 25th Anniversary (1968-1993)

A regular donation by Central Bank of Malta staff members to the Blood Donation Unit of the National Blood Transfusion Services – Malta
The Bank’s mid-1990s netball and football teams participating in the Government and Parastatal League
Former governor Francis J. Vassallo with staff members during the Governor’s Awards event held in May 1995.

Former governor Michael C. Bonello presenting a donation to Caritas Malta.
President Emeritus Dr George Abela signing the visitors’ book during a visit to the Central Bank of Malta, in the presence of former governor Michael C. Bonello on 20 January 2010 – Photo DOI Jeremy Wonnacott

Former governors of the Central Bank of Malta. From left to right: Roger J. A. Earland, the late Lino Spiteri, Michael C. Bonello, Emanuel Ellul and Francis J. Vassallo
Former governor Professor Josef Bonnici presenting a donation for musical instruments to the Malta Philharmonic Orchestra on behalf of the Foundation for the Assistance of Musical Development. The Foundation was co-founded by the Central Bank of Malta, Bank of Valletta plc and HSBC Bank Malta plc (October 2013)

Address by ECB President Dr Mario Draghi during the Governing Council Press Conference held in Malta on 22 October 2015
ECB Cultural Days 2015, Malta held in Frankfurt. Vernissage *The Spirit of the Day* – Sculptures by Joe Xuereb and Photographs by Daniel Cilia

Tenor Joseph Calleja performing during the launch of a programme of events marking the European Cultural Days, jointly organised by the European Central Bank and the Central Bank of Malta in Frankfurt on 3 November 2015

Photo on next page: Staff photo taken on 28 November 2017
Staff members participating in the annual President's Solidarity Fun Run organised in aid of the Malta Community Chest Fund Foundation on 4 December 2011

A recent photo of some of the first staff members who joined the Bank in 1968. From left to right: Anthony Sciberras, Albert Galea, Joseph Pace Balzan, Freda Sultana, Henry C. de Gabriele, Joseph V. Laspina and Saviour Briffa
H. E. the President of Malta Marie-Louise Coleiro Preca and former governor Professor Josef Bonnici during the launch of a social responsibility coin programme *Mit-tfal b’Solidarjëta* on 5 June 2015
Participation of the Central Bank of Malta in the *Notte Bianca* event held in October every year

The Bank’s currency museum which is on permanent display in the foyer of the Bank’s main building at Castille Place
Address by the Hon. Professor Edward Scicluna, Minister for Finance, at the conference jointly organised by the EIB and CBM on Investment and Investment Finance: the Case of Malta on 31 October 2017

Signing of the latest Collective Agreement between the Bank and the in-house union Union Haddiema Bank Ċentrali on 5 May 2017
Aerial views of St James’s Counterguard in the background of the Bank’s main building at Castille Place, which today houses Binja Ġlormu Cassar, Binja Laparelli and Ġnien ta’ Ġlormu
PART II

THE CENTRAL BANK OF MALTA’S OPERATIONS AND HISTORY
7. A BRIEF HISTORY OF THE CENTRAL BANK OF MALTA

The Bank’s beginnings and premises

In 1964, a United Nations mission headed by Professor Wolfgang F. Stolper (1912-2002), co-author of the Stolper-Samuelson theorem and a former student of Schumpeter’s at Harvard University, recommended the establishment of a central bank in Malta. This mission was intended to study the difficulties associated with the restructuring of the Maltese economy after the rundown of the British military bases in Malta. The team recognised the serious gaps in Malta’s financial infrastructure, especially in respect of advice to Government on financial and monetary matters. Acting on this advice, the Maltese Government sought technical assistance from the Bank of England and from the IMF to establish a central bank. In February 1967, Dr Philip L. Hogg, a senior official of the Bank of England, with considerable experience of other newly-independent countries in the Commonwealth, arrived in Malta to carry out preliminary organisational and legislative work.

The bill relating to the Central Bank of Malta was first debated in the House of Representatives on 2 October 1967 and was enacted on 11 November 1967. The Act, No. XXXI of 1967 (Cap. 204), provided for the establishment of the Central Bank of Malta and the determination of its functions, the transfer of the assets and liabilities of the previous Note Security Fund to the Bank, and for the repeal of various legislation relating to currency, including the Currency Notes Ordinance 1949. On 17 April 1968, the Central Bank of Malta was formally established with Dr Hogg appointed as the first Governor of the Bank.

ATT Nru. XXI ta’ l-1967


[11 ta’ Novembru, 1967]
The main building of the Bank, situated on St James’s Bastion and on the opposite side of Castille Place, is located on the site formerly occupied by the Vernon Club, a social club for British services personnel which was built in the 1870s. The premises were transferred to the Government of Malta on 5 April 1968 and subsequently to the Central Bank of Malta on a 99-year lease as from 1 July 1968. The Bank decided to retain the external structure of the Vernon Club and to rebuild the interior to meet the needs of the new institution, which included a new basement and security vaults. The redesign and execution of the works were entrusted to Messrs England and England. The restructured premises, this time housing the Central Bank of Malta, were inaugurated on 13 February 1971.
In 1969, a formal application for a grant of arms, known as Memorial, was lodged with the Duke of Norfolk, the Earl Marshal at the College of Arms. The Memorial gave details of the Bank’s constitution, its history and the law under which it was set up. The Armorial Bearings were designed by the late eminent artist Chevalier E. Cremona who sought to capture an element expressive of the Maltese spirit, namely, the mural crown surmounting the crest, symbolic of Malta’s historic role as a fortress; the Maltese national colours on the shield; the George Cross awarded to Malta for bravery in April 1942 by King George VI; the dolphin on the head of the key, a fish known in classical Mediterranean literature and often appearing as a prime heraldic figure; and the laurel and palm branches, symbols of honour and peace, respectively, supporting the mural crown. The horizontal key on the shield is appropriate to the Armorial Bearings of the Bank, the governing financial institution in Malta and a keystone of economic order and stability. The design also includes two supporting Knights of Malta symbolising a key period in the Islands’ history and representing confidence and strength, the two virtues incorporated in the Bank’s motto, “Fiducia Fortis” – “In Confidence Strength” and “1968”, the date of the Bank’s foundation. In 2008, to mark the Central Bank of Malta becoming part of the Eurosystem, a new logo was introduced depicting the Bank’s coat of arms alongside the term “Central Bank of Malta” in English and Maltese and separated by the term “Eurosistema”.

The establishment of the Central Bank of Malta filled a major institutional gap within the domestic banking structure while it also brought together into one institution a number of closely related functions that had hitherto been performed independently by a number of different Governmental units. Over the years, the Bank’s functions expanded such that the premises on St James’s Bastion were no longer sufficient. In view of this, in 1987 the Bank acquired property at St James’s Counterguard, which lies across the Valletta main ditch underneath St James’s Bastion. Plans to develop the site at St James’s Counterguard as an annexe to the Bank’s main building gained momentum in the late 1980s and construction works began in August 1990. Great emphasis was placed on blending the new structure with the historic nature of the site following the designs of Professor Richard England.
The new building, now known as Binja Ġlormu Cassar and formerly known as the “St James’s Counterguard Annexe”, was officially inaugurated on 18 April 1993, coinciding with the 25th anniversary of the setting up of the Central Bank of Malta.⁶⁶,⁷⁷ Adjacent to the Annexe is a polverista (gunpowder magazine), which

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ville Cassar was a 16th century Maltese architect and military engineer, who designed many public, religious and private buildings in Valletta.

⁷⁷ Pending the finalization of works at St James’s Counterguard Annexe, the Bank had temporarily leased premises at Fafner House in Blata l-Bajda to house the Economics Department and the Library in the late 1980s and early 1990s.
dates back to the 17th century and forms part of the fortifications built by the Knights of Malta. The Central Bank of Malta restored the polverista to its original state with works being finalised in 2007. The Bank now utilises this building primarily to host the Victor Pasmore Gallery.28

The Central Bank of Malta launched its own website in 1999 to display information related to the Bank and the services it offers. The website includes information about the Bank’s history and its functions, the national currency, exchange rates, the money and capital markets and financial legislation. It also displays press and statistical releases issued by the Bank, together with its publications and economic research. The website was upgraded in November 2014 with improved navigation features in order to provide users with enhanced content and accessibility. The website was revamped again in 2016 to introduce the e-shop concept. By means of the latter, collectors and other interested individuals may purchase numismatic coins online. The Bank has also invested heavily in its library and launched its new electronic platform, which can also be accessed from the website. The new electronic platform includes the library catalogue, an electronic journal database and a collection of e-books.

Since its first year of operations, the number of workers grew fivefold, increasing from 67 at the end of 1968 to 355 in 2017 (see Chart 23). To alleviate a growing

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28 Victor Pasmore was a 20th century British artist and architect, who pioneered the development of abstract art in Britain in the 1940s and 1950s.
need for office space, the Bank leased additional premises in Valletta in 2011 to house its Economics and Research Department. This led to an internal relocation of other offices within the main premises and in the St James’s Counterguard Annexe. At the same time, there were plans to develop an unoccupied space adjacent to the Annexe as the Central Bank of Malta took over additional responsibilities and increased its personnel. Works on the new Annexe 2 building – known as Binja Laparelli – began in 2014 and were finalized in 2017.29

Binja Laparelli

Mission Statement

Originally, the Central Bank of Malta was set up to fill the gaps in Malta’s financial arrangements mainly with respect to advice to Government on financial and monetary matters. Once established, the Bank sought to contribute to national economic development by fostering an environment which ensured overall price stability and a sound financial system. In order to achieve this mission, the Bank set a number of objectives.30

29 Francesco Laparelli was a 16th century Italian architect, who was sent by Pope Pius V to supervise the construction of Valletta.
30 These included: promoting sound monetary policies within the framework of economic objectives, managing the exchange rate policy and the official external reserves in the best interests of the country, safeguarding the integrity and efficiency of the financial sector, encouraging research in economic matters particularly in national and international issues, developing and maintaining competent staff with the structure to handle the tasks required to fulfill its mission, enhancing the quality of customer service and maintaining good working relationships with the domestic and international financial communities.
Over the years, the Bank’s mission statement has evolved in line with its changing responsibilities. In 2007, the Bank’s mission and objectives were reviewed to align them with those of the Eurosystem. The Bank’s primary objective, as an independent institution forming part of the Eurosystem, is that of maintaining price stability while it is also entrusted with all major central banking tasks. These include the formulation and implementation of macro-prudential policies to ensure the stability of the financial system, supporting the development and integration of financial markets as well as providing an adequate supply of banknotes and coins.

