Central Bank of Malta

THIRTY-FIFTH ANNUAL REPORT

AND

STATEMENT OF ACCOUNTS

2002

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MISSION AND OBJECTIVES

OUR MISSION

To maintain price stability and to ensure a sound financial system, thereby contributing to sustainable economic development.

We will seek to achieve this mission by:

- Pursuing appropriate interest and exchange rate policies
- Maintaining the value of the external reserves
- Safeguarding the integrity of the financial sector
- Promoting and supporting the development of financial markets and efficient payment and settlement systems
- Issuing notes and coins to meet the demands of the public
- Conducting economic analyses and publishing economic and financial statistics
- Advising the Government on economic and financial matters

In order to achieve the above objectives, the Bank commits itself to provide effective support functions through a sound financial control system, appropriate information systems and the development of competent and qualified staff.

CENTRAL BANK OF MALTA

BOARD OF DIRECTORS

(As at 1st January 2003)

Mr Michael C Bonello
Governor

Mr David A Pullicino
Deputy Governor

Mr Saviour Falzon	*Director*
Mr Alfred F Lupi	*Director*
Mr Joseph V Gatt	*Director*

Executive Management Committee
(As at 1st January 2003)

Mr Michael C Bonello
Governor & Chairman

Mr David A Pullicino
Deputy Governor

Mr Alfred Demarco
Deputy General Manager
Economics Division

Mr Godfrey Huber
Deputy General Manager
Finance and Banking Division

Mr René G Saliba
Deputy General Manager
Financial Markets Division

Mr Herbert Zammit LaFerla
Deputy General Manager
Financial Stability Division

Mr John Agius
Deputy General Manager
Resource Management Division

Audit Committee
(As at 1st January 2003)

Mr Alfred Lupi
Chairman

Mr David A Pullicino
Member

Mr Saviour Falzon
Member

Monetary Policy Advisory Council
(As at 1st January 2003)

Mr Michael C Bonello
Governor & Chairman

Mr David A Pullicino
Deputy Governor

Mr Saviour Falzon
Director

Mr Alfred F Lupi
Director

Mr Joseph V Gatt
Director

Mr Alfred Demarco
Deputy General Manager
Economics Division

Mr René G Saliba
Deputy General Manager
Financial Markets Division

Mr Herbert Zammit LaFerla
Deputy General Manager
Financial Stability Division

Investments Policy Committee
(As at 1st January 2003)

Mr Michael C Bonello
Governor & Chairman

Mr David A Pullicino
Deputy Governor

Mr Godfrey Huber
Deputy General Manager
Finance and Banking Division

Mr René G Saliba
Deputy General Manager
Financial Markets Division

Mr Anton Caruana Galizia
Senior Manager
Economic Research Department

Mr Raymond Filletti
Senior Manager
Financial Control Department

Mr Saviour Briffa
Senior Manager
Reserve Management Department

Mr Stephen Attard
Manager
Correspondent Banking Office

Mr Mario Bugeja
Manager
Investments and Reserves Office

THE BOARD OF DIRECTORS

(As at 1st January 2003)

Left to right:

Seated: Mr D A Pullicino (Deputy Governor), Mr M C Bonello (Governor and Chairman), Dr B Muscat (Secretary)

Standing: Mr S Falzon (Director), Mr A F Lupi (Director), Mr J V Gatt (Director)

Organisation Chart of the Central Bank of Malta

(As at 1st January 2003)

- Governor
  Mr Michael C Bonello
  - Deputy Governor
    Mr David A Pullicino
    - Deputy General Manager
      Economics Division
      Mr A Demarco
      - Economic Research Dept
        - Economic Analysis Office
        - Research Office
        - Statistics Office
        - Balance of Payments Office
      - Library & External Relations Dept
        - Library
        - External Relations Office
    - Deputy General Manager
      Finance & Banking Division
      Mr G Huber
      - Banking & Issues Dept
        - Retail Banking Office
        - Payment Systems Office
        - Currency Issue Office
      - Financial Control Dept
        - Finance Office
    - Deputy General Manager
      Financial Markets Division
      Mr R G Saliba
      - Domestic Markets Dept
        - Open Market Operations Office
        - Money & Capital Markets Office
        - Government Debt Analysis Office
      - Reserve Management Dept
        - Investments & Reserves Office
        - Middle Office
        - Correspondent Banking Office
    - Deputy General Manager
      Financial Stability Division
      Mr H Zammit LaFerla
      - Financial Stability Dept
        - Financial Stability Office
        - Risk Assessment Office
        - Audit Office
    - Deputy General Manager
      Resource Management Division
      Mr J Agius
      - Resources Dept
        - Human Resources Office
        - Administration Office
        - Security
      - Information Systems Dept
        - IT Services Office
        - Software Development
        - Records Management Services Office
  - Legal Office

LETTER OF TRANSMITTAL

CENTRAL BANK OF MALTA
VALLETTA

28th March 2003

Dear Minister

In accordance with Article 23(1) of the Central Bank of Malta Act 1967, I have the honour to transmit a copy of the annual accounts of the Bank, certified by the auditors, for the financial year ended 31st December 2002, a statement of the Bank's investments and a report on the Bank's operations during that year.

Yours sincerely

Michael C Bonello
Governor

Contents

Governor's Statement

The developments in Malta's external environment analyzed in last year's Annual Report were thought to have the potential to impact favourably on domestic economic growth in 2002. That cautiously optimistic scenario appears to have materialized. The Central Bank of Malta's latest estimates suggest that real GDP grew by about 3% last year after a 0.8% decline in 2001. This recovery was partly export-led as foreign demand revived somewhat after the sharp downturn in 2001, while efforts aimed at restructuring appear to have borne some results, especially in the manufacturing sector. Consumption expenditure also accelerated, though at the expense of a further reduction in the household saving rate as it grew faster than disposable income.

Looking ahead, the prospects for a consolidation of these favourable trends depend on a number of factors. In the short term, they will no doubt be influenced by developments in external demand. Here, even the more optimistic forecasts for the world economy over the next two years point to sluggish growth, well below the 3% average rate of the second half of the 1990s. This weak growth scenario, moreover, is subject to a number of downside risks emanating from the current geopolitical tensions. It is clear that in the presence of slow-growing and possibly increasingly volatile international demand, the domestic export sector is likely to face even more acute competitive pressures. At the same time, the near-term prospects for growth based on domestic activity are conditioned by the limited scope for demand expansion, due to the already low household saving rate and the need to further reduce the fiscal deficit.

In a longer-term perspective, sustained growth in Malta's small, open economy can only be ensured by a dynamic and innovative export sector, backed by continuous investment in physical and human capital. In a globalized, competitive world this is the only way the economy can sustain rising living standards.

In order to secure this objective and to strengthen the economy's capacity to withstand external shocks, policy efforts must be consistently and coherently directed to promoting a stable macroeconomic environment as well as efficient, market-based mechanisms for the allocation and use of resources. This year's statement focuses on how the Central Bank can assist in the achievement of these policy objectives through the actions it takes in fulfilling its responsibility for monetary policy.

A monetary policy that is effective in delivering price stability is the single most important contribution the Central Bank can make to sustainable economic growth. Both theoretical and empirical evidence confirms that there is no trade-off in the long term between stable prices and growth. An environment of price stability allows the market mechanism to allocate resources efficiently and constitutes an essential premise for investment decisions. High and unpredictable rates of inflation, on the other hand, not only erode the purchasing power of incomes, and therefore harm the weakest members of society, but also deter investment because they create uncertainty about the future evolution of production costs. Malta's major trading partners within the European Union and its competitors in the other EU accession countries, moreover, all maintain a strong policy focus on low inflation. In these circumstances, and particularly at a time of more intense global competition, safeguarding price competitiveness is a policy imperative for Malta.

The Central Bank pursues price stability by pegging the Maltese lira to a basket of low inflation currencies, namely the euro, the US dollar and the pound sterling. Past experience suggests that the fixed exchange rate regime has proved to be an efficient mechanism for this purpose. Domestic inflation has indeed tended to remain within a reasonable range of the average inflation rate in the countries represented in the currency basket. Over the past five years it has averaged 2.4 per cent, never departing from the basket-weighted foreign inflation rate by more than 0.8 of a percentage point.

This encouraging track record has been reinforced this past year by an important development designed to consolidate the credibility of monetary policy. This was the formal declaration of the Central Bank's full independence from Government through legislation, which assigned to the Bank exclusive responsibility for maintaining price and financial stability. This is an important undertaking given by the Monetary Authorities to investors and other economic agents because it precludes the possibility of interest rates being influenced by considerations that are not strictly germane to monetary policy.

It is appropriate to point out, however, that expectations in this regard must be tempered by a realization that the effectiveness of monetary policy in delivering its target is limited. Thus, for example, monetary policy can hardly be expected to produce the desired degree of price stability on its own. It needs to be complemented by an appropriate fiscal policy. This is because beyond certain levels budget deficits and debt generate inflation expectations, putting upward pressures on interest rates. Excessive government expenditures also tend to crowd out private investment and consumption and may, therefore, also hamper economic growth. In this regard, it is important that the process of fiscal consolidation currently underway – which has seen the budget deficit as a proportion of GDP halve over the past five years to around 5 per cent – be completed on schedule.

Another factor that conditions monetary policy in Malta is associated with the operation of a fixed exchange rate regime in a small, open economy. In order to defend the exchange rate peg, in fact, interest rates need to incorporate a premium to compensate investors for the additional risk that such vulnerable economies are usually perceived to represent. For example, although Malta's credit ratings are compatible with the country's level of development, and are comparable to those for Greece, interest rates in Malta are around a percentage point higher. Depending on the make-up of cost structures, this interest rate premium could place domestic enterprises at a disadvantage with respect to competitors in larger economies.

This situation arises from the inherent incompatibility of a fixed exchange rate regime and liberalized external capital flows, on the one hand, and an autonomous interest rate policy, on the other. If the interest rate in a small economy, for instance, is lower than the rate of return required by the financial markets, capital will seek a higher return abroad. And since attempts to address such capital outflows by reimposing exchange controls would seriously undermine the country's credibility as a stable and well-managed market economy, it is preferable to prevent such a situation from developing by maintaining the risk premium at an appropriate level.

From the monetary policy point of view, the surest way to overcome the disadvantages of small economic size is to adhere to a larger currency area. Small economies tend to have a relatively less desirable combination of interest rates and inflation rates due to the higher risk premium. This is indeed one of the reasons behind the formation of common currency areas like the euro area, which has induced even economies that are much larger, and consequently less vulnerable than Malta's, to surrender autonomy over monetary policy in order to secure the advantages of integration.

Together with an appropriate mix of monetary and fiscal policies, a stable financial sector is another essential requisite for macroeconomic resilience and an efficient allocation of resources. Low and stable inflation in itself promotes financial stability. In addition, experience shows that this objective is also achieved by removing controls on interest rates and lending, providing a reliable payment mechanism and allowing the financial sector to integrate freely with the international financial system, while safeguarding the robustness of banks and other financial institutions through rigorous prudential regulation and supervision. In this regard, a number of further initiatives were taken in the pursuit of these objectives during the past year, as documented elsewhere in this Report.

These stability-oriented policies have already produced significant gains. For many years the exchange rate has not experienced undue volatility, inflation has been moderate and there has been in recent times an inflow of capital that would probably not have materialized to the same extent had the previous system of administrative controls been retained. They have also contributed to enhance Malta's image as an investment location and to sustain the country's international credit ratings.

It must be stressed, however, that sound monetary, fiscal and exchange rate policies and the safeguarding of financial stability are necessary but not sufficient conditions for sustained economic growth and development in a globalized world economy. They need to be complemented by supportive policies in other domains and by the commitment of the social partners to promote an environment conducive to the attraction of high-value added, export-oriented operations. In this regard it is well to recall that Malta's living standards remain in good part financed by a current account deficit, presently hovering around 5 per cent of GDP. This means that the country is spending more than it earns. This situation can only be justified if resources are invested wisely so as to generate an income stream in the future, and thus lead to a reversal of the deficit. The thrust of economic policy generally must, therefore, be to achieve this objective.

There are a number of complementary approaches through which this long-term goal could be achieved. Of prime importance is further investment in human capital through the education and life-long training of the labour force. This will enhance the quality of human resources and strengthen the labour market. The operation of the labour market is in fact a critical determinant of national competitiveness. In this context, the objective should be a suitable balance between wage levels, productivity and taxation. It is essential that wages do not move out of line with productivity, particularly in the public sector, and that taxation levels do not serve as an excessive disincentive to work and investment. The Government could contribute by further improving the efficiency and transparency of the public administration and by facilitating the redeployment of some of its own human resources to sectors of the economy where they can be used more productively. At the same time, every effort should be made to preserve the social fabric. In this respect the welfare system needs to be reassessed, particularly with a view to moving away from universal schemes towards more focused programmes aimed at fulfilling genuine needs and to structure benefits in a way that it pays to work.

In conclusion, two important points deserve to be emphasized. The first is that monetary policy has only one instrument available, interest rates. And that instrument is best used to promote medium-term price stability. This is because the economy's growth potential is determined by structural and technological fundamentals, and a monetary policy aimed at price stability allows this potential to be maximized. The second point is that monetary policy is not able to solve the structural and other problems of the real economy. The latter respond better to more targeted policies, at both the macro and micro levels. To the extent that the resultant policy mix is implemented successfully, Malta's risk premium would be reduced. This will make it possible to adopt a more relaxed monetary policy stance consistent with the maintenance of the exchange rate peg.

Central Bank Operations

The recent changes to the Central Bank of Malta Act and developments in the EU accession process were key factors influencing the Bank's policies, internal organisation and operations during 2002.

The amendments to the Central Bank of Malta Act, which entered into force on October 1, 2002, formally established price stability as the primary objective of the Bank, reinforced its independence and gave the Bank the operational flexibility needed to carry out its functions in a liberalized financial environment, while at the same time providing for more accountability and transparency. The amendments also vested the sole authority to take decisions on monetary policy in the Governor. The Monetary Policy Advisory Council, which was given a statutory basis, is responsible for advising the Governor on matters related to monetary policy.

In practice, the amendments left the Bank's monetary policy strategy unchanged. Monetary policy aims at achieving price stability by pegging the Maltese lira to a basket of three currencies of low inflation countries – namely the euro, the US dollar and sterling. In August the Monetary Authorities revised the weights of the component currencies of the basket to reflect current trends and likely future patterns in Malta's external trade more closely. The revision resulted in a larger weight being given to the euro at the expense of the US dollar and, to a lesser extent, the pound sterling.

Over the year the Bank continued to ease its monetary policy stance, cutting the central intervention rate by a total of 50 basis points to 3.75%. The Bank lowered official interest rates by 25 basis points in January in response to weak global economic conditions and subdued domestic demand. In December, following reductions in interest rates abroad and a period of sustained expansion in its external reserves, the Bank cut official interest rates by another 25 basis points.