“In 2007, the Bank’s mission and objectives were reviewed to align them with those of the Eurosystem”

The Bank is also responsible to collect, compile and publish economic and financial statistics, act as a banker to the Government and to the banking system and actively manage its financial assets. 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.

**Governance**

In terms of the Central Bank of Malta Act, the Board of Directors is responsible for the policy and general administration of the business of the Central Bank of Malta. In preparation for euro adoption, the Central Bank of Malta Act was amended whereby the Board’s powers were qualified to take into account the functions imposed on the Bank by the two primary Treaties of the EU and the protocol on the Statute of the ESCB and of the ECB.\(^3\) The Board currently consists of the Governor, two Deputy Governors and four other non-executive directors. Prior to 2013, the Board included one Deputy Governor and three non-executive directors.

The Governor has the sole responsibility for the performance of the functions imposed, and the exercise of powers conferred, on the Bank by or under the Treaties and the Statute. The Governor and the two Deputy Governors are responsible for the day-to-day management and operations of the Bank in accordance with the policy of the Board and are answerable to the Board for their

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\(^3\) The two core treaties are the Treaty on EU and the Treaty on the Functioning of the EU.
acts and decisions. The Deputy Governors assist the Governor in the performance of duties related to monetary policy and financial stability, respectively.

The Governor and Deputy Governors are appointed by the President of Malta, acting on the advice of the Prime Minister. The other Board Members are appointed by the Prime Minister. The Governors and the Directors of the Bank are appointed for a term of five years and are eligible for re-appointment. The Bank is accountable to the House of Representatives and the Governor may be requested to report on the conduct of the Bank before a committee of the House of Representatives, currently the Economic and Financial Affairs Committee, and to provide such committee with any information deemed necessary.

The Bank’s first Board of Directors was constituted on 17 April 1968 when the Governor-General of Malta, on the advice of the Prime Minister, appointed Dr Philip L. Hogg as Governor of the Bank and Mr Victor A. DeMarco as Deputy Governor. Magistrate Dr Giovanni F. Gouder, Dr Victor A. Mercieca and Mr Indri Cilia were appointed as Directors.

The first three Governors of the Central Bank of Malta were expatriates assigned to the Bank under the IMF’s Technical Assistance Programme. Besides Dr Philip L. Hogg, these included Mr Borge Andersen and Mr Roger J. A. Earland (see Table 9). On the termination of Mr Earland’s appointment in January 1974, the post of Governor remained vacant and the Bank was for the most part left under the direction of a Deputy Governor until 3 June 1987 when Mr Anthony P. Galdes became the first Maltese national to be appointed to the post. In September 1993, Mr Francis J. Vassallo was chosen for the job following the termination of Mr Galdes’s tenure in June 1993. Subsequently, Mr Emanuel Ellul was appointed Governor from October 1997, after having served as a Deputy Governor. Two years later, Mr Michael C. Bonello was appointed as Governor, a position which he occupied for twelve years making him Malta’s longest serving Governor. In July 2011, Professor Josef Bonnici was appointed as Governor and served up till mid-2016. The current Governor, Dr Mario Vella, took the post on 1 July 2016.

The first Deputy Governor of the Central Bank of Malta was Mr Victor A. DeMarco who occupied the position until the termination of his appointment in April 1972. Except for a short period in 1973, when Mr Carmel L. Farrugia was Deputy Governor in an acting capacity, the post remained vacant until January 1974
A Brief History of the Central Bank of Malta

when Mr Lino Spiteri was appointed as Deputy Governor. Mr Spiteri served as Deputy Governor until November 1981 when he was elected to the House of Representatives and appointed Minister for Finance. Subsequently, Mr Henry C. de Gabriele acted as Deputy Governor, and for some time also as Governor, up to November 1986 when he was confirmed in the post following the resignation of Mr Spiteri from the Bank.\textsuperscript{32} Towards the end of 1996, Mr Emanuel Ellul was chosen to serve as Deputy Governor until he became Governor. The post of Deputy Governor remained vacant until July 1999 when Mr David Pullicino was selected as Deputy Governor and served up to March 2010 after which Mr Alfred DeMarco took over, a role which he assumed up to March 2015.

\textsuperscript{32} Mr Spiteri was on political leave of absence between 1981 and 1986.
The governance structure of the Bank was modified in 2013, given the augmented responsibilities for the institution, particularly in the area of financial stability. The Central Bank of Malta Act was amended to add a Deputy Governor position focusing on financial stability with Mr Alexander Demarco being appointed Deputy Governor as from January 2014. On the termination of Mr Alfred DeMarco’s appointment in March 2015, Mr Alfred Mifsud was appointed Deputy Governor – a role which he held up to mid-2017. Mr Oliver Bonello was appointed Deputy Governor in July 2017.

Over the years, a number of changes were made to the Bank’s organisational structure in order to improve human resource efficiency and to reflect the Bank’s changing responsibilities. The current organisation structure, incorporating five divisions with every Division led by a Chief Officer, was introduced in December 2015.
A number of internal committees assist the Board of Directors in determining the Central Bank of Malta’s strategic direction, policy formulation and general management of the Bank. The Executive Committee, formerly known as the Policy Advisory Committee and with roots going back to 1994, acts as an advisory body to the Board of Directors on policy and general administration. It is chaired by the Governor and includes the Deputy Governors and the Chief Officers. The Management Committee, set up in 2011, is composed of Heads of Department and is responsible for the day-to-day management of the Bank’s operations. It is mandated to ensure that the Bank’s operations are carried out effectively and efficiently. Policies governing the management of the Bank’s financial assets fall under the remit of the Investment Policy Committee (IPC). The latter, which started operating in 1994, is chaired by the Governor and includes the Deputy Governors and senior officials. The IPC also reviews the performance of the Bank’s portfolio and assesses the overall investment policy. Finally, the Audit Committee, established in 2001 and made up of three non-executive Directors of the Bank’s Board of Directors, was set up to strengthen the independence of the audit function, improve the quality of the internal control, audit and accounting functions, and to strengthen the objectivity and credibility of financial reporting.

The Accounts of the Central Bank of Malta

The Central Bank of Malta is statutorily bound to publish a monthly return of its assets and liabilities. This information is transmitted to the Minister for Finance and is published in the Government Gazette. The Bank is also legally required to transmit to the Minister for Finance, within three months of the close of its financial year, a copy of its annual accounts and a report on its operations during the year. The Minister is then obliged, not later than the first sitting of the House of Representatives after 7 April, to lay a copy of the annual accounts and the report before Parliament. These annual accounts consist of the balance sheet as at the last working day of the financial year, together with a profit and loss statement.

The first financial statements published by the Bank covered the period 7 June 1968 to 31 December 1968 and were prepared in accordance with the Central Bank of Malta Act, 1967. The Directors’ report, which is produced by the Board of Directors and lays out the Board’s responsibilities in respect of the financial statements, was first prepared in 1994. During the same year there was a significant change within the Auditors’ report whereby the auditors delved deeper
on how they conducted their audit. In 1998, the Bank adopted the International Accounting Standards (IAS) and introduced the Cash Flow Statement, while in 1999 the Statement of Changes in Equity was also presented. As from 2002 the Bank adopted the International Financial Reporting Standards (IFRS). The latest milestone was in 2008 when Malta joined the Eurosystem and the Bank prepared the financial statements in accordance with the provisions established by the Governing Council of the ECB under Article 26.4 of the Statute of the ESCB as outlined in the accounting guideline on the legal framework for accounting and financial reporting.

Over the years, the Bank’s balance sheet has evolved in line with the changing responsibilities of the Bank but it has rarely decreased in size in nominal terms (see Chart 24). The Banks’ assets have grown from around €149 million in 1968 to over €5,500 million in 2016. Following the global financial crisis, central banks’ balance sheets around the world have expanded considerably due to measures intended to enhance the functioning of the monetary policy transmission mechanism, including asset purchase programmes. The Bank’s balance sheet has followed suit and expanded rapidly, especially after 2014. Relative to the rapid economic growth, however, the ratio of the Bank’s assets to GDP has decreased over the years and stabilized at around 50% since the mid-1990s.

![Chart 24: CENTRAL BANK OF MALTA BALANCE SHEET](image)

*Source: Central Bank of Malta.*
Financial assets constitute the largest share of the Bank’s assets (see Table 10). As at 2016, financial assets accounted for more than three-fifths of the Bank’s assets. Financial assets include marketable debt securities and other investments held by the Bank as well as balances held with banks, both inside and outside the euro area. Prior to the adoption of the euro, Malta operated under a fixed exchange rate regime, and the Central Bank of Malta was required to maintain an adequate level of external reserves. Its financial assets were mainly in the form of convertible currencies. The latter were intended to safeguard the international value of the currency by sustaining the country’s imports for a reasonable period of time. In a monetary union with a freely floating exchange rate system and a currency with an international reserve status, these considerations play a very minor role and nowadays securities make up the largest share of financial assets.

Table 10
STYLISTED CENTRAL BANK OF MALTA BALANCE SHEET
(EUR millions)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold and gold receivables</td>
<td>9.4</td>
<td>136.5</td>
<td>1.1</td>
<td>4.5</td>
</tr>
<tr>
<td>International Monetary Fund</td>
<td>17.2</td>
<td>91.8</td>
<td>168.1</td>
<td>150.5</td>
</tr>
<tr>
<td>Monetary policy and other claims within the Eurosystem</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>503.0</td>
</tr>
<tr>
<td>Financial assets</td>
<td>145.4</td>
<td>820.5</td>
<td>1,609.0</td>
<td>3,757.3</td>
</tr>
<tr>
<td>Other assets</td>
<td>2.5</td>
<td>226.0</td>
<td>56.4</td>
<td>90.8</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>174.5</strong></td>
<td><strong>1,274.7</strong></td>
<td><strong>1,834.5</strong></td>
<td><strong>4,506.1</strong></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency in circulation</td>
<td>109.5</td>
<td>649.8</td>
<td>985.6</td>
<td>920.9</td>
</tr>
<tr>
<td>Customer Balances</td>
<td>39.0</td>
<td>421.1</td>
<td>469.0</td>
<td>500.6</td>
</tr>
<tr>
<td>Monetary policy and other liabilities within the Eurosystem</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>2,430.9</td>
</tr>
<tr>
<td>Special drawing rights allocated by IMF</td>
<td>11.5</td>
<td>16.6</td>
<td>97.0</td>
<td>121.4</td>
</tr>
<tr>
<td>Others Liabilities</td>
<td>8.6</td>
<td>181.4</td>
<td>75.5</td>
<td>125.0</td>
</tr>
<tr>
<td>Provisions and revaluation accounts</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>61.9</td>
</tr>
<tr>
<td>Capital</td>
<td>1.2</td>
<td>1.2</td>
<td>11.6</td>
<td>20.0</td>
</tr>
<tr>
<td>Reserves</td>
<td>4.7</td>
<td>4.7</td>
<td>195.8</td>
<td>325.4</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>174.5</strong></td>
<td><strong>1,274.7</strong></td>
<td><strong>1,834.5</strong></td>
<td><strong>4,506.1</strong></td>
</tr>
</tbody>
</table>

Source: Central Bank of Malta Annual Reports (various).
TARGET balances play an increasingly important role in the Bank’s balance sheet since the country joined the euro area. Up to 2015, the Central Bank of Malta ended its financial year with a liability within the Eurosystem, which is included within the item ‘Monetary policy and other liabilities within the Eurosystem’. In 2016, the Central Bank of Malta ended its financial year with a claim on the Eurosystem, implying that the Central Bank of Malta was a net recipient of cross-border payment flows from other countries, mainly reflecting the strength of Malta’s economy and balance of payments position. The balance was recorded within ‘Monetary policy and other claims within the Eurosystem’. The latter incorporates also securities held for monetary purposes which, since 2015, consist mainly of securities acquired by the Bank within the scope of the Public Sector Purchase Programme.

“TARGET balances play an increasingly important role in the Bank’s balance sheet since the country joined the euro area”

Apart from TARGET balances, ‘Monetary policy and other liabilities within the Eurosystem’ includes deposits held by banks covering the minimum reserve requirements, overnight deposits and other deposits used to settle payments. Prior to euro adoption, however, deposits held by credit institutions at the Central Bank of Malta were included within customer balances and thus, the two time periods are not directly comparable.

As an issuer of banknotes, notes in circulation are a substantial part of a central bank’s liabilities. In fact, at the onset of the Bank’s operations, currency in circulation, which at a time consisted only of legal tender notes, became the Bank’s major liability representing more than 90% of its liabilities in June 1968. The Central Bank of Malta issued Maltese decimal coins for the first time in March 1972, and, henceforth, these were included with the total currency issued. On euro adoption in 2008, the Central Bank of Malta became responsible for the issuance of euro banknotes in accordance with the principles and rules

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33 TARGET is the real-time gross settlement system and the interbank payment system for the clearing of cross-border transfers in the euro area.

34 Under this programme, national central banks may purchase, in the secondary market, euro-denominated securities issued by euro area central, regional or local governments, recognised agencies located in the euro area and international organisations and multilateral development banks located in the euro area.
established within the Eurosystem. Although banknotes still form a significant part of the Bank’s liabilities, their share has decreased over time and as at the end of 2016 they accounted for around 17% of the Bank’s total liabilities. The issuance of euro coins also falls under the remit of the Central Bank of Malta which continues to issue coins on behalf of the Government of Malta in an agency capacity. However, currency coin issues are classified as a Government liability instead of a Central Bank of Malta liability.

“As an issuer of banknotes, notes in circulation are a substantial part of a central bank’s liabilities”

In its role as a banker to the public sector the Central Bank of Malta also provides deposit facilities to the Government of Malta and other Maltese public sector corporations which form part of the Bank’s liabilities.

The Bank’s operational history

The Central Bank of Malta has played a key role in several important events including the liberalisation of the financial services sector in the 1990s, Malta’s preparation for EU membership in 2004 and the adoption of the euro in 2008. Its operational history can be subdivided into three main periods, reflecting the Bank’s evolution from an organisation carrying out central banking functions in the context of Malta’s fixed exchange rate regime to an institution forming an integral part of the Eurosystem. The Central Bank of Malta is established by the Central Bank of Malta Act (Cap. 204) and operates under the aforementioned Act. After euro adoption, the Bank is also governed by the Statute of the ESCB, as well as the relevant provisions of the Treaty on the Functioning of the EU. The Central Bank of Malta also operates in terms of the legal framework of the ESCB. Much of this framework is directly applicable and has the force of law in Malta since 2008.

35 The respective share of the total value of euro banknotes in circulation due to each central bank in the Eurosystem is calculated in accordance with the banknote allocation key. As at December 2016, the share of the Central Bank of Malta stood at 0.0850% of the euro banknotes in circulation. If the value of the euro banknotes actually issued is greater than the value according to the banknote allocation key, the difference is recorded in the Bank’s balance sheet as a liability, and vice versa.

36 In terms of the agency agreement between the Central Bank of Malta and the Government of Malta on the issuance of euro coins, the Government makes a capital contribution to the Bank which is included within the Bank’s reserves. This reserve represents seigniorage revenue arising from the issue of euro coins. The Government has agreed not to withdraw such revenue and retain the amounts in a reserve account held at the Central Bank of Malta.
1968-1994 – A new institution during the years of economic transformation

Soon after the appointment of the first Board of Directors and senior officials, the Central Bank of Malta actively began to recruit personnel for the executive and clerical grades. The recruitment process continued steadily in the following year and the number of employees almost doubled in 1969 as the volume of the Bank’s work expanded, caused largely by the transfer from Government of basic central banking functions.

In its first year of operation, the Bank had two main departments – the General Manager’s and Research. Under the former there were five offices: Chief Accountant’s, Secretary’s, General Manager’s, Banking and Currency. The Chief Accountant’s Office was responsible of maintaining the Bank’s own principal book of accounts and dealt with all payments made on its behalf. Thus, items such as wages, general and capital expenditure fell under the responsibility of this office. Moreover, this office was in charge, under the direction of the Chief Accountant, for preparing the Bank’s financial statements.

Matters related to administration and personnel were handled by the Secretary’s Office. This Office was responsible also for recording the minutes of meetings of the Board of Directors, as well as for the maintenance of the building and for general supplies and equipment. The General Manager’s Office was in charge of securities and other valuables and carried out operations in connection with the deployment of external reserves.

The Banking Office handled the banking services required by the Bank’s customers including the public sector and the banking system. The issue of currency to the public and its withdrawal fell under the remit of the Currency Office, which was responsible for ordering the currency, supervising the quality of the currency in circulation and dealing with all aspects of currency control, including damaged currency and counterfeits.
The Research Department was established to support the statutory responsibilities of the Central Bank of Malta to act as an advisor to the Government on financial and economic matters. The Research Department commented on economic and financial developments in Malta and abroad in the Quarterly Review and Annual Report, which are still being published on an on-going basis. Staff also prepared reports for the IMF Consultation Mission during their visits to Malta as well as papers and background material for the annual general meetings held by the IMF. The Research Department was also responsible for maintaining the Bank’s library, which was the first specialised library of its kind in Malta.
When the Central Bank of Malta commenced operations in 1968, the Maltese currency was pegged at par to sterling. One of the main functions of the Bank during this period was the implementation of exchange rate policy, which was the joint responsibility of the Central Bank of Malta and the Government. While the Government was responsible for determining the external value of the Maltese Lira, the recommendation had to come from the Central Bank of Malta. In effect, thus, the Bank had to take the lead in respect of exchange rate policy. Moreover, the Central Bank of Malta also focused on the management of the country’s external reserves, the supervision of the banking system, the issue of currency and the provision of banking services to the Government, public sector organisations and commercial banks. Furthermore, the Bank was obliged to keep the Minister for Finance informed of its policies. Close and cordial relations were maintained with the Ministry by means of frequent contacts between senior officials of the two institutions.

“When the Central Bank of Malta commenced operations in 1968, the Maltese currency was pegged at par to sterling”

The Bank’s role in implementing exchange rate policy assumed particular significance in the early 1970s when, following the breakdown of the Bretton Woods system in August 1971 and the UK authorities’ decision to float sterling, the direct one-for-one link with the sterling was discontinued. In July 1972, the Bank started determining the exchange rate of the Maltese pound on the basis of a formula which pegged the pound – renamed as the Maltese Lira in 1983 – to a number of currencies according to pre-specified weights. The weights given to the basket currencies reflected Malta’s trading patterns and the main objective of exchange rate policy was to control imported inflation without hindering Malta’s competitiveness. The composition of the basket was revised whenever deemed necessary and, as from 1979, the Central Bank of Malta started to disclose in more detail changes in the basket’s composition to keep the general public aware of the adjustments being made (see Box 3).