The Bank remains statutorily responsible to ensure the overall stability of the financial system. During the year it strengthened its capability to detect and assess weaknesses in the system. The Bank also collaborated in an extensive exercise undertaken by an IMF/World Bank Mission under the Financial Sector Assessment Program (FSAP), which aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries.

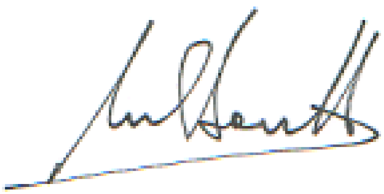
In January, the Bank's responsibility for licensing, regulating and supervising credit and financial institutions in terms of the Banking Act, 1994 and the Financial Institutions Act, 1994 was transferred to the Malta Financial Services Authority (MFSA). Additionally, in October, when the Financial Markets Act entered into force, the Bank's responsibility for the supervision of the Malta Stock Exchange was also transferred to the MFSA. It should be stated that the transfer of these responsibilities was implemented smoothly and according to plan. During the year, the Bank and the Authority reached agreement on a Memorandum of Understanding which establishes the modalities for co-operation and for the exchange of information in the area of financial services, and which should enable the two institutions to fulfil their respective statutory responsibilities more effectively.

The amendments to the Central Bank of Malta Act also put in place a framework governing payment systems that complemented the setting up of the first formal payment system in Malta compliant with international standards. In fact, the Bank, together with domestic credit institutions, established the Malta Real-time Interbank Settlement System, or MaRIS, which started operating fully in October. The establishment of MaRIS represents an initial step in the integration of Maltese payment systems with other cross-border payment systems, including the TARGET system that operates in the euro area.

During the year the Bank continued to develop its relations with the European System of Central Banks (ESCB) and the European Central Bank (ECB). Following an invitation from the ECB to all accession countries, the Bank nominated the officials who will represent it on twelve committees of the ESCB in an observer capacity with effect from April 2003. Meanwhile, contacts intensified across the whole range of the Bank's operations as both sides prepared for Malta's eventual accession to the European Union.

Reflecting the sharp drop in market interest rates abroad during 2002, which more than offset the positive income effect of the strong increase in the Bank's external reserves, the Bank's net profits amounted to Lm19.8 million as against Lm26 million in 2001.

On behalf of the Board of Directors, I would like to thank the Bank's staff for their dedication and hard work. Without their contribution, the achievements described in more detail elsewhere in this Report would not have been possible.



Michael C Bonello

Part I

FINANCIAL AND ECONOMIC DEVELOPMENTS

1. The International Environment

1.1 The World Economy

World economic and financial conditions remained weak during 2002. The global economy is thought to have grown by only 1.7% after 1.1% in 2001. Considerable monetary and fiscal stimulus, which boosted public and private spending in the United States and Europe, along with a rapid build up of inventories, provided an encouraging start to the year. A further slide in world equity markets and increased geopolitical uncertainty later hurt both household and business confidence and slowed the momentum of the much-awaited economic recovery.

In the United States, although growth is estimated to have reached 2.3% in 2002, the economic performance was uneven during the year despite record low interest rates, benign inflation and a high degree of government spending. In the first half of the year, strong consumer spending combined with the end of a de-stocking period helped the economy expand at the fastest rate in nearly two years. Moreover, low mortgage rates spurred demand for residential investment. During the second half of the year, however, the contribution to growth from inventories faded, while a widening current account deficit, along with a contraction in manufacturing production, led to a decline in output. As a result, layoffs increased rapidly and the unemployment rate rose to 6% by the end of the year.

Meanwhile, in the euro area, GDP growth is estimated at an anaemic 0.8% in 2002 after 1.5% in 2001, reflecting lower business investment and a further contraction in private consumption. A sustained increase in unemployment hurt consumer confidence, while a slide in the world stock markets had a negative impact on business sentiment. In addition, industrial production was erratic throughout the year. As far as price developments are concerned, however, inflation in the euro area eased slightly as a result of lower oil and food prices and the appreciation of the euro.

Table 1.1
INTERNATIONAL ECONOMIC INDICATORS
Percentage change from previous period

Country	Real GDP % change			Inflation (Consumer prices) % change			Current account balance as % of GDP		
	2001	2002 [1]	2003 [2]	2001	2002 [1]	2003 [2]	2001	2002 [1]	2003 [2]
United States	0.3	2.3	2.6	2.8	1.6	1.9	-3.9	-4.9	-5.1
European Union	1.6	0.9	1.9	2.6	2.1	2.0	-0.2	0.5	0.5
Euro area	1.5	0.8	1.8	2.5	2.4	2.2	0.1	0.9	0.9
United Kingdom	2.0	1.7	2.2	2.1	2.0	1.8	-2.1	-1.7	-2.3
Japan	-0.3	-0.7	0.9	-0.7	-1.1	-1.1	2.1	3.2	3.8
Advanced countries	0.8	1.7	1.7	2.2	1.4	1.7	-0.9	-1.3	-1.5
Developing countries	3.8	4.1	4.5	5.7	5.6	6.6	1.2	1.4	1.2
Countries in transition [3]	5.0	3.9	4.5	15.9	11.3	8.8	-	-	-
World total	1.1	1.7	2.2	2.9	2.7	2.3	-	-	-

[1] Estimates
[2] Forecasts
[3] Includes countries of Central and Eastern Europe and the former USSR

Sources: *OECD, Economic Outlook* , Paris (December 2002)
Goldman Sachs, Global Economics, (January 2003)
Consensus Economics, Consensus Forecast, London (February 2003)

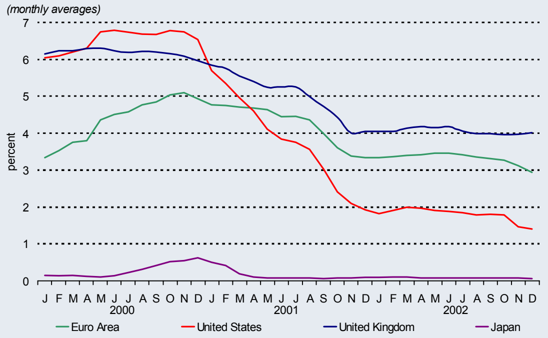
Economic activity in the United Kingdom picked up in the second and third quarter, after having barely grown at all in the previous two quarters. The economy was mainly driven by a robust services sector, and higher government and consumer consumption, the latter underpinned by low interest rates and surging housing wealth. During the last quarter of the year, however, the economy slowed down as a slide in business investment and lower exports affected manufacturing output negatively. Overall, GDP growth is thought to have slowed down to 1.7%, as can be seen in Table 1.1. Nevertheless, during the year the labour market continued to tighten, with unemployment falling to very low levels by historical standards, while headline inflation picked up to 2%.

The Japanese economy contracted in real terms for the second consecutive year as deflation persisted. Output recovered during the first half of 2002, largely due to a low level of inventories, which stimulated production, and a weak yen, which supported a rapid increase in exports. Concurrently, business sentiment and profit expectations improved, while the level of unemployment fell as manufacturers resumed hiring workers. Subsequently, however, the Japanese economy weakened, as the yen appreciated heavily, undermining export growth and corporate profits. Moreover, equity prices fell to record lows, while the banking sector registered losses for the eighth straight year, dampening investment and, hence, domestic demand.

1.2 Interest Rates and Exchange Rates

Short-term interest rates during 2002 fluctuated in line with inflation expectations and underlying economic conditions. Hence, in both the United States and the euro area, money market rates declined in response to the monetary policy adopted by the Federal Reserve (Fed) and the European Central Bank (ECB), respectively. In the UK, interest rates rose slightly in the first six months of the year, but declined thereafter although the Bank of England left monetary policy unchanged. Meanwhile, money market rates in Japan stood at 0.1% until the end of March before declining to just above zero and remaining there until the end of the year.

Chart 1.1
SHORT-TERM INTEREST RATES
(monthly averages)



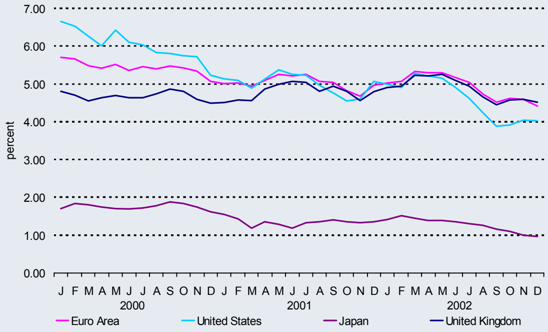
Source: Reuters
London interbank offered rates (LIBOR)

In the United States, money market rates tended to rise in the early months of the year, before resuming a downward trend amid signs of a slow return to growth. Despite a weaker economic outlook and increased uncertainty, which kept investors wary about the performance of US assets, the Federal Reserve considered its monetary policy stance sufficient to support economic activity. As a result, it cut interest rates only once during the year, bringing the targeted federal funds rate down to 1.25%. Short-term rates stood below the federal funds rate till the end of October before rising above it in the last two months of the year.

In the euro area, money market rates tended to rise in the first six months of the year. Later, however, euro area rates eased as the major European economies failed to show any sign of recovery. Despite this apparent economic weakness, the ECB held back from lowering interest rates, citing risks to price stability. In December, however, the ECB lowered interest rates by 50 basis points, since inflationary risks had receded, while economic growth was still under threat. Short-term rates in the euro area tended to stay below the ECB's refinancing rate throughout the year.

In the United Kingdom, money market rates rose early in the year, as can be seen in Chart 1.1, before easing slightly in the second half of the year amid signs of slower economic growth. Notwithstanding the surge in house prices and buoyant consumer spending, the Bank of England left its repo rate unchanged at 4% throughout the year, as inflation edged below the

Chart 1.2
LONG-TERM INTEREST RATES
(monthly averages)



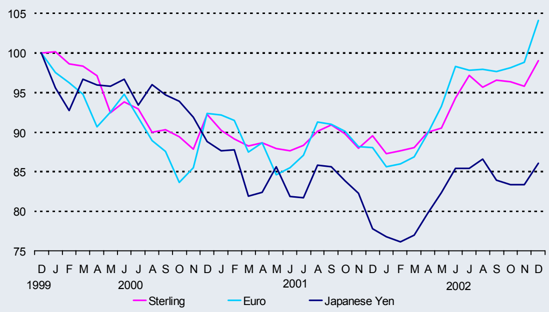
Source: Reuters

Bank's target of 2.5%. Money market rates hovered around the repo rate during the year.

Japanese money market rates fluctuated minimally above zero throughout the year, as Chart 1.1 shows, reflecting the Bank of Japan's zero interest-rate policy within the context of persisting deflationary pressures. In October, the Bank of Japan eased monetary policy by increasing its purchases of long-term government bonds and, hence, providing further liquidity to the banking system.

Long-term interest rates in the major economies fluctuated according to the markets' expectations on economic activity and inflation, as well as movements in short-term rates. Accordingly, long-term interest rates tended to rise during the first half of the year, as the global economy seemed to be on the path of recovery. However, as Chart 1.2 shows, during the second half of the year, long-term interest rates fell as the economic situation in the major economies, particularly the United States and the euro area, deteriorated.

Chart 1.3
EXCHANGE RATE MOVEMENTS OF SELECTED CURRENCIES AGAINST THE US DOLLAR
(index of end-of-month rates, end-1999=100)



Source: Central Bank of Malta

During 2002 the US dollar depreciated by nearly 20% against the euro, as Table 1.2 shows. To a lesser extent, the dollar also lost ground against the pound sterling and the Japanese yen.

The US dollar began the year strongly, extending its gains against the major currencies, particularly the euro and sterling. The Fed's optimism about the outlook of the economy and the markets' perception that a fast US recovery would bolster growth elsewhere, coupled with concerns over Germany's budget deficit and growing imbalances within the British economy, gave further support to the dollar and weakened the euro and sterling. Concurrently, the yen weakened across the board, after the Japanese authorities welcomed a depreciating currency to stimulate exports and fight deflation.

During the second quarter, however, the US currency began to lose ground across the board, amid growing concerns that the United States would only manage to stage a tepid economic recovery, and fears about the extent of American involvement in the Middle East conflict. As Chart 1.3 shows, after mid-June, the dollar weakened further against the major currencies, particularly the yen, as Japanese stocks outperformed US equities. This induced the Japanese central bank to intervene heavily on the foreign exchange markets to moderate the damage of a strong yen on the country's export sector. In July, the dollar fell below parity with the euro and depreciated further against sterling, undermined by a large drop in manufacturing activity and increased scepticism regarding US corporate earnings. Meanwhile, the Japanese currency also strengthened against the dollar, following the decision by the Japanese authorities to end their campaign to halt the rise of the yen.

In August, following positive data about the manufacturing sector and consumer spending, the dollar staged a modest recovery across the board. During September, however, the dollar lost further ground against the euro and sterling, as fresh economic data gave contrasting signals over the health of the United States economy, while concerns over a possible conflict with Iraq increased. Meanwhile, the dollar regained its strength against

Table 1.2
AVERAGE EXCHANGE RATES OF THE EURO, STERLING AND THE YEN AGAINST THE US DOLLAR - 2002

	US$/euro	US$/Stg	Yen/US$
January	0.8840	1.4333	132.57
February	0.8697	1.4227	133.57
March	0.8762	1.4225	131.04
April	0.8852	1.4416	130.90
May	0.9169	1.4602	126.46
June	0.9190	1.4833	123.46
July	0.9934	1.5559	118.03
August	0.9784	1.5386	119.03
September	0.9807	1.5554	120.70
October	0.9814	1.5572	123.92
November	1.0017	1.5716	121.48
December	1.0214	1.5883	121.74
Average for the year	0.9461	1.5037	125.14
Closing rate on 31.12.02	1.0496	1.6110	118.74
Closing rate on 31.12.01	0.8904	1.4541	131.63
High for the year	1.0496 (Dec. 31)	1.6110 (Dec. 31)	134.73 (Jan. 24)
Low for the year	0.8582 (Jan. 31)	1.4093 (Jan. 25)	115.83 (July 16)
Percentage appreciation (+)/depreciation (-) of the currency vs the dollar from closing rate on 31.12.01 to closing rate on 31.12.02	17.9	10.8	9.8

Source: Reuters

the yen, as the Japanese authorities announced radical measures to help combat deflation and sustain their banking sector.

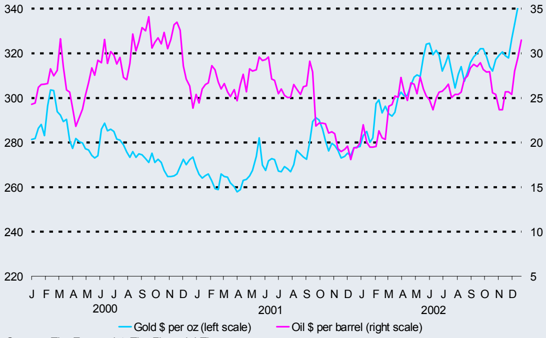
Early in the final quarter of the year, the dollar moved higher against the euro and sterling, helped by stronger US economic data, mounting concerns over the state of the European banking sector, and by the hesitation of the ECB to lower interest rates in support of growth. In November, however, the dollar came under further pressure as the Fed's decision to lower interest rate was seen by investors as a sign that the problems of the US economy were more severe than had been anticipated. Later in the month, the decision by the ECB and the Bank of England to keep their monetary policy stance unchanged further undermined the dollar.