On 1 September 1971, the Central Bank of Malta took over from the Treasury the responsibility of exchange control administration. The Government had

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37 The ‘Lira Maltija’ and its symbol ‘LM’ were designated as the unit of currency in Malta in 1983 (Central Bank of Malta, 2013).
appointed the Bank as the agent for the administration of exchange control for most purposes of the Exchange Control Ordinance 1959. This led to the setting up of the Exchange Control Department. While 1972 marked the first full year of operation of the Exchange Control Department, it also saw the coming into force of the Exchange Control Act 1972, which replaced the Exchange Control Ordinance of 1959. The new Act abolished the preferential treatment previously accorded to the Sterling area countries such that all movements of gold, foreign currency and foreign-denominated securities in and out of Malta became subject to the same controls.

The Exchange Control Division had three major responsibilities: (i) authorising payments abroad in excess of the limits delegated to the banks and other authorised dealers; (ii) authorising foreign participation in local enterprises; and (iii) permitting residents to lend funds to locally registered companies with non-resident participation. During this period, rules were in place that stipulated a limit to the travel allowance of residents for trips abroad while banks were authorised to effect payments abroad against production of customs entry form. The Division was also responsible for approving applications for personal investments abroad. In addition to its routine functions, the Division managed other schemes as the need arose. For example, during 1976, the Exchange Control Division took on a project to update its records of foreign investments belonging to private individuals. The rationale behind this large-scale exercise was the creation of a detailed and comprehensive index of all foreign investments held by Maltese residents. During that year, this Division also started to administer the Special Repatriation Deposit Scheme which was designed to attract the repatriation of capital from abroad in order to boost the Central Bank of Malta’s external reserves and underpin the stability of the external value of the lira.

In its early years, a committee was formed to examine the feasibility of establishing a stock exchange in Malta. In the absence of a bourse, the Bank had the power to control, with respect to both timing and soundness, the offer for sale of any shares or bonds on the local market. It was recognised that

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38 As a member of the Sterling Area, Malta’s exchange control followed closely that of the UK. Exchange control was introduced in Malta at the outbreak of World War II and was given a permanent status in 1959 with the enactment of the Exchange Control Ordinance.

39 The Central Bank of Malta delegated limited authorities to authorised dealers to process and approve applications mainly for routine payments abroad. Payments in respect of imports, together with most current payments, fell under this category. On the other hand, payments of a capital nature as well as certain specified types of current payments had to be approved by the Exchange Control Division.
the absence of a local stock exchange hindered Malta’s economic progress as an appreciable portion of local funds were invested abroad. Consequently, one of the main objectives of the Bank was to foster the development of a capital market. Simultaneously, the Central Bank of Malta sought to develop a money market, wherein instruments such as Treasury Bills could be readily traded. Partly for this purpose, the Bank added a sum of Malta Treasury Bills to its portfolio. Nonetheless, activity in this market remained negligible for almost two decades and it was only in the mid-1990s that activity intensified under the impact of the setting up of the MSE by virtue of the Malta Stock Exchange Act, 1990 and of the Bank’s initiatives to put into effect a more active monetary policy in the mid-1990s, as well as an increase in issuances of such instruments reflecting persistent and rising fiscal deficits.

Banking legislation was absent when the Bank started its operations. However, the commercial banks co-operated with the newly established Bank and basic statistical information was made available to the Central Bank of Malta, enabling it to better appraise monetary and banking developments. Regular monthly meetings started being held between top officials of the Central Bank of Malta and the commercial banks which at that time were limited to five: Bank of Industry, Commerce and Agriculture Limited; Barclays Bank DCO; the National Bank of Malta; Scicluna’s Bank and B. Tagliaferro and Sons Limited. These meetings became an important forum for exchanging ideas and for announcing policy decisions.

The banking legislative framework was significantly strengthened in 1970 through the passing of the Banking Act 1970, which provided for the regulation of commercial banks and financial institutions. The Bank was nominated as the supervisor of such institutions in terms of this Act, which led to the establishment of a new department, called Audit and Bank Inspection, on 1 January 1970. Apart from internal checking and examination of the accounting work of the Bank, this Office was also responsible for the supervision of commercial banks and financial institutions, for the issuance of banking licences and for the vetting of stocks and shares offered for sale to the public.

The Central Bank of Malta supervised credit and financial institutions through a combination of on-site inspections and the analysis of periodic returns. This information allowed the Bank to assess a number of indicators of bank soundness, including capital adequacy, liquidity and exposure to risk. Moreover, the Central
Bank of Malta was also entrusted with the supervision of the MSE. The Bank’s permission was also required for any offer for sale of securities to the public.

An important role that the Central Bank of Malta has assumed since its inception, and one that it still continues to perform up till today, is that of banker to the Government and the local credit institutions. Soon after the Bank's establishment, the Government began transferring departmental accounts to the Central Bank of Malta with the process being finalized on 30 June 1970. On that day the Government's main account, that of the Treasury, was transferred to the Central Bank of Malta from Barclays Bank DCO, which had served as Government banker for nearly half a century.

The volume of Government transactions processed by the Central Bank of Malta grew rapidly as the Government used the cheque system to pay for wages and salaries, social assistance and other benefits. Moreover, the Government at the time was also involved in bulk buying of essential commodities such as wheat and cement. During this period, the Banking Office handled the banking side of these operations including the opening of letters of credit with banks overseas and forward dealing in foreign currencies, while the Investments Office would provide forward cover facilities for Government, thereby minimising exchange rate risks and price fluctuations.

Cashier services offered by the Banking Office ca. 1971
Besides its services to the Government, the Central Bank of Malta also acted as banker to the rest of the banking system, in line with its statutory requirements. In the early years, the Bank’s function as the banker to the commercial banks consisted mainly in the provision of the interest-bearing call account facility. An important milestone for the Central Bank of Malta was the setting-up of the Clearing House in 1971. With its establishment, the commercial banks began to exchange cheques directly to one another with only the net balance being processed in the books of the Central Bank of Malta. Before the formation of a clearing house, the banks had to maintain reciprocal accounts with one another to settle their clearing debts. The number of cheques written in Malta was high in the 1970s as an increasing number of individuals discovered the convenience in the use of cheques for making purchases and settling debts. In addition, the Government was also a major issuer of cheques. Thus, the Clearing House resulted in increased efficiency.

*“An important milestone for the Central Bank of Malta was the setting-up of the Clearing House in 1971”*

The Central Bank of Malta also operated a foreign exchange market in which the credit institutions were active participants. The Bank dealt in ten major currencies, namely the US dollar, the Pound sterling, the Deutsche mark, the Italian lira, the Swiss franc, the Belgian franc, the Dutch guilder, the Japanese yen, the French franc and the ECU.

In an effort to improve the financial infrastructure, the Central Bank of Malta, together with the commercial banks, were linked to the SWIFT system in 1990. The Central Bank of Malta made available its premises to house this infrastructure and offered access to the SWIFT system to commercial banks. SWIFT enabled the commercial banks to transmit high-speed messages related to their business with international banks. The Bank invested heavily in the modernization of its information and communications technology during this period, with the installation of a main-frame computer and the computerization of a wide range of its operations.

In 1989, the Central Bank of Malta engaged the services of international consultants to study and draw up its information technology strategy. Given the increasing importance of information technology, in 1991 the Bank set up the Information Technology Department.
Prior to the establishment of the Central Bank of Malta, the issue of currency notes in Malta was under the responsibility of the Currency Board in terms of the Currency Notes Ordinance, 1949. The currency was backed by the Note Security Fund which consisted of investments in securities issued by the British government and later also included MGSs.

When the Bank was established, it assumed responsibility for the issue and control of currency notes and coins in Malta through its Currency Office. It accordingly took over the assets and liabilities of the Note Security Fund. Throughout the years, the Bank issued various series of banknotes with the last one, its fifth, issued in 1989. The currency in circulation at the time of the Central Bank of Malta’s establishment consisted of a wide diversity of banknotes issued in terms of various Ordinances passed in 1914, 1939 and 1949, many of which were intended for temporary issuance in times of war. The Bank thus embarked on a policy intended to gradually replace the currency in circulation with a unified pattern. The first series of currency notes, consisting of 10 shillings (half a pound), £1 and £5, were issued by the Central Bank of Malta between 1968 and 1969 and were written in English with the denomination in pounds.

“In 1972, the Central Bank of Malta issued its first series of decimal coinage, with the Malta pound retained as the currency unit”

On 16 May 1972, one year after decimalization in UK, Malta changed over to a decimal currency thus ending the old British system consisting of pounds, shillings and pence which had been declared legal tender in Malta since 1825. In 1972, the Central Bank of Malta thus issued its first series of decimal coinage, with the Malta pound retained as the currency unit. The pound was divided into 100 cents and each cent into 10 mils.

During that year, the Central Bank of Malta also issued the first non-circulating, legal tender coins for numismatic purposes, under an agreement signed in May 1972 with the Sovereign Military Order of Malta, based in Rome. The Order was instrumental in setting up the Malta Mint in 1973, which was housed at the Central Bank of Malta. The joint venture between the Bank and the Sovereign Military Order of Malta came to an end in September 1976. In subsequent years, the Bank continued to issue gold and silver coins for numismatic purposes, produced in Malta and in other mints abroad.
Eventually, the Malta Mint moved to larger premises in Sa Maison, Pietà in 1985 and geared up its operations to produce coins for circulation, a process that culminated in the production of millions of coins when a new set was issued in the second half of the 1980s.

The second series of currency notes, consisting of £m1, £m5 and £m10, was issued in January 1973. The 10 shilling note was replaced by a 50 cents coin. This series was denominated in liri on the obverse and pounds on the reverse. During the same year, a Coinage Advisory Board was set up by the Minister for Finance, consisting of six Government appointees and one official from the Central Bank of Malta. The purpose of the Board was to advise Government and the Bank on the denomination, form, design and other matters relating to currency issues.

In March 1979, to commemorate Malta’s new status of neutrality and the termination of military facilities to foreign powers on 31 March 1979, the Central Bank of Malta embarked on its third series of currency issue, keeping the same £m1, £m5, and £m10 denominations. This issue included the new circular emblem of Malta, which had replaced the armorial bearings of the Central Bank of Malta.
The fourth series of currency notes was issued in 1986 and included denominations of Lm2, Lm5, Lm10 and Lm20, of which the Lm2 and Lm20 note were new denominations. The latter was introduced to satisfy the growing demand for higher denomination notes. The Lm1 note was not re-issued this time as it was set to be replaced by the Lm1 coin. These notes featured the word ‘Lira’ on its own without its accompanying English version, the Pound. In fact, following an amendment to the Central Bank of Malta Act by Act XIII of 1983, the unit of currency in Malta became legally known as the Lira Maltija, with its corresponding symbol, Lm. The Lm1 coin was introduced in 1986 with the issue of the second series of coins that substituted the first decimal series of 1972. The new set of decimal coins included seven denominations and a total of 41 million coins were struck at Malta Mint in the period 1985-1987.

“The Lm1 coin was introduced in 1986 with the issue of the second series of coins that substituted the first decimal series of 1972”

In September 1989, the Central Bank of Malta issued the fifth and final series of currency notes again with denominations of Lm2, Lm5, Lm10 and Lm20. The notes contained the armorial bearings of the Central Bank of Malta rather than Malta’s emblem.

The first series of currency notes were printed by Bradbury, Wilkinson & Co. Ltd while the remaining series were printed by Thomas De La Rue & Co. Ltd. On the other hand, the first series of decimal coins were minted at the Royal Mint, Llantrisant, in the UK. Eventually, some of the coins started being produced by the Malta Mint following its opening in 1973 until operations were in full gear with the production of the second series of coins in the second half of the 1980s. In 1988, responsibility for the running of the Malta Mint was transferred from the Government to the Central Bank of Malta. The Malta Mint ceased operations in 1995 after it was deemed that local coinage production was no longer economically feasible. Following the closure of the Malta Mint, new coins, both definitive and commemorative, were produced overseas. Further information about the series of currency notes and coins issued by the Central Bank of Malta can be found in Box 6.40

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40 Further information on the various currencies in use in the Maltese Islands, starting from those used by the Carthaginians, can be found in Sammut (2001).
BOX 6: MALTA’S CURRENCY NOTES AND COINS

The first official Maltese currency notes were introduced in August 1914 during World War 1, prompted by reasons of expediency and precaution. The notes, which consisted of five denominations of shillings and pounds, were intended only as a temporary measure and were demonetised a year after. Malta became dependent once again on the importation of currency notes and coins from Britain to satisfy its currency needs. This arrangement was disrupted for a second time with the outbreak of World War II. In response, an ordinance was passed by the Council of Government on 13 September 1939 to provide for the issuance of currency notes that would be convertible into sterling at par. Most of these notes were put in circulation at different dates during 1940.

The issue of local paper currency was established on a permanent basis through the 1949 ordinance. The latter provided for the creation of a Currency Board with the first note emission effected on 8 May 1951 with the issue of £1 and 10 shilling notes, bearing a portrait of King George VI and a representation of the George Cross. Currency notes of the same design and denomination, but bearing the portrait of Queen Elizabeth II, were issued on 26 April 1954. On 2 June 1961, in response to demand for a higher denomination, a £5 denomination note was issued for the first time. Two years later, a 10 shilling and £1 note were issued on the same design, and the three came to be known as the ‘Pictorial’ series.

When the Central Bank of Malta was established in 1968 it took over the role of issuing currency from the Currency Board. At the time, there were several different paper currencies in circulation and the Central Bank of Malta sought to promote a unified pattern by issuing its own notes. Thus, in June 1968, the Central Bank of Malta issued its first £5 and 10 shillings

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1 The images of the coins and banknotes depicted in this book do not reflect the true size of the actual coins and notes.
2 Following the outbreak of World War I, hoarding of gold and silver coins set in, leading to a run on the banks. The war also rendered the importation of money to Malta difficult. Under these emergency circumstances, an ordinance was proposed providing for the issue of Government paper currency in Malta.
notes, bearing the imprint of the Central Bank of Malta. The notes bore the same design as the 1961 and 1963 notes, that is, the portrait of Queen Elizabeth II. However, the colour changed from blue to dark brown for the £5 note and from green to red for the 10 shillings note. The £1 note was issued a year later, in 1969, bearing the same design as the 1963 issue but in a different colour. These three notes were written in English with the denomination pounds and bore the signature of Governor Hogg. Together, they form the first series of the Bank’s currency. All the previous notes printed by the Currency Board in 1951, 1961 and 1963, stopped being legal tender in Malta in December 1969.

First series of banknotes
Following the breakdown of the Bretton Woods system, in May 1972, Malta broke away from the parity of the British Pound and set up its own currency. The British coins in local circulation were thus demonetised in stages while a set of Maltese coins was issued in replacement, with the Malta Pound retained as the major currency unit. The Malta Pound was divided into 100 cents and each cent into 10 mils. The Maltese decimal issue had eight denominations with themes from Maltese history on the obverse as follows:

- coin of 2 mils with the eight-pointed Maltese cross;
- coin of 3 mils with a bee on a honeycomb design;
- coin of 5 mils with a clay lamp known as ‘imnara’;
- coin of 1 cent with the George Cross;
- coin of 2 cents with the helmeted female head of Penthesilea on the fountain at the Magistral Palace;
- coin of 5 cents with the stone altar of Ħaġar Qim temples;
- coin of 10 cents with the ceremonial galley of Grand Master de Rohan;
- coin of 50 cents with the Great Siege Monument of Antonio Sciortino of 1927.

A total of 24 million coins were initially minted at the Royal Mint, Llantrisant, in the UK with Christopher Ironside designing the reverse of the coins. In December 1975, an octagonal 25 cents coin was introduced by the Central Bank of Malta to commemorate the first anniversary of the Republic of Malta with the coin beginning to circulate in 1976. Following the opening of the Malta Mint in 1973, some of the coins started being produced in Malta, the first time since the arrival of the British in Malta in 1800.

The introduction of the new decimal coinage prompted the Central Bank of Malta to issue a new series of notes. Thus, the currency notes issued in the early 1940s were demonetized by December 1971.³ On 15 January

³ The notes were issued during the Second World War and were of small denomination to make up for the lack of coinage experienced because of transportation problems. At the end of the war, these small denomination notes became obsolete and fell into disuse.
1973, the Central Bank of Malta issued its second series of currency notes. This issue saw the elimination of the half pound denomination, which was replaced by the 50 cents coin, and the introduction of the £M10 denomination. The new notes included £M1 (green colour), £M5 (blue colour) and the £M10 (dark and light brown colour).

This series was denominated in liri on the obverse and pounds on the reverse. The three currency notes had an almost common design on the front featuring a map of the Maltese islands and the coat-of-arms of the Central Bank of Malta. The £m1 portrayed the war memorial at Floriana while the £m5 and £m10 portrayed a bronze statue of Neptune. Each note had a different pictorial painting on the back.

The new notes had enhanced security features, including a vertically running security thread and a fluorescent mark in the form of an eight-pointed cross. The notes also contained a watermark showing an allegorical head of Malta, designed by the Maltese artist Emvin Cremona.
The third series was issued on 30 March 1979 to mark Malta’s new status of neutrality and the termination of military facilities to foreign powers. The Central Bank of Malta kept the same denominations of £m1, £m5 and £m10. Each currency note had a different theme on the front. The £m1 depicted a stone sentry box known as a ‘gardjola’, the £m5 depicted a female statue representing ‘culture’ and the £m10 depicted a statue representing ‘justice’. All three notes had a pictorial vignette at the back. Instead of the previous armorial bearings, these currency notes bore the emblem of the Republic of Malta.

On 17 March 1986 the Central Bank of Malta issued its fourth series of currency notes which included denominations of Lm2, Lm5, Lm10 and
Lm20, of which the Lm2 and Lm20 notes were new denominations. The Lm1 note was omitted this time as it was set to be replaced by the Lm1 coin. The notes had an almost identical design on the front depicting the then President of the Republic, Agatha Barbara; an old traditional Maltese sailing craft; a map of the Maltese Islands, a dove holding an olive sprig and a sculptural motif. The vignettes at the back differed for each note.

For the first time, this series of notes feature the word ‘Lira’ on its own without its accompanying English version, the Pound. This was possible following an amendment in the legislation in 1983 whereby the ‘Lira Maltija’ and its corresponding symbol ‘Lm’ were designated as the unit of currency in Malta.
The Lm1 coin was introduced in 1986 with the issue of the second series of coins that substituted the first decimal series of 1972. The new set of decimal coins included denominations of the then newly struck Lm1 coin, 50 cents, 25 cents, 10 cents, 5 cents, 2 cents and 1 cent. The use of the scallop-shaped mils had decreased substantially by that time until they were withdrawn in 1994. The second series of decimal coins was designed by Malta Mint’s engraver Noel Galea Bason, and had themes
on Maltese flora and fauna. These were struck at the Malta Mint. By the end of 1988, only the second series coins were legal tender, with the first series slowly demonetized in the previous two years. In 1991, the Central Bank of Malta issued a new set of coins of the second series, identical to the previous one except for the theme on the back which depicted the new emblem of Malta.