Towards the end of the quarter, the resignation of two senior US government officials, and the weakness of the equity markets sent the dollar to further lows against the euro and sterling. Subsequently, concerns over the ability of the US to attract sufficient inflows to sustain its rising current account deficit, along with a higher unemployment rate and rising tensions over Iraq and North Korea, dragged the dollar even lower.

1.3 Key Commodities

The price of oil rose notably during the first six months of 2002, mainly on account of cold weather in Europe and the United States, and the coming into effect of the OPEC output cut agreed in November 2001. Moreover, rising tensions in the Middle East lent further upside support to oil prices. Whereas oil prices stabilised during the second and third quarters,

Chart 1.4
COMMODITY PRICES



Source: *The Economist, The Financial Times*

towards the end of the year, the upward trend continued after strikes in Venezuela contributed to a shortage in supply and the possibility of a war in Iraq increased. Consequently, oil ended the year at US$31.48 per barrel, up from the US$19.38 that prevailed at the end of 2001[1].

The price of gold increased steadily during 2002, supported by strong demand from investors using the metal as a risk management tool. The deepening mistrust of corporate accounts, a weaker dollar and growing tensions between India and Pakistan and in the Middle East pushed gold prices higher during the first part of 2002. As can be seen in Chart 1.4, this trend was reinforced during the second half of the year by the increase in global economic uncertainty, by geopolitical concerns and by investors' desire to hedge against the risks in the capital markets. As a result, gold ended the year at US$342.50 per ounce, up by 23.3% from the US$277.70 per ounce at which it had ended 2001.

[1] Oil prices refer to Brent oil.

2. Output, Prices and Employment

After having contracted slightly in 2001 as a result of the downturn in the electronics and tourism industries, the Maltese economy began to recover during the year under review. This pick up in economic activity essentially reflected two developments: buoyant domestic demand during the first half of the year, and a rebound in exports, particularly of electronic components, during the second half. The turnover of a large part of the manufacturing sector also continued to increase, buoyed by both foreign and domestic demand. On the other hand, tourism activity continued to decline, although it did so at a significantly slower pace during the third and fourth quarters.

Domestic demand growth slowed down during the second half of the year, with both private and public consumption expanding at a markedly slower pace than in the previous quarters. The deceleration in private consumption may have been due to the fact that, on account of weak labour market conditions, disposable income growth remained moderate. The private sector's intake of workers during 2002 was, in fact, significantly below the levels recorded in recent years and, as a result, the unemployment rate rose slightly. This general absence of demand pressures contributed to a decline in the headline inflation rate, which had risen quite sharply in 2001 as a result of a number of supply-side shocks.

2.1 Aggregate Demand[1]

The Central Bank estimates that real GDP grew by 3.1% in 2002, as against the 0.8% contraction registered in 2001. In 2002 price increases tended to be more moderate than in the previous year, which had been characterised by a sharp rise in inflation.

In the first half of the year, real GDP growth was mainly driven by private and public consumption, whereas in the second half, when domestic demand moderated, growth was sustained by a significant recovery in exports, particularly of electronic components.

2.1.1 Consumption expenditure

As can be seen from Table 2.2, growth in real private consumption expenditure accelerated to 2.3% in 2002, from 1.9% in 2001. This recovery was primarily

Table 2.1
GDP AT CONSTANT 1995 PRICES BY CATEGORY OF EXPENDITURE

Lm millions

	1998	1999	2000	2001	Jan. - Sept. 2001	Jan. - Sept. 2002
Private consumption expenditure	781.5	829.0	892.1	909.0	674.6	694.2
Government consumption expenditure	242.0	240.6	253.6	260.9	191.5	201.5
Gross fixed capital formation	308.5	320.9	376.5	333.4	248.8	236.2
Inventory changes	-9.8	8.6	24.5	-40.8	-44.0	-40.0
Domestic absorption	**1,322.2**	**1,399.1**	**1,546.7**	**1,462.5**	**1,070.9**	**1,091.9**
Exports of goods and services	1,137.1	1,230.7	1,299.9	1,236.5	941.7	924.5
Imports of goods and services	1,167.4	1,285.6	1,420.1	1,284.0	960.9	938.1
Balance of trade in goods and services	**-30.3**	**-54.9**	**-120.2**	**-47.5**	**-19.2**	**-13.6**
GROSS DOMESTIC PRODUCT	**1,291.8**	**1,344.2**	**1,426.5**	**1,415.0**	**1,051.7**	**1,078.4**

Source: National Statistics Office

[1] The GDP data commented upon in this section are Central Bank estimates, which in large part are based on trends shown by official GDP data during the first nine months of the year.

Table 2.2
YEAR-ON-YEAR PERCENTAGE CHANGES IN GDP AT CONSTANT 1995 PRICES

percent

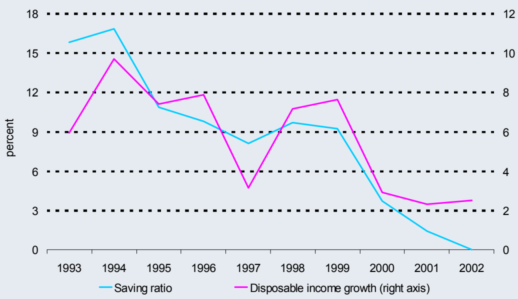
	1998	1999	2000	2001	2002 Central Bank estimates
Private consumption expenditure	2.5	6.1	7.6	1.9	2.3
Government consumption expenditure	-4.0	-0.6	5.4	2.9	4.0
Gross fixed capital formation	-3.4	4.0	17.3	-11.4	-3.6
Domestic Absorption	**2.9**	**5.8**	**10.5**	**-5.4**	**2.0**
Exports of goods and services	8.1	8.2	5.6	-4.8	0.5
Imports of goods and services	2.5	10.1	10.4	-9.6	-0.5
GROSS DOMESTIC PRODUCT	**3.4**	**4.1**	**6.1**	**-0.8**	**3.1**

Source: National Statistics Office, Central Bank estimates

registered during the first six months of the year, when consumption expanded sharply compared with the corresponding period of 2001. In the second half of the year, however, consumption grew at a progressively slower pace. The overall growth in domestic demand, therefore, remained relatively moderate - especially when compared with 1999 and 2000. Expenditure by Maltese tourists abroad continued to decline significantly, while a large part of the reported increase in imports of consumer goods was intended for re-export rather than for domestic consumption. On the other hand, the upward trend in domestic sales by manufacturing industry persisted, even for sub-sectors such as furniture, which did not appear to have been adversely affected by the removal of protective levies.

The rebound in private consumption during the first half of the year proved to be transitory, reflecting the lack of a consistent recovery in disposable income. Though the latter expanded at a slightly faster pace than in 2001, this merely reflected the fact that disposable income growth in that year had been significantly dampened by a sharp drop in non-wage income (i.e. interest, dividends and income from self-employment). While the latter recovered slightly during 2002, and the share of direct taxation out of personal income remained stable, wage income grew at a much slower pace, reflecting both lower employment levels and relatively moderate wage increases. Taken together these factors contributed to a further decline in the household saving ratio, which, as can be seen from Chart 2.1, is now estimated to be close to zero, down from 9.2% in 1999 and over 15% ten years ago. The latest decline in this ratio could be a temporary reaction to the favourable credit conditions prevailing in recent years, with interest rates at historically low levels and banks actively promoting new consumer credit facilities.

Chart 2.1
HOUSEHOLD SAVING RATIO* AND DISPOSABLE INCOME



* Household saving as a percentage of disposable income

Source: National Statistics Office, Economic Policy Division, Central Bank estimates for 2002

To some extent, the acceleration in private consumption during the first half of the year may have been fuelled by a significant increase in Government recurrent expenditure. This occurred in spite of the fact that Government employment remained virtually unchanged from the previous year's level and mainly reflected higher outlays on the part of Government entities.

2.1.2 Gross fixed capital formation

After having contracted substantially during 2001 as a result of the downturn in the electronics industry, investment began to recover during the year under review. Gross fixed capital formation is, in fact, estimated to have increased in nominal terms, on the back of a continued rise in construction activity. The latter, which is commented upon in more detail below, mainly reflected the speeding up of work on the new hospital, though a rise in private sector demand also contributed. Imports of capital goods, in nominal terms, remained stable during the year, in contrast with the 15.8% drop registered in 2001. However, since the price per unit of machinery as usually measured continued to rise, investment is estimated to have contracted in real terms. The rate of capital formation in the manufacturing sector declined slightly, as net investment by the electronics sub-sector was dampened by the prevailing excess capacity, while investment outlays by the rest of manufacturing remained virtually unchanged, with cutbacks in a number of sub-sectors being offset by expansion in the paper and printing, chemicals and furniture sub-sectors.

2.1.3 External demand and supply

As has been explained in the preceding chapter, global demand conditions remained subdued during 2002. Nevertheless, a gradual recovery in Malta's exports of goods and services gathered momentum during the year, mainly reflecting a turnaround in exports by the electronics industry. In fact, whereas the value of exports of electronic components during the first half of the year was 15% below the level for the same period of 2001, in the second half it rose by nearly 10% year-on-year. At the same time, the export performance of the rest of manufacturing industry continued to improve, with turnover rising once again, even if at a slower pace than in 2001. Furthermore, there was a sharp rise in re-exports, which nearly doubled in nominal terms. The decline in tourism activity also tended to moderate gradually as the year progressed, though the fall in earnings persisted.

This modest recovery in export activity was not accompanied by a commensurate increase in imports.

Table 2.3

LABOUR MARKET: MAIN INDICATORS

number of persons

	Sept. 2001	Sept. 2002
Labour supply	145,236	144,460
Males	104,172	103,274
Females	41,064	41,186
Registered unemployed	6,984	7,520
Males	5,770	6,074
Females	1,214	1,446
Unemployment rate (%)	4.8	5.2
Gainfully occupied	138,252	136,940

Source: Employment and Training Corporation

This can be explained by two factors: a reported decline in imports of machinery in real terms and a continued run-down of inventories of industrial supplies by manufacturing firms. This reflected the uncertainty that still prevails with regard to the possibility of a strong recovery in external demand this year, which may be leading firms to be more cautious in their investment and inventory management strategies. In addition, another factor that might be affecting inventory decisions is a (reported) deterioration in Malta's terms of trade, with producers facing higher prices of imported inputs while having to cut the prices of their exports.

2.2 The Labour Market

Data compiled by the Employment and Training Corporation (ETC) indicate that labour market activity contracted during the nine months to September 2002, the latest month for which such data are available. The gainfully occupied population, which is defined by the ETC as the total number of persons registered with the agency as being in full-time employment, declined by 0.4%, whereas during the same period last year there had been a 1% increase. This notwithstanding, registered unemployment rose only marginally during the period. The ETC data, in fact, also show a 0.3% decline in the labour supply, implying that a substantial majority of those who lost their full-time employment chose to remain economically inactive.

Table 2.4
GAINFULLY OCCUPIED BY SECTOR

number of persons

	Sept.					
	2001			2002		
	Public	Private	Total	Public	Private	Total
i. Direct production	**2,960**	**37,855**	**40,815**	**2,814**	**37,849**	**40,663**
including						
Footwear and clothing	0	3,275	3,275	0	2,897	2,897
Construction	135	6,624	6,759	133	6,783	6,916
Electronics, appliances and	0	5,867	5,867	0	5,985	5,985
Food	21	3,034	3,055	19	3,019	3,038
Agriculture[1]	0	2,162	2,162	0	2,200	2,200
Transport equipment[2]	809	1,885	2,694	689	1,884	2,573
Other[3]	1,995	15,008	17,003	1,973	15,081	17,054
ii. Market services	**13,297**	**50,700**	**63,997**	**12,882**	**50,394**	**63,276**
including						
Wholesale and retail	0	15,289	15,289	0	15,429	15,429
Hotel and catering	461	9,501	9,962	455	9,083	9,538
Community and business	4,709	11,053	15,762	5,189	11,398	16,587
Transport	2,476	5,236	7,712	2,393	5,110	7,503
Malta Drydocks	2,689	0	2,689	1,971	0	1,971
Banks and financial institutions	419	3,721	4,140	454	3,579	4,033
Other	2,543	5,900	8,443	2,420	5,795	8,215
iii. Temporarily employed	**254**	**749**	**1,003**	**279**	**766**	**1,045**
including						
Apprentices and trainees	230	749	979	252	766	1,018
Pupil workers	0	0	0	0	0	0
Student workers	24	0	24	27	0	27
iv. Government[4]	**32,437**	**0**	**32,437**	**31,956**	**0**	**31,956**
Gainfully occupied	**48,948**	**89,304**	**138,252**	**47,931**	**89,009**	**136,940**

[1] Includes fishing.
[2] Excluding Malta Drydocks.
[3] Other manufacturing and directly productive industries, including textiles.
[4] Includes Government Departments, Armed Forces, Revenue Security Corps and airport security personnel.

Source: Employment and Training Corporation

The drop in the labour supply, however, came entirely from the male component, as the female labour force continued to grow, albeit at a much slower pace than in previous years. This would seem to confirm that the contraction in the labour supply can for the most part be traced to the successful implementation of early retirement schemes, especially in the shipbuilding and ship repair sectors. The latter, in fact, were mainly responsible for the drop in public sector employment, shown in Table 2.4. During the nine months to September 2002, however, there was also a decline in employment in Government departments, though this mainly reflected a transfer of employees to Government-controlled companies.

The private sector's demand for labour also weakened during 2002. In fact, while full-time employment with this sector increased during the first nine months of the year, it did so by much less than in the corresponding period of 2001. Moreover, the slackening in the rate of private sector job creation was spread across most sectors of economic activity.