Second series of decimal coins

The fifth and final series of currency notes was issued by the Central Bank of Malta on 18 September 1989, coinciding with the 25th anniversary of Malta’s Independence. The new notes were of the same denominations and size as the fourth series. The front of each note had an identical design showing the allegorical figure of Malta holding a rudder, as well as the emblem of the United Nations and doves, reflecting Malta’s commitment to international peace. The notes also contained the armorial bearings of the Central Bank of Malta, moving
away from the concept of Malta’s emblem. The back of the currency notes showcased episodes in Maltese history associated with Maltese national identity and the quest for autonomy. In 1994, 1997, 1999 and 2001, various enhanced versions of all denominations of the fifth series were issued.
Maltese banknotes were replaced by the euro when Malta became a member of the euro area on 1 January 2008. There are seven denominations of euro banknotes with each denomination distinguished by a different size and colour. The euro banknotes do not have any national side, unlike the coins which have a country-specific side.

In 2012, the ECB announced the introduction of a second series of euro banknotes. This is called the ‘Europa’ series due to the portrait of Europa – a figure from Greek mythology and the origin of the name of the European continent – in the watermark and the hologram. With state-of-the-art security features, this series is being introduced gradually over several years.

Euro coins
Euro banknotes - first series
As regards international relations, once the Central Bank of Malta was established, it immediately proceeded with its application for membership in the IMF. Following the approval by the IMF Board of Directors, Malta became the 110th member of the IMF on 11 September 1968. The Central Bank of Malta also established close relations with the Bank for International Settlements in Basel, Switzerland, by placing a portion of its foreign exchange holdings on deposit with the institution in order to diversify its external assets. In addition, the Central Bank of Malta established correspondent relations with central banks and leading commercial banks in several other countries for the purpose of diversifying its external reserves and to facilitate business transactions as Malta’s overseas trade developed. Fifteen years later, in 1983, Malta submitted a formal application for membership of the International Bank for Reconstruction and Development (IBRD), forming part of the World Bank Group, and became a member during the same year.

1994-2007 – Greater autonomy for the Central Bank of Malta amid an overhaul of the financial services sector

This period was marked by a notable change in the Bank’s policy orientation as part of an overhaul of the financial services sector, following the comprehensive package of financial legislation that was enacted in 1994 to close the gap between international legislative standards and domestic ones. In the ‘avis’ published by the European Commission in 1993, following Malta’s application to join the EU in 1990, it was stated that for accession negotiations to get under way “a thoroughgoing overhaul of the Maltese economy’s regulatory and operational systems” was necessary. This required the liberalisation of the financial sector, the abolition of exchange controls, the alignment of banking regulations with those of the EU and an independent role for the central bank. Within the framework of the programme of financial liberalisation, the Central Bank of Malta sought to improve the workings of the money and capital markets in preparation for the conduct of a more market-oriented monetary policy and to generate a market-driven interest rate structure.

In October 1994, the Maltese Parliament approved the necessary amendments to the Central Bank of Malta Act, which were aimed at enhancing the Bank’s role in setting monetary policy. Foremost among the changes that entered into effect with the amendments to the Central Bank of Malta Act was the transfer of the
power to determine the entire structure of bank interest rates, a responsibility that was previously shared with the Minister for Finance. Prior to these reforms, while the Central Bank of Malta always had the prerogative of establishing the bank deposit rates through an administrative notice, it was the Minister for Finance who was responsible for setting the maximum levels of bank lending rates, through the issue of a Legal Notice. By virtue of this reform, the Bank thus assumed sole responsibility for the formulation and implementation of monetary policy.

“By virtue of this reform, the Bank assumed sole responsibility for the formulation and implementation of monetary policy”

Subsequently, the Central Bank of Malta embarked actively on a programme to develop the operational framework for monetary policy. Towards this end, the Central Bank of Malta sought to put an end to direct controls and move towards a market-oriented mechanism in the conduct of monetary policy. Monetary policy started to be determined by the Bank’s Monetary Policy Council (MPC) who met on a monthly basis. At the time, the MPC was composed of the Bank’s Board of Directors and senior officials. The Central Bank of Malta gradually started to move towards more market-oriented instruments until open market operations became the main tool of monetary policy. The amended Act also strengthened the independence of the Central Bank of Malta. An important change in this regard was the prohibition of temporary advances to the Government, which were previously provided under a facility known as “Ways and Means”. This change was intended to preclude monetary financing and monetising of the public debt so as to avoid undermining the effectiveness of monetary policy.

The enactment of a new Banking Act and the Financial Institutions Act, also in 1994 to replace the 1970 legislation, confirmed the Central Bank of Malta’s role in banking supervision as it was appointed as the Competent Authority responsible for credit and financial institutions. This function was carried out through continuous surveillance, with the main focus of such inspections

41 Whereas the Central Bank of Malta continued to be responsible for supervision of banks and other financial institutions licensed under the Banking Act and the Financial Institutions Act, the MFSC continued to supervise banks licensed under Malta Financial Services Centre Act which were formerly known as offshore banks. To ensure proper coordination regarding bank regulation and supervision, a Joint Banking Committee was set up in 1994. This arrangement continued until the banking regulatory function was transferred from the Central Bank of Malta to the MFSA in 2002.
being the commercial banks’ risk management practices and the assessment of their balance sheet. Ensuring compliance by the commercial banks with the requirements of the Banking Act also continued to be a major objective.

In 1995, in a move to reduce its participation in the foreign exchange market and encourage the development of an interbank market, the Central Bank of Malta reduced the number of currencies it was ready to deal in to three, namely, the US dollar, the Deutsche mark and pound sterling. In 1998, the Central Bank of Malta stopped offering forward contracts in foreign exchange to the Maltese Government or public sector corporations in order to facilitate the development of the foreign exchange market by giving credit and financial institutions a more active role in such market.

“This period was also characterised by the gradual easing of exchange controls”

This period was also characterised by the gradual easing of exchange controls. For instance, in 2000, allowances for travel were raised and direct investment abroad by residents was totally liberalised while also granting greater latitude in opening and operating bank accounts denominated in foreign currency. This liberalisation process necessitated a review of the functions performed by the Bank’s Exchange Control Department, which previously had as its main focus the administration of capital controls.

A Risk Management Unit was created in 1997, following a restructuring exercise of the Bank’s corporate structure, to assess risk and conduct business process analysis. This unit was set up to support the strategic role of the Executive Management Committee. Moreover, during 2000, the Bank officially set up its Legal Unit to assure stronger compliance at the Bank.

Towards the end of the 1990s, the Bank was also actively involved in preparatory work in the run-up to Malta’s EU membership process and staff at the Bank prepared several reports in connection with membership negotiations. At the same time, the Bank participated actively in the screening process that the EC conducted on Malta as a prerequisite to negotiations on EU membership. The Central Bank of Malta also collaborated with the ECB on matters of common interest and monitored closely all relevant developments in the monetary policy
field. Technical experts from the ECB also advised on statistical reporting in the area of monetary, banking and balance of payments data.

The early 2000s were characterised by Malta’s preparations for EU membership. This process also required the Central Bank of Malta to adjust to the new legislative and operational environment in line with the country’s forthcoming commitments. The changes to the Central Bank of Malta Act in 2002 and developments in the EU accession process were key factors that influenced the Bank’s policies, internal organisation and operations during this period.

“The early 2000s were characterised by Malta’s preparations for EU membership”

The amended Central Bank of Malta Act, which came into force on 1 October 2002, formally established price stability as the primary objective of the Central Bank of Malta. In this regard, the Act distinguished between the primary objective of price stability and the other objectives of the Bank. Moreover, the Act introduced additional measures to reinforce the Bank’s independence at various levels. In particular, the amendment removed any powers of the Minister for Finance to direct the Central Bank of Malta on the use of its financial resources, thereby ensuring financial independence.

The revised Act strengthened the Central Bank of Malta’s independence with respect to monetary policy. These changes ensured that the Bank was fully responsible to formulate and implement monetary policy without external interference. The amendments vested the sole authority to take decisions on monetary policy in the Governor while the Monetary Policy Advisory Council, which replaced the MPC, became responsible for advising the Governor on matters related to monetary policy. This was the first time that the structure, functions and proceedings of the Monetary Policy Advisory Council were regulated by law. The aim of monetary policy was to achieve price stability by pegging the Maltese lira to a basket of currencies of major trading partners, namely the euro, the US

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42 The secondary objectives included three important functions namely, ensuring overall stability in the financial system, promoting a sound and efficient payment system and compiling and publishing statistics. The other objectives included in the amended Act were already included in the previous version of the legislation. Directly or indirectly, these secondary objectives supported the Bank’s primary role of achieving price stability.

43 For a summary of the amendments refer to Central Bank of Malta (2002).
dollar and pound sterling, and on the other hand, through a more active interest rate policy.

Another important change brought about by the new Act was the prohibition of monetary financing, that is, the purchase of debt instruments directly from the Government or from the public sector in general on the primary market. This development complemented a previous amendment to the Act which provided for the termination of temporary advances to the Government. Nonetheless, the Central Bank of Malta continued to act as a market-maker for Malta Government securities in the secondary market, a role which it has undertaken since its foundation in 1968 in order to enhance liquidity and foster more stable and orderly conditions in the sovereign debt market. Despite efforts by the Bank to encourage the introduction of private market-makers or primary dealers to complement the Bank’s market-making role, there was no interest from the private sector to take on this role, mainly on account of the small size and thin trading conditions of the domestic market.

The Bank’s market-making function is performed through the Government Securities Office, which publishes daily prices and yields for Malta Government securities, namely MGSs and Malta Government Treasury bills. Thus, the Central Bank of Malta has contributed significantly to the development of the domestic money and capital markets and has enhanced the liquidity of these securities. Up till 1991, the Central Bank of Malta’s market-making role with respect to Government Stocks was conducted on an over-the-counter basis. With the commencement of trade on the MSE in January 1992, the Bank’s role in the capital market took on a new dimension with the appointment of a broker who was assigned the task of intervening in trading operations on the Exchange in respect of such securities.