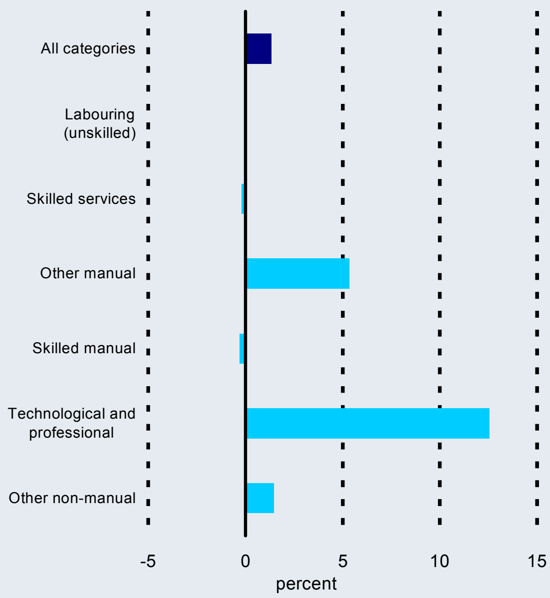
In particular, there was a sharp decline in employment in manufacturing establishments producing textiles, leather and clothing and footwear. Employment in the rest of manufacturing, on the other hand, increased, primarily on account of an intake of workers by the electronics industry. The construction sector also continued to add to its labour complement, although at a slower pace than in 2001. Furthermore, overall employment in the services sector rose, even though some sub-sectors shed labour. As can be seen from Table 2.4, a drop in the number of full-time employees with banks and financial institutions was more than offset by higher employment in the wholesale and retail trades and in the community and business sub-sector. The demand for labour in the tourism sector, however, declined, with hotels and catering establishments employing 4.4% fewer workers in September 2002 than they did in the same month of 2001.

The Labour Force Surveys (LFSs) carried out by the National Statistics Office (NSO) in the course of the year to some extent explain why registered unemployment did not increase in response to the sharp decline in full-time employment. Whereas ETC data only refer to the officially registered full-time employment market, the LFSs also include information on part-time employment, which increased sharply during 2002, especially amongst males. Thus, the drop in full-time employment seems to have resulted in a shift to part-time work rather than to a fall in labour market participation. This explains why, as Chart 2.2 shows, both the activity rate and the employment rate[2] rose from the previous year's level.

Chart 2.2
LABOUR MARKET PARTICIPATION RATES

Source: National Statistics Office

Chart 2.3
CHANGE IN UNEMPLOYMENT BY SKILL CATEGORY IN 2002



Source: Employment and Training Corporation

2.2.1 Unemployment[3]

At the end of December 2002, the number of persons listed on the unemployment register was only slightly above the previous year's level. This end-year position, however, gives little indication of labour market trends during the year.

The number of the registered unemployed, in fact, rose by more than 500 in January, in part reflecting redundancies following the closure of a soft-drinks bottling plant. Subsequently, in line with the seasonal pattern seen in previous years, the number of the registered unemployed declined significantly up to June. This drop was similar to that observed in the corresponding months of 2001, in spite of a significant number of redundancies in the relatively labour-intensive textiles and clothing industry. Subsequently the number of persons on the register increased continuously up to November, nearly reaching 7,900. In December, however, registered unemployment

[2] The employment rate and the activity rate represent the LFSs' gainfully occupied and labour force aggregates, respectively, as a percentage of the working-age population.

[3] This section is based on data from the ETC's unemployment register. These data are available for the period up to December 2002. Hence, they are more up-to-date than the employment data commented upon in the previous section of this chapter.

dropped by 350, so that the number of job seekers at the end of the year was only slightly above the previous year's level.

A breakdown of the unemployed by skill category, presented in Chart 2.3, shows that the main increases were in two categories, the technological and professional and the other manual. In the case of the former, the increase was mainly in the 20-24 age group, and probably reflected the influx of new graduates that had not yet been absorbed by the market by the end of the year. As for the increase in the number of persons seeking manual jobs, this may partly reflect the fact that the construction sector's demand was more restrained than in 2001 together with the above-mentioned redundancies in the textiles and clothing industry. Consequently, at the end of the year, the number of persons seeking unskilled manual employment amounted to nearly two-thirds of the registered unemployed.

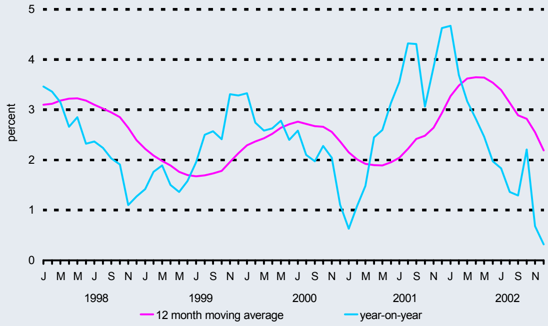
The average duration of unemployment also increased marginally during 2002. Thus, the proportion of the unemployed who had been registering for more than a year amounted to over 40% by the end of December. A breakdown of registered unemployment by age distribution indicates that the majority of new job seekers was in the under 30 years of age category, with a smaller number being in 30-49 age bracket. On the other hand, the number of registrants aged over 50 declined slightly, though it still constituted 14.6% of the total.

2.3 Prices and Wages

2.3.1 Retail prices

The rate of inflation slowed down notably in 2002 after having risen during the preceding year, with the twelve-month moving average measure, the headline rate[4], falling to 2.2% in December from 2.9% a year earlier. Furthermore, over the same period, the year-on-year increase in the Retail Price Index (RPI), which is a more timely indicator of inflationary pressures, dropped from 4.6% to 0.3%.

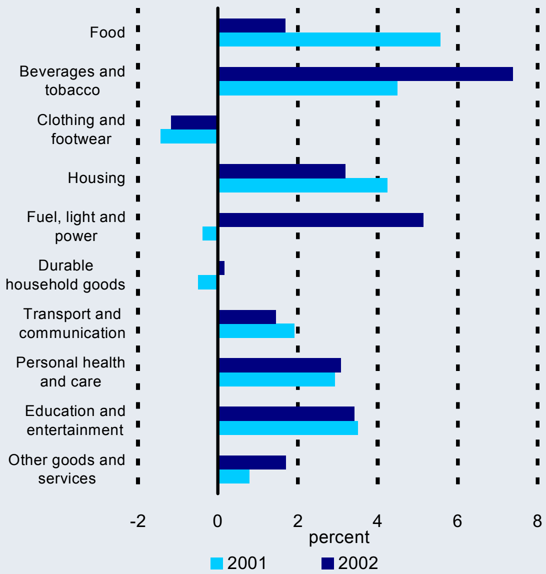
Chart 2.4
RETAIL PRICE INFLATION



Source: National Statistics Office

As with the previous year's rise, the decline in inflation during 2002 was mainly driven by the food sub-index. The latter, which accounts for nearly a third of the overall weight of the RPI basket, had risen steeply during 2001, when a number of supply-side factors had driven food prices sharply upwards. The effects of this factor gradually subsided during 2002. Although the restructuring of the distributive sector that had followed the closure of two major discount stores in 2001 had pushed retail prices upwards, the rise in the price level was of a one-off nature, as the remaining operators quickly adjusted to the new

Chart 2.5
INFLATION RATES OF COMMODITY SECTIONS IN THE RPI *



* Represents the twelve-month moving average change in each sub-index at the end of the year.

Source: National Statistics Office

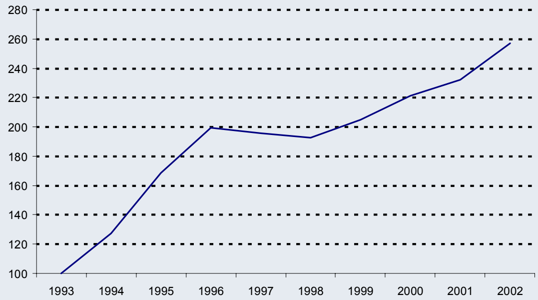
[4] The latter is calculated by comparing the average level of the RPI for a given twelve-month period with the average for the preceding twelve-month period.

business environment. Similarly, last year's spike in the prices of locally-produced fruit and vegetables dissipated during 2002, as, starting from the second quarter, production volumes began to recover. Furthermore, the lowering of tariffs on a number of imported foodstuffs led to a decline in the food sub-index by the end of the year.

As Chart 2.5 shows, the twelve-month moving average inflation rates for most sub-indices of the RPI increased during 2002. In fact, only the clothing and footwear sub-index registered a drop. In some cases, the acceleration in price increases was attributable to fiscal measures, such as the removal of rebates on electricity and water bills (which affected the housing and the fuel, light and power sub-indices) and the increase in the excise duty on cigarettes (which boosted the beverages and tobacco sub-index). Similarly the linking of oil prices to international market prices as from the beginning of the year had a significant impact on the fuel, light and power and the transport and communications sub-indices.

In sum, although the rate of inflation decreased substantially during 2002, this was mainly the result of a decline in food prices. In fact, Central Bank estimates of underlying inflation show a slight increase over 2001. This mainly reflected a sharper rise in the prices of services such as education and entertainment, although a higher rate of imported

Chart 2.6
ADVERTISED REAL ESTATE PRICES
(1993=100)



Source: Local Press, Central Bank estimates

inflation probably also contributed. In fact, imported inflation, which is determined by the interaction of inflation in Malta's trading partners and exchange rate movements, is estimated to have risen slightly during 2002. This is because although inflation in the euro area, Malta's main source of imports, remained relatively stable and low during the year, the Maltese lira lost ground against the appreciating euro. Due to the lack of domestic demand pressures, however, core inflation remained fairly close to that of Malta's main trading partners.

2.3.2 Real estate prices

Real estate prices, as well as the prices of other assets held by households, affect private consumption through the wealth effect. They are also of interest *per se*, because they refer to a large and important market. The Central Bank monitors house price

Table 2.5
ESTIMATED CHANGE IN AVERAGE WAGES[1]

percent

Category	1998	1999	2000	2001	2002
Unskilled	6.3	6.4	3.2	6.2	2.8
Skilled	3.3	5.5	2.7	6.8	2.4
Clerical	3.7	7.5	2.6	8.1	2.6
Administrative[2]	2.0	2.9	2.8	8.7	2.1
Average wage across categories	**4.2**	**6.0**	**2.8**	**7.1**	**2.6**
excluding civil service employees	**5.3**	**7.1**	**3.7**	**5.3**	**2.4**

[1] The Table shows Central Bank estimates based on data drawn from collective agreements and provided by the Department of Employment and Industrial Relations, and on the Schedule of Pay Scales published by the Ministry of Finance. The average wage for each labour category was computed as a weighted mean of the average minimum wage and the average maximum wage.
[2] Refers to middle management and professionals, as the wages of the top managerial grades are not covered by collective agreements.
Source: Department of Employment and Industrial Relations, Ministry of Finance, Central Bank estimates

movements through an index of asking prices, stratified by type and locality. Chart 2.6 illustrates trends in the average asking price of dwellings (including finished terraced houses and flats and maisonettes in shell form) over the ten years to 2002. As can be seen in the Chart, this measure indicates an acceleration of property price inflation in 2002, although this was not as pronounced as the one observed in the mid-nineties. There is some evidence to suggest that this development may have been due to the inflow of funds from abroad in connection with the Investment Registration Scheme[5] combined with the weak performance of the capital market. In this case, property price inflation can be expected to moderate in the future.

2.3.3 Wages

Increases in wages that are not matched by productivity increases can fuel inflationary pressures, especially in sectors where price elasticity of demand is low. In order to gauge wage inflation, therefore, the Central Bank compiles annual estimates of changes in average gross weekly wages broken down by skill category. These estimates, presented in Table 2.5, are derived from collective agreements that are in force during the year under review[6]. Thus they are representative only of the wages of unionised workers, which are not necessarily indicative of developments in the non-unionised sectors of the economy. Furthermore, they exclude overtime pay, production bonuses and any other allowances or income in kind, which also add to labour costs.

The Bank's estimates, which are broadly in line with the results of a similar exercise carried out by the Economic Policy Division of the Ministry for Economic Services, suggest that overall wage inflation moderated significantly during 2002. In fact, average gross wages are estimated to have increased by just 2.6%, compared with 7.1% in 2001. This deceleration partly reflects the fact that in 2001 there had been a major revision in civil service salary pay scales resulting from the collective agreement that had been finalised in 1998. Last year, civil service salaries were increased only by the cost-of-living-adjustment (COLA). Since the latter is based on the social wage, which is close to the minimum wage, it translates into lower percentage rises for higher-paid workers.

The deceleration in wage inflation was also noted in the private sector, where the average increase in gross salaries is estimated to have amounted to around 2.4%, less than half the rise recorded in 2001. In real terms, therefore, the wages of most employees covered by the Central Bank's estimates increased marginally from the previous year's level, as inflation averaged 2.2% during 2002. This in essence reflected the response of private sector firms to weak demand conditions. Public sector firms also seem to have awarded relatively moderate wage increases. National accounts data on employment income, which capture the overall change in remuneration across the entire labour market, also confirm that there has been a deceleration in average wage growth during 2002. As has been described in a previous section of this Chapter, this development translated into moderate growth in disposable income and may also have helped to dampen upward pressures on prices.

2.4 Sectoral Analysis

2.4.1 Manufacturing[7]

During the first nine months of 2002 value added in manufacturing industry increased slightly to Lm242.6 million, from Lm241.9 million a year earlier. This mainly reflected a marginal increase in profits. The latter occurred even though overall turnover in manufacturing declined by Lm20.7 million, or 2.8%, from the previous year's levels. This drop in turnover was solely attributable to a contraction in exports of electronic components during the first six months of the year. Such exports rose sharply during the third quarter, but the significance of the increase must be

[5] The Investment Registration Scheme allowed Maltese residents who had undeclared investments abroad as at September 1, 2001 to regularise their position.

[6] The exercise covers around 23,500 private and public sector employees and approximately 27,000 civil servants. Taken together these comprise more than 40% of the full-time gainfully occupied population.

[7] The analysis in this section is largely based on data compiled by the NSO on the basis of a quarterly survey carried out among 450 manufacturing establishments.

Table 2.6
MANUFACTURING PERFORMANCE - SELECTED INDICATORS[1]

Lm millions

	Jan. - Sept.		
	2000	**2001**	**2002**
Change in exports	**183.9**	**-102.2**	**-29.5**
of which:			
Radio, TV, telecom, etc [2]	183.5	-122.2	-33.3
Others	0.4	20.0	3.8
Change in local sales	**6.1**	**10.4**	**8.9**
of which:			
Food and beverages	1.3	6.0	3.1
Others	4.8	4.4	5.8
Change in net investment	**34.5**	**-28.4**	**-4.0**
of which:			
Radio, TV, telecom, etc [2]	35.8	-30.6	-5.0
Others	-1.3	2.1	1.0

[1] Based on a survey of representative firms conducted by the National Statistics Office.
[2] Mainly comprising firms producing electronic components.
Source: National Statistics Office

interpreted in the light of the fact that the previous year's third quarter performance had been particularly poor.

Though the manufacturing sector's total exports during the nine months to September 2002 were down by Lm30 million, or 5.1%, from the previous year's level, the drop was substantially smaller than the 15% decline reported in the same period a year earlier. The deceleration of the contraction in exports essentially reflected the bottoming out of the cyclical downturn in the international demand for electronic components. At the same time, the export performance of the rest of manufacturing industry remained positive, with turnover rising by 1.7% from the previous year's level. This was well below the 9% increase recorded during the same period of 2001, but the deceleration mainly reflected the previous year's exceptionally large growth in export sales by the electrical machinery sub-sector, which during that year had completed a number of large contracts. The turnover of this sub-sector declined in 2002, although it remained well above the levels of the preceding years. The deceleration could also be traced to the fact that the tobacco, machinery and equipment, and furniture sub-sectors experienced lower export sales compared with the same period of 2001. On the other hand, there was a sharp increase in exports by the food and beverages, printing and publishing, clothing, fabricated metal products, medical and precision equipment and other transport equipment sub-sectors.

Domestic sales of locally-manufactured goods also continued to increase sharply, in spite of the faster pace of the trade liberalisation process. During the nine months to September, in fact, such sales rose by nearly Lm9 million, or 5.5%, from the previous year's level. As can be seen from Table 2.6, a large part of this increase was once again due to the food and beverages sub-sector. Nevertheless, domestically-oriented manufacturers of clothing, printed and published materials, furniture, plastic and rubber and other non-metallic minerals also reported significantly higher turnover. In some cases, such as furniture and food and beverages, however, the increase in local sales may reflect the branching out of manufacturing firms into the importation and distribution of imported products, leading to a drop in the local value-added component of their turnover. A rise of over Lm2 million was also registered in local sales by the communications sub-sector, though this partly reflected the reclassification of certain activities previously included under the electrical machinery category. On the other hand, domestic sales by the tobacco industry, which in previous years had been moving on a significant upward trend, contracted during the first nine months of 2002.

The continued decline in combined foreign and domestic sales of manufactured goods meant that capacity utilisation in manufacturing fell further during 2002. This, together with the uncertainty surrounding the short-term prospects for global demand, probably contributed towards a further contraction in net investment by manufacturing firms during the first nine months of the year, albeit a much smaller one than that registered in the same period last year. The reduction in outlays on plant and machinery was once again mainly attributable to the electronics sub-sector, as investment in the rest of manufacturing industry remained broadly stable. Capital expenditure by the food and beverages, plastic and rubber, electrical machinery, tobacco and medical and precision equipment sub-sectors, which had carried out expansion projects last year, declined, but these reductions were offset by increases in the furniture and chemicals and printing and publishing sub-sectors.

At the end of September 2002, the number of persons employed in the firms surveyed was down by 890 from the previous year's level. The greater part of this drop was attributable to the clothing, leather and textiles sub-sectors, which in recent years have been facing increasing competition from developing countries. However, the drop in employment was not confined to these relatively labour-intensive sub-sectors, as firms across most of manufacturing also reduced their labour complement during 2002. The only exceptions were the radio, television and communications and printing and publishing sub-sectors.

The decline in the demand for labour also left its mark on wages. Growth in average weekly earnings[8] for employees in manufacturing industry, in fact, eased to 4.7% in the first nine months of 2002, from 6% in the previous year. The latest increase, moreover, was largely driven by a substantial rise in wages in the radio, television and communications and the printing and publishing sub-sectors, where increases of 10.2% and 15.1%, respectively, were reported, even though earnings in these sub-sectors were already significantly higher than those prevailing in the rest of manufacturing industry. Wage inflation in most other sub-sectors was relatively moderate during 2002, with average weekly earnings actually declining in some cases.

2.4.2 Tourism

During 2002 the tourism sector experienced a further fall in activity, with arrivals for the ten months to October being down by 5.1% from the level for the corresponding period of 2001[9]. Most of the drop was concentrated in the first six months of the year, however, when the industry was still suffering from the negative effects on air travel of the events of September 11, 2001. More than half of the decline was attributable to the two main source markets, Germany and the UK. The drop in arrivals, in turn, resulted in lower occupancy levels, even though the average tourist's length of stay remained almost unchanged from the previous year. As a result, gross tourism receipts decreased by 7.6%. On a more positive note, cruise passenger arrivals continued to rise, with passengers from Spain and the UK, in particular, increasing sharply. The number of cruise liners visiting the islands rose by 15.2%, as Malta managed to attract a sizeable share of Mediterranean cruise traffic diverted from the Eastern Mediterranean on account of the unrest in the Middle East.

Whereas the overall situation deteriorated, a rise in arrivals from a number of source markets, particularly Italy, Belgium and Russia, was noted. Arrivals from Italy were up by 8.1% from the previous year's level. This rise took place mainly in the summer months and benefited the higher accommodation categories most.

[8] Including overtime pay, bonuses and income in kind.
[9] At the time of writing, official data on tourist arrivals and bed nights sold were available up to October only.

Table 2.7
TOURISM ACTIVITY INDICATORS

	Jan. - Oct.			Percentage change		
	2000	2001	2002	2000	2001	2002
Tourist arrivals	**1,085,773**	**1,070,499**	**1,016,239**	**-0.3**	**-1.4**	**-5.1**
of which:						
UK	376,122	403,229	391,540	0.7	7.2	-2.9
Germany	184,661	147,313	130,383	-2.0	-20.2	-11.5
Rest of Europe	430,309	432,823	415,095	0.5	12.2	9.7
Others	94,681	87,134	79,221	0.5	-0.6	-0.4
Bed nights stayed (millions)	**9.1**	**10.0**	**9.5**	**-13.3**	**10.0**	**-5.1**
Average length of stay (days)	**8.4**	**9.4**	**9.4**	**-11.9**	**11.5**	**0.0**
Earnings (Lm millions)	**232.9**	**227.0**	**209.7**	**-0.3**	**-2.5**	**-7.6**

Source: National Statistics Office.

The increase in Italian arrivals, however, was not large enough to compensate for the drops in arrivals from the UK and Germany. UK arrivals, in fact, were down by 2.9% during the first ten months of 2002, in contrast with the rise recorded during the same period a year earlier. Most of the drop took place in the first five months of the year, after which arrivals from the UK began to recover gradually, to the extent that in October they actually rose. This rebound may have been in response to an intense marketing campaign carried out by the Malta Tourism Authority (MTA), which in 2002 changed its promotion strategy, in that the Tour Operator Support Scheme (TOSS), which had focused on the UK market, was phased out in favour of the allocation of the MTA's entire budget to marketing. This shift in strategy may also have helped to dampen the decline in the number of arrivals from Germany, which fell by 11.5% during the first ten months of 2002, following a 20.2% drop in 2001.

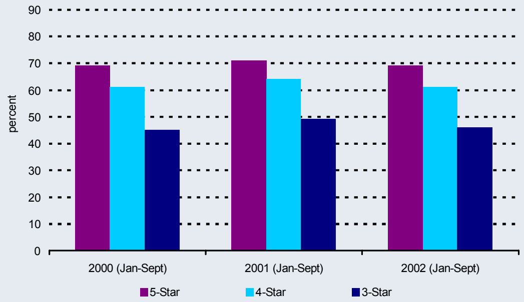
In addition, the tourism industry also suffered significant losses in the Scandinavian, Austrian, Swiss, French, and Dutch markets, while arrivals from Libya continued to decline, falling to half the level recorded in 2000, before the UN sanctions were lifted.

During the ten months to October 2002, the number of bed nights sold by the tourist industry was down by 5.1% from the level for the corresponding period of the previous year. Lower activity was recorded in holiday complexes and in the lower accommodation categories, while a higher turnover was reported by three- and four-star hotels. The latter was probably due to the fact that a major reclassification exercise conducted in 2001 had shifted holiday complexes to comparable hotel categories, increasing the number of three- and four-star hotels at the expense of the lower categories. In fact, as Chart 2.7 shows, occupancy rates[10] in three- and four-star hotels actually dropped during the year. The same occurred in respect of 5-star hotels, where the total number of beds has remained unchanged since 2000.

As has been noted earlier, the greater part of the drop in tourist arrivals took place during the first half of the year. In the second half the decline was less pronounced, and provisional data for the fourth quarter indicate that arrivals had started to recover. The official data for October, for instance, show a 7% year-to-year increase. Furthermore, a survey conducted by the Malta Hotel and Restaurants Association (MHRA) shows that occupancy levels in four-star and five-star hotels increased substantially during the final quarter of 2002, with a further rebound expected in the first quarter of 2003. The latter is expected to benefit five-star

[10] Occupancy rates are calculated as the number of bed nights sold as a proportion of the total available in each accommodation category. Official data were available only up to September.

Chart 2.7
AVERAGE OCCUPANCY RATES IN MAJOR HOTEL CATEGORIES



Source: Ministry for Economic Services; Economic Survey.

accommodation, in particular, on account of the hosting of a number of large conferences. It must be noted, however, that these comparisons are being made with the months immediately following the tragic events of September 11, 2001, and thus changes are being calculated from a very low base.

2.4.3 Construction

During the nine months to September 2002, turnover in the construction industry rose by Lm11.9 million, or 12.1% compared with the same period a year earlier. As can be seen from Table 2.8, this acceleration was primarily fuelled by higher demand from the public sector. In fact, General Government's outlays on construction were 24% higher than in the comparable period of 2001. This was, in turn, largely attributable to the speeding up of work on the Mater Dei hospital. In fact, the Financial Estimates published with the latest Budget Speech indicate that during 2002 the Ministry of Health is expected to have spent Lm27.0 million on this project, up from Lm15.9 million in 2001. Outlays on the construction and upgrading of the road network also increased. At the same time, while expenditure by public authorities and enterprises declined from the year-ago level, it remained quite high relative to the levels recorded in previous years as work on such projects as the construction of the Cirkewwa ferry terminal were still in progress. Private sector construction activity also continued to rise during the first nine months of 2002, albeit at a slower pace than in the corresponding period of 2001. As a result, the share of the private sector in the total turnover of the construction industry declined for the third consecutive year.

The increased demand for construction buoyed factor incomes in the industry, which rose by Lm4.6 million, or 15% compared with the same period last year. More than three-quarters of this increase was employment income, which in part reflected a further growth in the construction industry's demand for labour. Growth in the number of full-time employees in the sector, however, slowed down to nearly half that registered in 2001. By contrast, the increase in average remuneration levels accelerated sharply. These trends may be indicative of the tight labour market conditions that characterise this sector. Demand for construction workers has, in fact, been increasing almost

Table 2.8
CONSTRUCTION ACTIVITY INDICATORS

		Jan. - Sept.	
	2000	2001	2002
Total sales (Lm millions)	**84.2**	**98.1**	**110.0**
of which:			
Private sector	52.4	58.0	61.7
Government enterprises	1.9	3.8	3.4
General Government	29.8	36.3	44.9
Value added (Lm millions)	**27.2**	**30.6**	**35.2**
Share of value added in GDP (%)	2.7	2.9	3.3
Private employment (as at September)	**6,297**	**6,624**	**6,783**
Share in gainfully occupied (%)	4.6	4.8	5.0

Source: National Statistics Office.

continuously since 1999, exacerbating the mismatch between the supply and the demand for skilled workers in the sector, and leading to higher operating costs. Nevertheless, profits in the industry expanded by 10% during the period reviewed, helped by the higher turnover and the recovery in property prices.

2.5 Outlook for 2003

Malta's economic performance is heavily conditioned by developments abroad, especially in the major industrial countries. At the start of 2003 the outlook for these economies remains highly uncertain. Not only did the expected recovery fail to materialise in 2002, but it has once again been postponed, this time to the second half of 2003. In preparing its economic forecast for 2003, therefore, the Central Bank has adopted a cautiously optimistic view about the likely economic developments in the major industrial countries during the year, with the risks being definitely on the downside. The forecast is thus based on the assumption that demand for goods and services in Malta's major trading partners will grow by only 1% during the year. Foreign inflation is assumed at 2%. No attempt is, however, made to assess the possible effects of the international geopolitical situation. A similar approach has been adopted with regard to the domestic political scene. Thus it has been assumed that there will be no economic policy changes arising from the outcome of either the referendum on EU accession or the subsequent general elections. Furthermore, the forecasts are based on the fiscal projections presented in the Budget for 2003 and on the assumption of an unchanged monetary policy.

On this basis, the Central Bank sees the possibility of a continuing improvement in the growth rate, although this will still remain below Malta's economic potential. Unlike last year, however, when growth received a strong boost from domestic private and public consumption, investment, and to a lesser extent exports, should be the main engines of growth in 2003.

The recovery in domestic exports will be partly driven by the electronics industry, where exports were already rising in the second half of 2002 after a year-and-a-half of decline. In fact, the global semiconductor industry is expected to grow by about 10% in 2003, although the industry's profitability is likely to remain under pressure due to falling prices. However, the sector still appears to be operating below full capacity, and given the uncertainties about the timing and strength of the global recovery, it is not expected to undertake much new investment during the year.

Table 2.9
OUTLOOK FOR SELECTED ECONOMIC INDICATORS

percent

	2001	2002	2003
		Central Bank estimates	
GDP growth at constant market prices	(0.8)	3.1	3.1 - 3.7
Growth in GDP components at constant prices			
Private consumption expenditure	1.9	2.3	1.8 - 2.4
Government consumption expenditure	2.9	4.0	0.9 - 1.5
Gross fixed capital formation	(11.4)	(3.6)	3.3 - 3.9
Inventories (% of previous year GDP)	(2.9)	(2.0)	(0.1) - (0.7)
Exports of goods and services	(4.8)	0.5	1.8 - 2.4
Imports of goods and services	(9.6)	(0.5)	2.3 - 2.9
Unemployment rate	5.1	5.5	5.2 - 5.6
Inflation rate	2.9	2.2	1.4 - 1.8
Fiscal borrowing requirement (% of GDP)	5.1	4.6	4.0 - 4.4
External goods and services deficit (% of GDP)	4.5	4.7	5.3 - 5.9

Figures in parentheses are negative.

Meanwhile, the other export-oriented manufacturing sectors, especially the clothing industry, are likely to continue to encounter intense competitive pressures, partly due to excess capacity world-wide but also because of strong competition from Asia, particularly China.

This notwithstanding, export growth in 2003 should not be restricted to the electronics sector. Tourism is also expected to recover gradually following the setback suffered in 2002. Growth in tourism is expected to take hold during the second half of the year, when the global economic recovery should be quite firmly established.

Despite the fact that no new major investment is likely to be undertaken by the electronics industry and that work on the new hospital has reached a very advanced stage, gross fixed capital formation is expected to return to positive growth in 2003. In fact, work on a number of private sector tourism-related projects and further increases in government capital expenditure, particularly on new schools, should help sustain growth in construction investment. Investment in machinery and equipment is also expected to recover, as firms come under increasing pressure to hasten the pace of restructuring in the face of the lowering of protective barriers and greater competition. However, the pick-up in investment is more likely to take hold during the second half of the year when global economic conditions should improve and the issue of Malta's future relations with the EU will have been settled.

The growth rate in domestic private consumption observed in 2002 may ease only marginally in 2003, partly because the underlying thrust of fiscal policy will remain expansionary. Household disposable income should be positively affected by the adjustments to the income tax bands announced in the latest Budget and by an expected marginal reduction in the unemployment rate arising from higher investment and increased export activity. Growth in private consumption will also partly be sustained by a declining trend in the propensity to save and an increase in credit to the personal sector, aided by relatively low interest rates. Government consumption, on the other hand, should grow at a slower pace if the fiscal stance is to be tightened further, especially in the light of the reduction in the effective income tax rate.