The revised Act of 2002 also introduced a number of measures to make the Central Bank of Malta more accountable and transparent. Towards this end, the Bank was required to issue a statement following each meeting of the Monetary Policy Advisory Council explaining the decisions taken and the thrust of monetary policy. Moreover, the Governor was obliged to appear before a Committee of the House of Representatives, if requested to do so, to report on the conduct of monetary policy.
An important milestone during the period under consideration was the transfer on 1 January 2002 of the banking supervision function from the Central Bank of Malta to the MFSA, which replaced the MFSC. Consequently, the Bank ceased to be the Competent Authority in terms of the Banking Act 1994 and the Financial Institutions Act 1994, with the responsibility to license, regulate and supervise banks and financial institutions shifting to the MFSA. Furthermore, in October 2002, when the Financial Markets Act entered into force, the Bank’s responsibility for the supervision of the MSE was also transferred to the MFSA. The transfer of these responsibilities was implemented smoothly and the two institutions signed a Memorandum of Understanding (MoU) in February 2003 to establish the modalities for co-operation and the exchange of information in the area of financial services. A second MoU was signed in May 2003 to cover the areas of regulation, oversight and the smooth functioning of payment and securities settlement systems.

“The Central Bank of Malta remained statutorily responsible to ensure the overall stability of the financial system”

The Central Bank of Malta remained statutorily responsible to ensure the overall stability of the financial system. The importance of financial stability was already enshrined in the initial legislation that established the Central Bank of Malta in 1968, where the Act referred to the Bank’s role in promoting a sound financial structure and to foster an orderly capital market in Malta. Following the 2002 amendments, however, the Bank’s responsibility was made more explicit as the Act specifically stated that one of the objectives of the Bank is “to ensure the stability of the financial system.”

To ensure financial stability, the Central Bank of Malta assumed the role of a macro-prudential authority. In anticipation of this new role, the Central Bank of Malta increased its human and technical resources to be able to monitor the overall stability of the domestic financial system and in 2000, the Bank established a Financial Stability Office. The Bank’s statutory responsibility to ensure financial stability is performed through the continuous monitoring of the various components of the financial system, including the domestic payment and settlement systems. Efforts are geared towards the early identification and timely correction of potential weaknesses that may render the financial system
vulnerable to domestic and international shocks. The involvement of central banks in financial stability is important because financial stability and price stability are complementary goals. Price stability cannot exist without a stable financial system, as the latter is indispensable for the successful implementation of monetary policy.

In fulfilling its statutory obligation, the Central Bank of Malta may act as a lender of last resort when it deems necessary, to grant loans to any credit institution incorporated in Malta in order to safeguard financial stability. This is done in exceptional cases and against forms of security as the Board of the Bank may consider appropriate. Throughout its history, the Bank was never required to activate this exceptional facility.

As from 2003, the Central Bank of Malta assumed a new role related to this field with the introduction of the Depositor Compensation Scheme and the Investor Compensation Scheme which entered into force in January 2003 as an additional layer of security for depositors and investors. The Bank is represented on the Management Committees of these two Schemes and also acts as investment manager for both schemes.

“Central banks have always been interested in the smooth functioning of the national payment system”

The 2002 amendments to the Central Bank of Malta Act also put in place a framework governing payment systems. As issuers of money, central banks have always been interested in the smooth functioning of the national payment system in order to maintain trust in the currency and ensure its smooth circulation. The Act put the onus for the efficiency and safety of payment systems in Malta on the Central Bank of Malta and enables the Bank to regulate, oversee and, where necessary, operate payment systems in Malta. This framework complemented the setting up of the first formal payment system in Malta compliant with international standards. The Central Bank of Malta, together with domestic credit institutions, in fact established the Malta Real-time Interbank Settlement System (MaRIS) which started operating fully on 1 October 2002. Soon after its establishment, the system handled more than 95% of all interbank payments. The establishment of MaRIS was the first step in the integration of Maltese payment systems with other
cross-border payment systems, including the TARGET system that operates in the euro area. Messaging within MaRIS is based on SWIFT standards and the system was fully automated, permitting a payment to be entered and processed in real time and providing the recipient with instant confirmation of the receipt of funds.

By 2002, the Bank’s role in the administration of exchange controls was mostly of a surveillance nature given that the authority to approve almost all transactions had been delegated to authorised dealers in foreign exchange. Moreover, the liberalisation measures announced by the Government over a number of years meant that most transactions between residents and non-residents no longer required the approval of the authorities until all restrictions were lifted once Malta joined the EU in 2004. To enhance its information on capital flows, the Central Bank of Malta continued to collect such data through reporting forms submitted by banks and other intermediaries in terms of the External Transactions Act which replaced the Exchange Control Act.

In preparation for EU membership, the Bank collaborated with the EU Directorate of the Ministry for Foreign Affairs and other Government entities to update national documents relating to Malta’s progress with the implementation of the EU acquis communautaire. The Bank’s contribution focused mainly on the areas of the free movement of capital and services, EMU and statistics. The Central Bank of Malta was also involved in the preparation of the 2002 Pre-accession Economic Programme, together with the Ministry for Finance and the Ministry for Economic Services. Various staff members participated in seminars organised by the ECB for accession countries, particularly those relating to payment systems, the operational framework used for monetary and foreign exchange operations, the Bank’s communication strategy and internal audit. Meanwhile, the Bank continued to make use of technical assistance from the ECB and national central banks.

Following Malta’s accession to the EU in May 2004, the Central Bank of Malta became a member of the ESCB and took up a shareholding in the subscribed capital of the ECB. Given that Malta joined the EU as a ‘Member State with a

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Some restrictions remained in effect in relation to property purchases in terms of a special derogation negotiated with the EU and with respect to contracts with life insurance companies not resident in either the EU or any other European Economic Area country. The latter restriction was lifted in 2005.
derogation’, monetary policy remained the Bank’s sole responsibility. Upon EU membership, the Central Bank of Malta joined the General Council of the ECB and formed part of the ESCB’s committees. By the end of 2004, officials from the Bank sat on 47 such committees, working groups and task forces. As part of its new commitments, the Central Bank of Malta also began hosting ESCB meetings.

Moreover, links with the ECB deepened across the entire range of the Bank’s operations, including statistics, currency and market operations, information technology and payment and settlement systems. The Bank also kept the Government regularly informed on its policies and on matters related to the eventual adoption of the euro, and began practical preparations in this direction.

“In May 2005, Malta joined ERM II with the commitment to maintain the exchange rate at its central parity of EUR1=MTL0.4293”

One year after EU membership, in May 2005, Malta joined ERM II with the commitment to maintain the exchange rate at its central parity of EUR1=MTL0.4293. Following entry into ERM II, preparations for euro-area membership were the highlight of the Bank’s activities and were spread across the entire spectrum of its operations. The Governor and Deputy Governor were members of several domestic committees, including the Steering Committee for Euro Adoption and the National Euro Changeover Committee which were set up to coordinate the switch over to the euro.

The Central Bank of Malta Act was amended by the House of Representatives in February and March 2007 to cater for the Bank’s membership in the Eurosystem, bringing the Act in line with the relevant provisions of the EC Treaty and the Statute of the ESCB and the ECB.

Having satisfied the necessary criteria for euro adoption, the ECOFIN Council, on 10 July 2007, confirmed Malta’s entry into the euro area and fixed the irrevocable conversion rate for the Maltese lira. Soon after the confirmation of the euro adoption date, the minting of the Maltese euro coins commenced at

45 This is a system intended to improve the stability of currencies of EU Member States, with currencies allowed to fluctuate as much as 15% from their assigned value.
the Monnaie de Paris, the French state mint, with the first deliveries reaching Malta in September. As regards the provision of euro currency notes, the Bank borrowed a total quantity of 72 million euro notes for a value of €1,566 million, from Banca d’Italia, until it began to procure its own stock of euro currency notes in 2009. The transfer of money from Italy to Malta was a delicate task carried out with the participation of almost two hundred people involving staff from the Central Bank of Malta, the Malta Police Force, Malta’s national airline and the Armed Forces of Malta.

Throughout the year, preparations for euro adoption entailed substantial work on the Bank’s information technology infrastructure. Moreover, work was carried out to ensure that accounting systems, statistics and payment and settlement systems were smoothly integrated into those of the ECB. The euro-changeover also demanded significant work in terms of communications strategy, particularly with respect to the appearance of the notes and coins and their security features.

Mr Jean Claude Trichet, former President of the ECB and Mr Michael C. Bonello, former Governor of the Central Bank of Malta on the occasion of the launching of the CBM/ECB joint communications campaign for the euro changeover on 30 September 2007
2008 – A new era for the Central Bank of Malta on joining the Eurosystem

On 1 January 2008, Malta became a full member of the euro area and the euro became Malta’s legal tender. The Central Bank of Malta joined the Eurosystem and became fully integrated in the decision-making bodies of the ECB. This event ushered in a new phase in the Bank’s history as its operational framework became increasingly aligned with that of the Eurosystem. Moreover, the Central Bank of Malta started to participate much more intensely in ECB structures. For example, whereas prior to euro adoption, the Governor of the Central Bank of Malta participated only in the General Council of the ECB, with euro area membership the Governor became a member of the Governing Council, which is the main decision-making body of the ECB. Consequently, Malta began to contribute to the formulation of the single monetary policy for the euro area. The Central Bank of Malta assumed responsibility for the implementation of the Governing Council’s monetary policy decisions in Malta, with the primary objective of price stability, defined as the annual increase in the Harmonised Index of Consumer Prices (HICP) in the euro area of below, but close to, 2% over the medium term. In this new role, the Bank regularly conducts open market operations with credit institutions established in Malta as part of the Eurosystem’s monetary policy operational framework. It also offers standing facilities, administers the minimum reserve system, and participates in the ECB’s asset purchase programmes.