Inflation should ease further in 2003 and converge towards the rate of inflation projected for the euro area countries. This is partly expected to arise from lower inflation in the EU countries, Malta's major source markets for imports. Furthermore, despite an expected further appreciation of the euro, especially *vis-à-vis* the US dollar, the increased weight of the European unit in the Maltese lira basket should dampen the adverse effects of this appreciation on import prices. Lower inflation in 2003 should also result from the further dismantling of protective tariffs.

Apart from these effects, wage inflation is expected to remain moderate in 2003 as the projected drop in unemployment will only be marginal. Besides, pressures to maintain competitiveness in the face of increased globalisation and excess capacity are contributing to wage moderation.

Although the Bank's forecast suggests an improvement in economic growth in 2003, this is subject to considerable downside risks in view of the uncertain international geopolitical situation. Tourism is one of the sectors likely to be the most affected. Despite the incipient recovery noted in the fourth quarter of 2002, which may primarily have reflected a base effect, the tourism sector during the first and possibly even the second quarter of 2003 could be adversely affected by a war in Iraq and the attendant heightened risks of terrorism. Thus, the recovery in tourism will largely depend on an early solution to the Iraqi crisis. Such downside risks are not restricted to tourism, but would also impact on manufacturing activity.

3. The Balance of Payments and the Maltese Lira

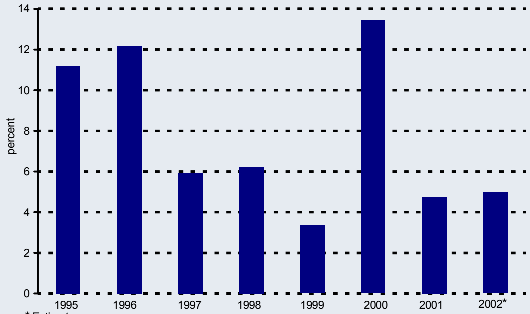
The Balance of Payments

The Maltese economy faced a difficult external environment during 2002. The internationally exposed sectors continued to be adversely affected by the events of September 11, and this negative impact was compounded by a downturn in Malta's main European markets and increased geopolitical uncertainty worldwide. Reflecting these factors, the Central Bank's estimates for 2002[1] show that the current account deficit widened from the previous year's level. At the same time, net inflows on the capital and financial account continued to be recorded, leading to an expansion in the official reserves[2].

3.1 The Current Account

During the nine months to September 2002, the current account deficit narrowed by Lm3.9 million to Lm18.8 million, as can be seen in Table 3.1. This was mainly due to a smaller merchandise trade gap and increased investment income, which outweighed a drop in the surplus on the services account.

Chart 3.1
THE CURRENT ACCOUNT DEFICIT
(as a percent of GDP)



* Estimate

Source : National Statistics Office, Central Bank of Malta

During 2002 as a whole, however, the current account deficit is estimated to have widened from Lm77.3 million to Lm85.4 million. As Chart 3.1 shows, this is equivalent to approximately 5% of GDP, on a par with the previous year's level, but below the level registered in 2000.

This widening was driven mainly by a lower surplus on the services account. In contrast, Customs data available for the full twelve months indicate that the merchandise trade gap narrowed.

Table 3.1
MAIN EXTERNAL BALANCES

Lm millions

	2000		2001		2002	
	Jan.-Sept.	Jan.-Dec.	Jan.-Sept.	Jan.-Dec.	Jan.-Sept.	Jan.-Dec.[1]
Current account balance	-73.8	-209.2	-22.7	-77.3	-18.8	-85.4
Goods balance	-237.8	-331.0	-188.2	-255.9	-165.2	-226.5
Services balance	136.4	163.7	149.2	177.6	114.9	155.1
Income (net)	19.0	-53.1	14.0	-2.5	34.4	-8.0
Current transfers (net)	8.6	11.2	2.4	3.4	-3.0	-6.0
Capital and financial balance [2]	89.1	111.6	70.0	192.7	101.3	205.8
Movements in reserve assets [3,4]	**45.0**	**97.6**	**-47.3**	**-115.3**	**-82.5**	**-120.4**

[1] Central Bank of Malta estimates.
[2] Excludes movements in reserve assets and includes the statistical discrepancy.
[3] A negative sign indicates an increase in reserve assets.
[4] The figure for 2002 excludes revaluation adjustments.
Source: National Statistics Office, Central Bank of Malta

[1] The Bank's estimates for 2002 are based on balance of payments data for the first three quarters of the year and from partial information available on the final quarter.

[2] The capital and financial account excludes movements in reserve assets and includes the statistical discrepancy.

Table 3.2
MERCHANDISE TRADE
(based on Customs data)

Lm millions

	2001	2002[1]	Change
Imports	**1,225.1**	**1,222.3**	**-2.8**
Consumer goods	279.1	297.8	18.7
Industrial supplies	644.9	621.2	-23.7
Capital goods and others	200.4	200.5	0.1
Fuel and lubricants	100.7	102.8	2.1
Exports	**880.6**	**905.4**	**24.8**
Domestic	790.8	777.1	-13.7
Re-exports	89.8	128.3	38.5
Trade balance	**-344.5**	**-316.9**	**-27.6**

[1] Provisional

Source: National Statistics Office

3.1.1 Merchandise trade

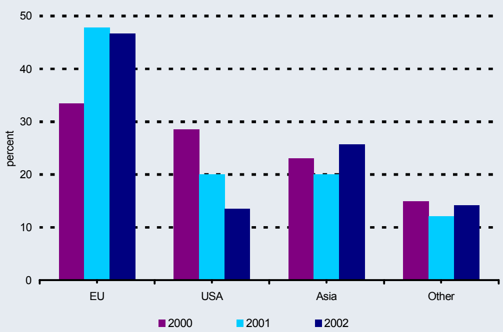
Following the exceptionally large gap recorded in 2000, the deficit on merchandise trade for 2002 narrowed for the second consecutive year. As can be seen from Table 3.2, the negative balance decreased to Lm316.9 million, as exports went up and imports dropped marginally.

Total exports rose by Lm24.8 million, or 2.8%, on account of higher re-exports, which surged by over 40%, with machinery and transport equipment, beverages and tobacco as well as fuels all contributing to the rise. In contrast, domestic exports decreased during the year, probably reflecting lower foreign demand and a fall in export prices during the first three quarters of 2002. However, whereas domestic exports dropped between January and June, they recovered during the second half of the year as exports of machinery and transport equipment, which includes electronics, increased.

Imports decreased by Lm2.8 million, with industrial supplies accounting for the decline. The latter contracted by 3.7%, with the fall being registered in the first quarter of the year. In contrast, imports of consumer goods expanded by 6.7%, with food and beverages, durable goods and 'other' consumer goods all contributing towards the increase. However, a significant proportion of the increase in imports of consumer goods was re-exported.

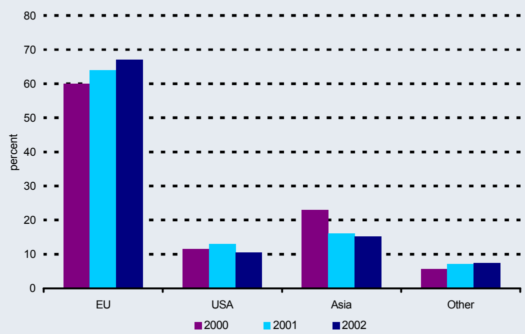
As Chart 3.2 and Chart 3.3 show, the European Union remained Malta's most important trading partner. During 2002, the EU's share of total exports stood at

Chart 3.2
DIRECTION OF TRADE - EXPORTS



Source: National Statistics Office

Chart 3.3
DIRECTION OF TRADE - IMPORTS



Source: National Statistics Office

47%, whilst its share of imports rose by 3 percentage points from the previous year to 67%. The share of total exports to Asia increased from 20% to 26%, probably reflecting developments in the electronics sector. In contrast, the share of total exports to the United States fell by 7 percentage points to 14%.

3.1.2 Balance on services

Net receipts on the services account are estimated to have fallen from the levels recorded in 2001, as net travel earnings, which account for most of these receipts, declined by 8.1% during the first three quarters of the year. Although net travel receipts are estimated to have risen during the final quarter of the year compared to the corresponding quarter of 2001, the increase is unlikely to have outweighed the drop registered in the first nine months of the year.

3.1.3 Income and current transfers

Investment income covers income derived from a resident entity's ownership of foreign financial assets as well as income generated by foreign-owned entities operating in Malta. The most common type is income on equity (dividends) and income on debt (interest). As a result of variations in the profits recorded by foreign-owned entities operating in Malta, which lead to outflows on this account, investment income is characterised by wide fluctuations. During the first three quarters of the year, the surplus on the investment income account widened by Lm20.4 million. However, in line with the usual seasonal pattern, the account is estimated to have recorded a deficit during the final quarter of the year, when company profits are usually booked. Consequently, a small deficit on the investment income account is estimated for 2002.

Meanwhile, the surplus on the current transfers account, which prevailed for the past eight years, is estimated to have swung into a deficit.

3.2 The Capital and Financial Account

Malta's capital and financial account is generally characterised by large fluctuations. As a result of this volatility, no attempt was made to estimate movements for the year as a whole. Therefore, the balance on this account, which is shown in Table 3.1, is taken to include the statistical discrepancy and is calculated as a residual between the estimated current account deficit and the movements in the Central Bank's reserves.

Net inflows on the capital and financial account are estimated to have increased during 2002, in line with the pattern observed during the first three quarters of the year. During the year, inflows on the capital and financial account were boosted by portfolio flows triggered by the Investment Registration Scheme that was launched in January, the sale of equity in Malta International Airport to foreign investors and increased official borrowing from abroad.

The Maltese Lira and External Competitiveness

3.3 The Maltese Lira

The Maltese lira weakened against the euro and strengthened against the US dollar during 2002, reflecting developments in international foreign exchange markets outlined in Chapter 1 of this Report. In fact, the sharp appreciation of the euro against the dollar in the first six months of the year and again in the last three months caused the Maltese lira to depreciate by 4.3% against the euro over the year. Conversely, after having weakened against the dollar during the previous two years, as can be seen from Chart 3.4, the lira gained 3.9% on average against the dollar. At the same time, as Table 3.3 shows, the lira also appreciated sharply against the yen and declined marginally against the pound sterling. The revision to the composition of the Maltese lira basket in August, which raised the share of the euro in the basket, resulted in narrower fluctuations of the

Chart 3.4
EXCHANGE RATE MOVEMENTS OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES
(index of end-of-month rates, end-1999 = 100)

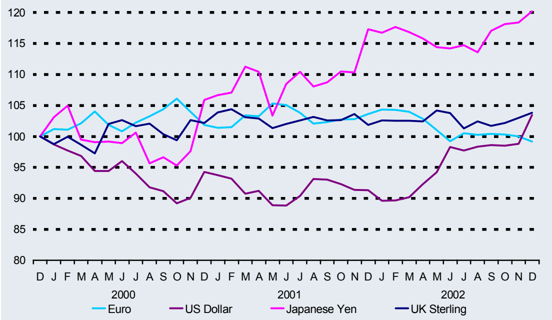


Table 3.3
EXCHANGE RATES OF THE MALTESE LIRA AGAINST SELECTED MAJOR CURRENCIES FOR 2002

	US$	Stg	Yen	Euro
Monthly Averages:				
January	2.2034	1.5381	292.2	2.4953
February	2.1832	1.5345	291.6	2.5096
March	2.1908	1.5403	287.0	2.5009
April	2.2098	1.5324	289.1	2.4955
May	2.2560	1.5455	285.2	2.4607
June	2.3140	1.5594	285.4	2.4216
July	2.3869	1.5345	281.6	2.4035
August	2.3622	1.5364	281.2	2.4154
September	2.3751	1.5270	286.7	2.4214
October	2.3763	1.5256	294.4	2.4219
November	2.4146	1.5362	293.4	2.4117
December	2.4479	1.5437	298.7	2.4039
Average for 2002	2.3100	1.5378	288.9	2.4468
Average for 2001	2.2226	1.5430	270.0	2.4815
% change	3.9	-0.3	7.0	-1.4
Closing rate on 31.12.2002	2.5074	1.5553	297.7	2.3910
Closing rate on 31.12.2001	2.2121	1.5258	290.4	2.4989
% change	13.3	1.94	2.5	-4.3
High for the year	2.5074	1.5704	302.5	2.5222
	(Dec. 31)	(June 10)	(Dec. 05)	(Feb. 01)
Low for the year	2.1627	1.5132	277.6	2.3856
	(Jan. 28)	(July 31)	(July 15)	(July 19)

Source: Central Bank of Malta

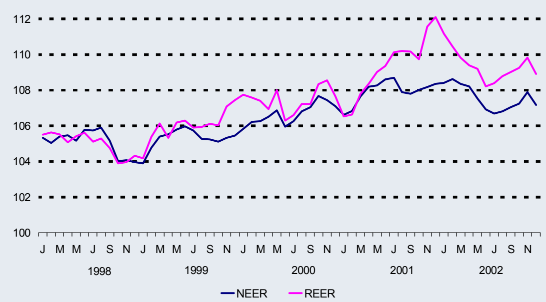
Maltese lira against that currency in the latter part of the year.

3.4 Effective Exchange Rates

Chart 3.5 depicts developments in the Nominal Effective Exchange Rate (NEER)[3] and the Real Effective Exchange Rate (REER)[3] indices for the Maltese lira. After having risen for the previous three years, the NEER index dropped by 1%, reflecting the depreciation of the Maltese lira against the euro. As Chart 3.5 shows, this drop was most pronounced in the first six months of the year, when the lira lost ground rapidly against the European single currency.

Meanwhile, the REER index, which takes into consideration relative inflation rates as well as the exchange rate movements captured in the NEER, fell during 2002. As Chart 3.5 shows, the REER was on a downward trend for most of the year and ended December 2.7% below its level twelve months earlier. The drop in the index can be attributed mainly to the fact that prices rose more slowly in Malta than they did in its main trading partners and competitors.

Chart 3.5
REAL AND NOMINAL EFFECTIVE EXCHANGE RATE INDICES FOR THE MALTESE LIRA
(1995 = 100)

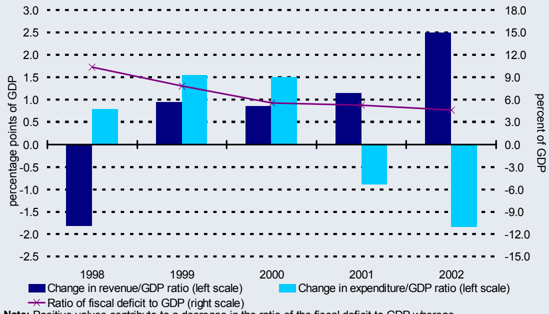


[3] A fall in these indices implies a gain in Malta's external competitiveness while a fall implies a deterioration.

4. Government Finance

The fiscal deficit for 2002 has been provisionally estimated at Lm78.5 million, down by Lm6.8 million from the previous year's level and only marginally above the original projection[1]. The ratio of the deficit to GDP fell to 4.6% from 5.2% in 2001. The shortfall was mainly financed through short-term borrowing and privatisation proceeds, and the year-end ratio of gross Government debt to GDP rose by 0.8 percentage points to 62.8%. Fiscal consolidation is set to remain a key macroeconomic objective in the coming year, with the Government targeting a deficit of Lm74.8 million, or 4.1% of GDP. In particular, the increase in revenue during 2003, though markedly lower than in the preceding year, should outstrip moderate expenditure growth.

Chart 4.1
CONTRIBUTIONS TO CHANGES IN THE RATIO OF THE FISCAL DEFICIT TO GDP



Note: Positive values contribute to a decrease in the ratio of the fiscal deficit to GDP,whereas negative values contribute to an increase.

Source: Ministry of Finance, National Statistics Office, Central Bank of Malta estimates.

4.1 Fiscal Performance in 2002

Developments in public finances during 2002 were characterised by a steep rise in both revenue and expenditure, up by 12% and 9.6%, respectively. Revenue, however, was boosted by two non-recurring items: the payment by Malta International Airport of Lm21 million in taxes and special dividends following the sale of its land to the Government, and some Lm10.5 million in fees connected with the Investment Registration Scheme. On the other hand, more than two-fifths of the increase in Government expenditure was due to the first-time inclusion in the Consolidated Fund account of subsidies that in past years had been accounted for through the Treasury Clearance Fund (TCF). The other major contributory factors behind the overall spending increase were the outlays on the new hospital, those connected with the National Programme for the Adoption of the *Acquis* (NPAA), social security benefits and the early retirement and voluntary resignation schemes offered to shipyard workers.

As Chart 4.1 shows, the fiscal deficit/GDP ratio fell for the fourth consecutive year in 2002 and, indeed, the pace of fiscal consolidation accelerated slightly when compared to the previous year. As the Chart also shows, the improvement in Government's budgetary position was underpinned by the surge in revenue, though the extent of this improvement was dampened by the rise in the spending/GDP ratio.

4.1.1 Revenue

During 2002, revenue expanded by Lm73.1 million, a marked acceleration when compared to the previous year. As Table 4.1 shows, revenue from direct taxation grew by Lm33 million, or 11.6%, which is more than double the rate of growth of nominal GDP. The yield from income tax surged by Lm 27.7 million, driven by a rise in personal incomes, the progressive structure of income tax rates and higher corporate profits, though some Lm5.4 million came from capital gains tax on the above-mentioned sale to the Government of land previously held by MIA. The increase in the yield from social security contributions was less robust, however, mirroring the decline in the number of the gainfully occupied.

Revenue from indirect taxes also recorded strong gains, mainly reflecting higher receipts from licences, taxes and fines. More than a third of this increase, however, reflected the reclassification of the Public Lotto Department's profits, previously treated as non-

[1] The final Government finance data for the year are usually not available before April of the following year.

Table 4.1
GOVERNMENT BUDGETARY OPERATIONS[1]

Lm millions

	2001	2002	2003	Change 2002	Change 2003
REVENUE	**608.9**	**682.0**	**704.2**	**73.1**	**22.2**
Direct tax	**285.7**	**318.7**	**331.5**	**33.0**	**12.8**
Income tax	166.3	194.0	198.8	27.7	4.8
Social security contributions[2]	119.4	124.7	132.7	5.3	8.0
Indirect tax	**248.4**	**278.2**	**288.8**	**29.8**	**10.6**
Value Added Tax	114.7	123.0	131.0	8.3	8.0
Customs and excise tax	60.9	61.6	66.5	0.7	4.9
Licenses, taxes and fines	72.8	93.6	91.3	20.8	-2.3
Total non-tax revenue	**74.8**	**85.1**	**83.9**	**10.3**	**-1.2**
Central Bank profits	25.9	25.7	20.0	-0.2	-5.7
Other revenue[3]	48.9	59.4	63.9	10.5	4.5
TOTAL EXPENDITURE	**694.2**	**760.5**	**779.0**	**66.3**	**18.5**
Recurrent expenditure	**613.6**	**656.9**	**670.8**	**43.3**	**13.9**
Personal emoluments	195.0	197.1	197.8	2.1	0.7
Operational and maintenance	45.3	46.5	44.2	1.2	-2.3
Programmes and initiatives [2]	261.9	278.9	292.2	17.0	13.3
Contributions to Government entities	52.0	69.9	76.2	17.9	6.3
Interest payments	58.7	63.7	59.8	5.0	-3.9
Other	0.7	0.8	0.6	0.1	-0.2
CURRENT BALANCE [4]	**-4.7**	**25.1**	**33.4**	**29.8**	**8.3**
Capital expenditure	**80.6**	**103.6**	**108.2**	**23.0**	**4.6**
PRIMARY BALANCE [5]	**-26.7**	**-14.8**	**-15.0**	**11.9**	**-0.2**
FISCAL BALANCE	**-85.3**	**-78.5**	**-74.8**	**6.8**	**3.7**
FISCAL DEFICIT/GDP (%)	**5.2**	**4.6**	**4.1**		

[1] Data for 2002 and 2003 are revised estimates and estimates, respectively, as shown in the *Financial Estimates 2003* published in November 2002.

[2] Government contributions to the social security account are excluded from both revenue and expenditure.

[3] Excludes proceeds from sale of public assets but includes grants.

[4] Revenue less recurrent expenditure.

[5] Revenue less total expenditure excluding interest payments.

Source: Ministry of Finance

tax income, although duty on documents, boosted by the stamp duty paid by MIA, and oil rental fees also rose sharply. At the same time, revenue from Value Added Tax (VAT) was up by Lm8.3 million, sustained by higher private consumption expenditure, while revenue from customs and excise duties remained virtually unchanged from the previous year's level.

In spite of the reclassification of lotto profits, non-tax income soared by Lm10.3 million. This was on account of the distribution of some Lm11 million in special dividends by MIA and the fees charged under the Investment Registration Scheme on the registration of previously undeclared assets held abroad.

4.1.2 Expenditure

Government expenditure rose by Lm66.3 million during 2002, with higher recurrent and capital spending accounting for 65% and 35% of the overall increase, respectively. In turn, almost a third of the rise in recurrent outlays was attributable to the inclusion for the first time of two major subsidy payments in the

Consolidated Fund, that provided to Malta Drydocks and the one made to the Malta Freeport Corporation.

The Government's wage bill edged up only marginally, reflecting the drop in the number of civil service employees, while increased costs of medical supplies contributed to a Lm1.2 million rise in operational and maintenance expenses. At the same time, programmes and initiatives absorbed an additional Lm17 million, mainly due to increased expenditure associated with the NPAA and higher social security payments as a result of population ageing.

Contributions to Government entities rose by an exceptional Lm17.9 million, though almost four-fifths of the increase mirrored the Malta Drydocks subsidies and Malta Freeport debt servicing costs that had previously been accounted for through the Treasury Clearance Fund. Interest payments, fuelled by the previous year's rise in the Government's long-term indebtedness, rose by Lm5 million, or 8.5%. Meanwhile, additional spending on the construction of the new hospital was responsible for nearly three-fifths of the Lm23 million increase in capital expenditure, with the cost of the voluntary resignation schemes offered to shipyard workers and higher outlays on the road-upgrading programme accounting for the remainder.

4.2 Government Debt and Financing Operations

As can be seen from Table 4.2, the fiscal shortfall for 2002 was mainly financed through an increase in Treasury bills outstanding, the sale of 60% of the Government's shareholding in MIA and the running down of Government deposits with the Central Bank. Transfers from sinking funds of converted loans amounted to Lm13.3 million, though these were largely matched by contributions to sinking funds amounting to Lm11.2 million. The Government also increased its borrowing from foreign sources, which rose by Lm4.7 million, following an agreement reached with the Council of Europe Development Bank on the part-

Table 4.2
GOVERNMENT DEBT AND FINANCING OPERATIONS

Lm millions

	2001	2002
FISCAL BALANCE	**-85.3**	**-78.5**
Financed by [1] *:*		
Increase in MGS outstanding	100.1	0.1
Increase in foreign loans	1.1	4.7
Proceeds from sale of assets	0.0	28.9
Contributions to sinking funds	-11.7	-11.2
Sinking funds of converted loans	22.0	13.3
Increase in Treasury bills outstanding	-13.5	59.3
Decrease in Government deposits	-12.0	24.5
Net cash movements and other funds [2]	-0.7	-41.1
GROSS GOVERNMENT DEBT	**1012.8**	**1,076.9**
Malta Government stocks	812.9	813.0
Treasury bills	159.5	218.8
Foreign loans	40.4	45.1

[1] Negative figures indicate an application of funds, meaning that Government would also have to finance these transactions in addition to the deficit during the year.

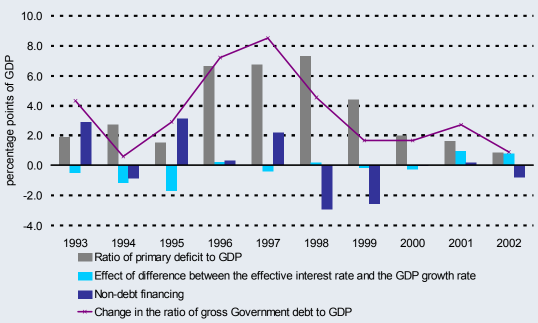
[2] This figure represents the difference between the fiscal balance and the sources of financing utilised during the year. A positive figure indicates a shortfall in financing, while a negative figure indicates overfinancing during the year.

Source: Malta Stock Exchange, Ministry of Finance and Central Bank of Malta financing of the new hospital. New issues of Malta Government stocks (MGS) merely replaced maturing securities, so that the amount of MGS outstanding remained practically unchanged from the previous year's level.

The gross Government debt rose by Lm64.1 million, or 6.3%, to Lm1,076.9 million. The year-end ratio of such debt to GDP stood at 62.8%, up by 0.8 percentage points from the previous year's level. Changes in the debt/GDP ratio can be attributed to three factors: the development in the primary budget balance, the extent to which the effective interest rate[2] exceeds nominal GDP growth, and non-debt financing. A primary deficit exerts upward pressures on the gross debt ratio, whereas, *ceteris paribus*, the debt/GDP ratio is left unchanged if the effective interest rate (i.e. the cost of servicing the debt) is equal to nominal GDP growth. As Chart 4.2 shows, the contribution of the primary deficit to the increase in the gross debt/GDP ratio continued to decline in 2002. On the other hand, the effective interest rate, at 6.3%, exceeded nominal GDP growth for the second consecutive year and this contributed to an increase in the debt/GDP ratio of 0.8 percentage points.

The Government's recourse to the money market for a significant part of its financing needs also altered the composition of the debt. In particular, the share of Treasury bills in the total debt rose to 20.3%, its highest since 1996, whereas the share of MGS fell to 75.5% from 80.3% in 2001. Foreign loans accounted for the remaining 4.2%.

Chart 4.2
CONTRIBUTIONS TO CHANGES IN THE RATIO OF GROSS GOVERNMENT DEBT TO GDP



Source: Ministry of Finance, National Statistics Office, Central Bank of Malta estimates.

4.3 Projected Fiscal Performance in 2003 and Medium-term Outlook

Fiscal operations in 2003 should remain centered on the Government's objective of placing public finances on a more sustainable footing. Fiscal consolidation will mainly be brought about by a sharp slowdown in expenditure growth. Thus, total revenue is projected to rise by Lm22.2 million, or 3.2%, whereas expenditure is expected to increase by just Lm18.5 million, or 2.4%. The previous year's one-off receipts will be mainly replaced by foreign financial assistance, while the latest collective agreement for civil service employees should lead to only a moderate increase in the Government's wage bill.

Receipts from direct taxation are expected to rise by Lm12.8 million, or 4%. While the widening of income tax brackets is expected to cost Government some Lm8 million in foregone revenues, leading to a sharp drop in income tax revenue growth, an anticipated improvement in employment levels should lead to higher receipts by way of social security contributions.

On the other hand, the lower income tax burden should lead to an expansion of private consumption expenditure and contribute to a Lm10.6 million, or 3.8%, increase in indirect tax revenue. In particular, the yield from VAT should rise by Lm8 million, while customs and excise duties, boosted by higher duties on tobacco products, are expected to contribute an additional Lm4.9 million. The removal of levies on imported goods, however, should lower income from licenses, taxes and fines. At the same time, non-tax revenue is expected to be only Lm1.2 million lower than in 2002, as a sharp rise in receipts by way of official grants following the signing of the fifth financial protocol with Italy and through higher EU pre-accession aid should largely compensate for the previous year's one-off receipts and lower Central Bank profits.

On the expenditure side, recurrent outlays are expected to rise by Lm13.9 million, accounting for about three-

[2] The effective interest rate is defined as the ratio of interest payments for the year to the stock of debt at the end of the previous year.

Table 4.3
MEDIUM-TERM FORECASTS OF FISCAL DEVELOPMENTS[1]

Lm millions

	2002	2003	2004	2005
Fiscal deficit	78.5	74.8	68.7	56.6
(as % of GDP)	4.6	4.1	3.6	2.8
Primary deficit	14.8	15.0	1.9	-10.8
(as % of GDP)	0.9	0.8	0.1	-0.5
General Government deficit	89.0	80.7	78.1	68.5
(as % of GDP)	5.2	4.5	4.1	3.4

[1] Figures based on projections made by the Ministry of Finance and published with the 2003 Budget speech.

quarters of the overall spending increase. Personal emoluments are expected to edge upwards by Lm0.7 million when compared to the preceding year, as the cost of the wage increases provided for by the 2002-2004 civil service collective agreement should be partly offset by a drop in the number of government employees. At the same time, operational and maintenance expenditure is projected to fall by Lm2.3 million, on account of anticipated cuts in payments related to the provision of utility services, supplies and contractual services. On the other hand, higher welfare benefits, the costs of the agriculture support scheme and of the public-private partnership initiatives launched in 2002 are expected to push expenditure on programmes and initiatives up by Lm13.3 million.

Meanwhile, contributions to Government entities, driven by an increase in funds channelled to Mount Carmel Hospital, are expected to rise by Lm6.3 million. Similarly, following the previous year's steep increase, capital expenditure should rise by an additional Lm4.6 million, with more financial resources being devoted to improving the country's road infrastructure. On the other hand, the replacement of maturing debt securities with new issues bearing lower interest rates should curtail interest payments.

The Government's medium-term projections on the fiscal deficit, the primary deficit and the General Government deficit are reproduced in Table 4.3. As the Table shows, fiscal consolidation is set to remain one of the key macroeconomic objectives throughout the three-year period to 2005. Furthermore, the Government plans to achieve this through an intensification of expenditure-reducing efforts rather than through additional taxation. The General Government balance, on which European Union fiscal benchmarks are based, is forecast to drop from 5.2% of GDP in 2002 to 3.4% of GDP in 2005.