“On 1 January 2008, Malta became a member of the euro area and the euro became Malta’s legal tender”

In order for the Governor to participate effectively in the decision-making process, the Bank established an internal structure that enables staff from different offices, with expertise in specialised areas, to brief the Governor on issues presented to the Governing Council. Apart from the Governor’s participation in the General and Governing Council meetings staff also contributes to the work of a number of ESCB committees, working groups and task forces, which provide technical support and advice to the decision-making bodies. The Central Bank of Malta, through its Economic Analysis and Research Department, also produces macroeconomic and fiscal projections, which are used as inputs to the production of euro area-wide projections.

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46 The General Council of the ECB meets four times annually whereas the Governing Council meets twice monthly.
Each year, the Central Bank of Malta hosts a number of ESCB committees or working group meetings in Malta. Among these events, the Bank hosted the first ECB Governing Council meeting in Malta on 22 October 2015, chaired by President Mario Draghi. It was also the first time that the European Cultural Days of the ECB were dedicated to Malta during that year. The programme of activities, aimed at highlighting the EU’s rich and diverse array of cultures, was held in Frankfurt am Main and covered a wide spectrum of performances.

"The Bank hosted the first ECB Governing Council meeting in Malta on 22 October 2015, chaired by President Mario Draghi"

Since 2008, under the foreign currency specialisation framework, the Central Bank of Malta has managed an amount of US dollar reserves on behalf of the ECB by way of a pooling mechanism, administered jointly with the Central Bank of Ireland. Apart from these reserves, the Central Bank of Malta also manages the country’s official reserves, which include money market instruments, government bonds and other fixed income securities. The management strategy of the Bank’s own portfolio remains the competence of the Bank’s IPC.
Prior to the adoption of the euro, the primary purpose of the reserves was to safeguard the value of the domestic currency within the framework of an exchange rate peg. In order to maintain confidence in the Maltese lira, the Central Bank of Malta Act obliged the Bank to keep an amount of external reserves equivalent to not less than 60% of its currency and deposit liabilities, a ratio which the Central Bank of Malta satisfied and surpassed. Since 2008, the main investment objective of the Central Bank of Malta is to maximize the return on the portfolio within the risk and liquidity parameters approved by the Board of Directors and the IPC. More recently, the Bank has engaged the services of two external asset managers to further diversify its portfolio. Furthermore, the adoption of the euro has ended the Bank’s role as market maker in the foreign exchange market.

The Central Bank of Malta remains responsible for ensuring the stability of the financial system, and formulating and implementing macro-prudential policy. The Bank publishes its financial stability analysis and findings in its annual Financial Stability Report, which is supplemented by a mid-year update. At the domestic level, the Central Bank of Malta collaborates very closely with the MFSA on financial stability issues and, where relevant, with the Ministry for Finance.
To foster this collaboration, the Bank and the MFSA agreed to establish a Joint Financial Stability Board (JFSB). The MoU between the two bodies was signed on 25 January 2013, concurrently with the first meeting of the Board.\(^{47}\)

The on-going integration of European financial markets has also strengthened the need for further co-operation at the EU level in the area of cross-border financial stability. The Bank contributes to the maintenance of financial stability within the euro area and the EU through its participation in the European Systemic Risk Board (ESRB) and the European Banking Association (EBA).\(^{48}\) The Bank also participates as an observer in the Supervisory Board of the ECB, which is the body entrusted with the supervision of credit institutions to be undertaken by the ECB under the Single Supervisory Mechanism. In fact, the Central Bank of Malta provided input for the ECB’s comprehensive assessment which started in 2014 as a financial health check of banks in the euro area.

*“Upon euro adoption, the domestic payments system (MaRIS) was replaced by TARGET2”*

Upon euro adoption, the domestic payments system (MaRIS) was replaced by TARGET2. The latter consists of a single shared platform for payments in euro, and connects the euro area central banks and other participants, such as financial institutions and stock exchanges, in payment and settlement systems. The migration from TARGET to TARGET2 was finalized on 19 November 2007 and Malta joined TARGET2 as part of the first wave of countries to use this new payment system.

\(^{47}\) The potential for synergies between the Central Bank of Malta and the MFSA have long been recognized. For example, in 2002, the two institutions signed two MoU to provide for enhanced co-operation, including the establishment of a Standing Committee on financial stability matters (Bonello, 2004b).

\(^{48}\) The ESRB is responsible for the macro-prudential oversight of the financial system within the EU to help prevent or mitigate systemic risks that arise from developments within the financial system. It was established in 2010 in response to the 2008 financial crisis.
The Central Bank of Malta, as part of the Eurosystem, is also involved in the implementation of TARGET2-Securities (T2S). The latter consists of a single, pan-European platform for securities settlement in central bank money. Like TARGET2, it brings substantial benefits to the European financial and payments industry as it has made cross-border settlement in Europe easier and more efficient. Together, these two platforms form the backbone of the European financial market infrastructure. T2S started operations on 22 June 2015 and the Central Bank of Malta, together with the MSE, were amongst the first institutions to join the system in its first migration wave.

![SEPA](image)

The Central Bank of Malta was also actively involved in the preparations leading to the launch of the SEPA project in the beginning of 2008. The objective of this project is to put all retail electronic payments – credit transfers and direct debits, credit card and debit card payments – across the euro area on the same platform of domestic payments. SEPA represents a major step towards closer European financial integration and in realising the full potential of the single market in Europe. SEPA is an initiative of the European banking industry, coordinated by the European Payments Council.

At the national level, the SEPA project is run by the National SEPA Coordination Committee. It is chaired by the Central Bank of Malta and has, as its members, stakeholders representing the banking sector, the public administration, public entities and the constituted bodies. The Central Bank of Malta was appointed as the Competent Authority for the implementation of SEPA by the Minister for Finance. The implementation was coordinated by the Central Bank of Malta and the Malta Bankers’ Association through the Payments System User Group, which also includes representatives of the banking community. This project also introduced the International Bank Account Number (IBAN), a defined standard for bank account numbers that uniquely identify a customer’s bank account held at a bank anywhere in the world.
The Central Bank of Malta remains responsible for the circulation of euro banknotes and the issuance of euro coins on behalf of the Maltese Government. During 2008 the Bank was directly responsible for managing the migration to the euro, including the withdrawal and disposal of Maltese lira banknotes and coins, as well as to ensure that the supply of euro banknotes and coins was sufficient to meet the needs of the public. The Central Bank of Malta also enhanced its forecasting processes to estimate the country’s cash requirements to ensure that the banking sector was adequately supplied with euro cash after the changeover. In 2009, the Bank was allocated a share in the printing of euro banknotes for the first time. The new banknotes were used mainly to refund to the Eurosystem the amount of notes the Bank had borrowed in 2008 in connection with the currency changeover. In addition, the Bank remains responsible for ensuring that the new currency in circulation is fit for use and that any counterfeits are quickly detected.

The Central Bank of Malta houses a permanent numismatic exhibition located at its main premises which exhibits coins and banknotes, going back to Punic times, which reflect the foreign ruling power or the neighbouring countries with which Malta traded. The museum also includes collector and commemorative coins issued by the Bank over the years. The Central Bank of Malta issues commemorative €2 coins as well as other collector coins in precious metal to commemorate important events or people, of both local and international interest, on a periodic basis. All coin products are available through the e-shop facility which was launched during the first half of 2016.

Through its Statistics Department, the Central Bank of Malta is responsible for the compilation and transmission of statistics on the basis of guidelines laid down by the ECB. A number of initiatives were pursued prior to euro entry to bring the Bank’s statistical reporting up to the rigorous standards demanded by the ECB. At the national level, the Bank continued to assume responsibility for collecting monetary and financial statistics while also collaborating with the
National Statistics Office in the compilation of Malta’s external statistics. Upon joining the euro area, the Bank began to transmit a range of statistics to the ECB which feature in the ECB’s Statistical Data Warehouse. Membership of the Eurosystem also necessitated the need for the collection of additional statistics, such as those related to the financial accounts. Moreover, the Bank invested in statistical databases and automated transmission systems to enable it to collect and transmit data in a more secure and efficient manner. A recent task assigned to the Central Bank of Malta has been that of becoming responsible for the Central Credit Register (CCR), a database which contains exposure-by-exposure information of debtors of resident credit institutions. The main purpose of the CCR is to create a credit data sharing system to support credit institutions in their analysis of existing or prospective borrowers’ creditworthiness.

More generally, membership of the Eurosystem has widened the Bank’s range of activities and provided an opportunity to enhance its technical expertise. While the Bank continues to be active within the Eurosystem, ESCB and ESRB, it also maintains strong relations with other international institutions such as the EC, the IMF, the World Bank, the European Bank for Reconstruction and Development (EBRD) and the Asian Infrastructure Investment Bank (AIIB). The Bank also seeks to maintain and develop relations with central banks of the Mediterranean region and of Commonwealth member states.
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ABOUT THE CONTRIBUTORS

**Tiziana M. Gauci** is a Senior Research Economist. She has worked on the analysis of monetary, financial and fiscal developments, the monetary transmission mechanism and firms’ financing conditions. She holds economics degrees from the University of Malta and the University of London.

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Sandra Zerafa coordinates publications within the Economic Analysis Department. She has contributed to the Bank’s publications on the euro area, general national statistics, access to credit and structural changes in the Maltese economy. She is currently responsible for the development of a database of historical macroeconomic data for Malta. She holds degrees in economics from the University of Malta.
The Bank’s 50th anniversary logo is the work of Michael Grech and Daniel Galea, students at the Malta College of Arts, Science and Technology’s Arts and Design Institute. The Bank chose the design from a shortlist of three winners from an initial eleven competitors.

The logo is inspired by the Bank’s official emblem, the fortifications and the Bank’s surroundings. The fortifications represent the Bank’s stability and its role as guardian of the country’s financial stability.