5. Monetary and Financial Developments

Monetary developments during 2002 mirrored those seen in the previous year as vigorous growth in the net foreign assets of the banking system drove broad money to a record increase, more than offsetting the effect of a further slowdown in credit expansion. The year was also marked by a shift in investor preference towards fixed-interest assets, such as bank deposits and bonds, combined with a recovery in economic activity.

In view of the domestic and global economic and financial developments described in earlier chapters of this Report and the continued increase in its external reserves, the Central Bank of Malta cut official interest rates twice during the year, first in January and again in December. These changes were soon transmitted to the money market, where rates quickly moved lower, while in the capital market Government bond yields eased more gradually. Meanwhile, equities registered their third annual decline, although they recovered slightly towards the end of the year.

5.1 The Monetary Base

The monetary base, M0, is a measure of the Central Bank's monetary liabilities and consists of currency in issue and banks' deposits with the Bank, excluding term deposits. M0 expanded by Lm45.2 million, or 8%, during 2002, compared with 0.6% in the previous year, when a contraction in bank deposits with the Central Bank had restrained growth in this aggregate. As Table 5.1 indicates, these deposits rebounded strongly in 2002, accounting for over half of the increase in M0, with the rest being attributable to an expansion in currency in issue.

Apart from the components of M0, the Table also shows the Central Bank's assets and remaining liabilities, movements in which are the sources of changes in the monetary base. As was the case in 2001, a sizeable expansion in the Bank's foreign assets was the main counterpart to growth in M0, although a fall in Government deposits also had an expansionary effect. On the other hand the Bank regularly absorbed

Table 5.1
THE MONETARY BASE AND ITS SOURCES

Lm millions

	2001	2002	Change
Currency in issue	441.8	461.2	19.4
Banks' deposits with the Central Bank[1]	125.8	151.6	25.8
Monetary base (M0)	**567.6**	**612.8**	**45.2**
Central Bank assets			
Foreign assets	760.4	880.8	120.4
Claims on Government	5.8	4.3	-1.5
Fixed and other assets	61.1	50.8	-10.3
Less:			
Remaining liabilities			
Private sector deposits	1.2	1.5	0.2
Government deposits	69.1	43.0	-26.1
SDR allocations	6.4	6.1	-0.3
Foreign liabilities	0.0	7.0	7.0
Other liabilities	87.9	170.3	82.3
Capital and reserves	95.1	95.3	0.3

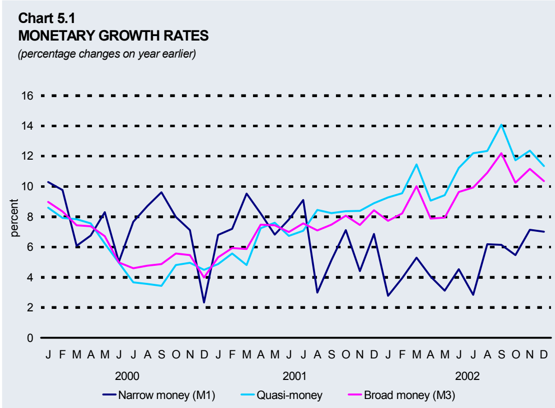
[1] Excluding term deposits, which are shown with "other liabilities".

liquidity from the banking system through the auction of term deposits, which boosted its "other liabilities" and hence dampened M0 growth.

5.2 Monetary Aggregates

Broad money, M3, which consists of currency in circulation and residents' deposits with the banking system, put on Lm285.1 million during 2002, to reach Lm3,038.1 million. Following this record increase the annual growth rate of M3, illustrated in Chart 5.1, climbed to 10.4%, from 8.4% in the previous year. Generally strong increases in M3 during the first nine months of the year pushed the annual growth rate to just over 12% in September, but this eased slightly towards the end of the year when the money supply grew less vigorously.

Foreign currency deposits grew at a faster pace than Maltese lira deposits and accounted for about a fifth of the increase in broad money during the year. When compared with the previous year's strong growth, however, a slowdown in the growth rate of foreign currency deposits is evident. In fact, as Table 5.2 shows, the growth rates of foreign currency demand and savings deposits slowed down sharply, more than making up for an acceleration in the growth of foreign currency time deposits. This is in spite of the



repatriation of funds in connection with the Investment Registration Scheme, that was in effect throughout the year, and a further liberalisation of exchange controls.

Narrow money, M1, which consists of currency in circulation and demand deposits, added Lm44.6 million, or 7%, to reach Lm680.1 million during the year. Although the annual growth rate of M1 at the end of December was similar to the previous year's, it tended to fluctuate widely on a monthly basis, as Chart 5.1 shows.

Currency in circulation, which amounts to just under two-thirds of narrow money, rose by Lm17.9 million, or 4.3% during the year, compared with an increase of

Table 5.2
MONETARY AGGREGATES

Lm millions

	2000		2001		2002	
	Amount	% Change	Amount	% Change	Amount	% Change
Broad money (M3)	**2,538.9**	**4.0**	**2,753.0**	**8.4**	**3,038.1**	**10.4**
of which:						
Narrow money (M1)	**594.7**	**2.3**	**635.5**	**6.9**	**680.1**	**7.0**
Currency in circulation	396.3	3.0	418.9	5.7	436.8	4.3
Demand deposits	198.4	0.9	216.6	9.2	243.3	12.3
Quasi-money	**1,944.2**	**4.5**	**2,117.5**	**8.9**	**2,358.0**	**11.4**
Savings deposits	629.4	-1.3	671.4	6.7	712.8	6.2
Time deposits	1,314.8	7.5	1,446.0	10.0	1,645.2	13.8
Foreign currency deposits	**224.8**	**8.8**	**285.6**	**27.1**	**341.4**	**19.5**
Demand	9.5	-9.5	14.3	50.7	19.2	34.4
Savings	123.1	0.4	153.2	24.5	160.2	4.5
Time	92.2	25.4	118.1	28.1	162.0	37.2

5.7% in the previous year. A seasonal decline occurred in January, but this was followed by a robust recovery in the following six months. Towards the end of the year, however, the demand for cash declined notably, with currency held outside the banking system increasing by an unusually small amount even in December.

Most of the fluctuations in M1 can be explained by changes in demand deposits, which grew by Lm26.7, or 12.3%, to Lm243.3 million during the year. Corporate demand deposits, which had hardly changed in the previous year, expanded by Lm18.7 million, accounting for most of the rise in such deposits.[1] Personal balances grew by roughly half this amount, representing a slowdown from the previous year's growth rate. This could reflect a shift from personal to corporate deposit accounts, which may have been related to the substantial amount of corporate bonds issued during the year. Meanwhile, deposits belonging to public sector enterprises also rose, following a contraction in the previous year.

Quasi-money was once again the main factor behind broad money growth during the year, putting on Lm240.5 million, which in absolute terms was the largest annual increase on record. This followed on strong growth in 2001, reflecting to some extent a continued preference among investors for safe and relatively liquid assets. At the same time, the buoyant dynamics of quasi-money may also be explained by the lower interest rates being offered on bonds combined with the general decline in global stock markets, which together reduced the opportunity cost of holding money. Thus, the annual growth rate of quasi-money accelerated to 11.4%, from 8.9% in 2001.

As for the components of quasi-money, time deposits rose by an unprecedented Lm199.1 million, or 13.8%, during the year, with the sharp increase in foreign currency time deposits shown in Table 5.2, most of which was attributable to the personal sector, contributing substantially to this rise. Personal time deposits increased by Lm139.1 million, with deposits having a term to maturity of two years or less, particularly those with a one-year term, registering the largest increase. Strong growth was also recorded in corporate balances, which put on Lm51.3 million, or 38.1%. Meanwhile, deposits belonging to public sector enterprises recovered strongly from the previous year's decline, with aggregate balances more than doubling to Lm43.4 million.

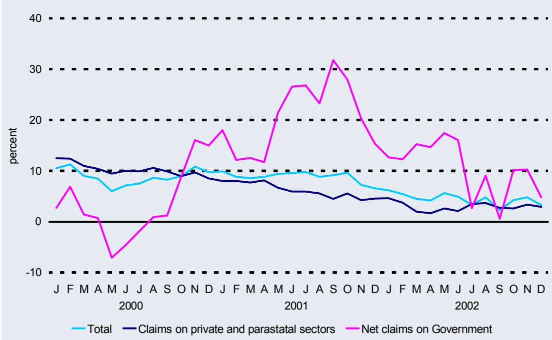
Savings deposits expanded by Lm41.3 million, or 6.2% during the year under review, broadly matching the previous year's growth. A sharp rise in personal balances, which added Lm42.8 million, accounted for most of the increase. Corporate deposits, on the other hand, advanced by only Lm6.8 million, or 6%, compared with the 26.7% growth recorded in the previous year.

5.3 Counterparts to Monetary Growth

Monetary expansion during 2002 was driven mainly by strong growth in the net foreign assets of the banking system, which, as Table 5.3 indicates, accounted for three-quarters of the total increase in broad money. Whereas domestic credit had been the main counterpart to monetary growth over the previous five years, its contribution declined sharply in 2002, mainly reflecting slower growth in lending to the private and parastatal sectors. The impact of changes in "other items (net)" on monetary expansion declined further, with a slight increase in such items exerting a mild dampening effect.

During 2002 domestic credit grew at a significantly slow rate, adding just Lm77.1 million, or 3.3%, compared with 6.6% the previous year. This was due

Chart 5.2
DOMESTIC CREDIT
(percentage changes on year earlier)



[1] The breakdown of deposits by term to maturity and by category of owner refers to deposits held with the deposit money banks only.

Table 5.3
BROAD MONEY AND ITS COUNTERPARTS

Lm millions

	2000	2001	2002
Broad money (M3)	**2,538.9**	**2,753.0**	**3,038.1**
Domestic credit	**2,184.2**	**2,328.3**	**2,405.4**
Net claims on Government	411.8	475.1	498.0
Claims on private and parastatal sectors	1,772.4	1,853.2	1,907.5
Net foreign assets	**970.8**	**1,083.5**	**1,297.1**
Central Bank	640.5	760.4	873.9
Banks	330.3	323.1	423.2
less:			
Other items (net)	**616.1**	**658.9**	**664.4**
COUNTERPARTS TO MONETARY GROWTH[1]			
Domestic credit	**7.9**	**5.7**	**2.8**
Net claims on Government	2.2	2.5	0.8
Claims on private & parastatal sectors	5.7	3.2	2.0
Net foreign assets	**0.1**	**4.4**	**7.8**
Central Bank	-4.1	4.7	4.1
Banks	4.2	-0.3	3.6
less:			
Other items (net)	**4.0**	**1.7**	**0.2**
Broad money (M3)	**4.0**	**8.4**	**10.4**

[1] Changes are shown as a percentage of broad money in the previous period.

to a further deceleration in credit to the private and parastatal sectors, as Chart 5.2 illustrates. As the Chart also shows, however, net claims on Government, which account for roughly one-fifth of total credit, also decelerated sharply during the year under review.

In contrast with the previous year, when the Government raised around Lm100 million in long-term debt, in 2002 the Government relied exclusively on issues of short-term debt securities to finance its additional funding requirements. Banks increased their holdings of Treasury bills by about Lm20 million in the course of the year, but they reduced their holdings of Government stock by roughly the same amount. Hence, their net claims on Government remained largely unchanged over the period. Meanwhile, Government deposits with the Central Bank contracted by Lm26.1 million, accounting for the entire increase in the banking system's net claims on Government.

Growth in claims on the private and parastatal sectors continued to decelerate steadily, dropping to just 2.9% in 2002. In absolute terms, claims on the private and parastatal sectors advanced by Lm54.3 million to Lm1,907.5 million, with the increase being divided more or less equally between the two sectors, as Table 5.4 indicates. These claims grew at a slower pace despite lower interest rates, reflecting to some extent a surge in debt securities issued by the private sector which allowed some firms to repay outstanding bank loans. Banks may also have adopted stricter lending policies, especially in the light of loan write-offs, further contributing to the decline in credit growth.

At the end of the year loans and advances (including bills discounted) represented around 95% of outstanding bank claims on the private and parastatal sectors, with the remainder consisting of bank holdings of corporate debt and equity. Bank loans and advances expanded at an annual rate of 2.8% during 2002, down from 4.7% in the previous year, reflecting a drop in the growth rates of loans to some of the largest sectors. Underlying this development, however, was a broad slowdown in lending to the private sector, which was only partly offset by increased lending to public sector entities.

In fact, claims on the private sector expanded by only 1.7%, less than half the previous year's growth rate. A large drop in loans and advances to the "all other" category, following a re-classification exercise undertaken by one bank, was a major reason for this slowdown, as Table 5.4 suggests. Furthermore, the manufacturing sector repaid bank loans during the year, while personal borrowing expanded less rapidly, adding almost Lm60 million, roughly Lm10 million less than in the previous year. However the growth rate of credit to the personal sector remained relatively high, buoyed by robust demand for loans to finance housing.

On the other hand borrowing by the hotel, restaurant and tourist trades was higher than in 2001, despite the issue of bonds by a number of firms in this sector. Loans and advances to the transport, storage and communication sector also grew at a faster pace. Meanwhile, the growth rate of claims on the parastatal sector accelerated to 10.1%, mainly reflecting unusually heavy borrowing by one particular public entity.

Following a significant expansion during 2001, the net foreign assets of the banking system extended their upward trend during the year under review, climbing by Lm213.5 million to Lm1,297.1 million. In contrast with the previous year, when the Central Bank accounted for all the increase, a recovery in the rest

Table 5.4

CLAIMS ON PRIVATE AND PARASTATAL SECTORS [1]

Lm millions

	2001			2002		
	Amount	Annual Growth (%)		Amount	Annual Growth (%)	
Claims on the private sector	1,587.1	4.1		1,614.5	1.7	
Claims on the parastatal sector	266.1	7.3		293.0	10.1	
TOTAL	**1,853.2**	**4.6**		**1,907.5**	**2.9**	
LOANS AND ADVANCES	Amount	Annual Growth (%)	Share of Total (%)	Amount	Annual Growth (%)	Share of Total (%)
Energy and water	95.2	-5.8	5.4	93.6	-1.7	5.2
Agriculture and fisheries	10.4	-45.5	0.6	10.3	-0.5	0.6
Manufacturing, shiprepair/building	204.3	-4.0	11.6	192.3	-5.9	10.6
Building and construction	85.2	-13.5	4.8	91.2	7.0	5.0
Hotel, restaurant and tourist trades	245.7	2.7	13.9	255.0	3.8	14.0
Wholesale and retail	300.0	2.7	17.0	298.1	-0.6	16.4
Personal	462.5	17.6	26.2	522.4	13.0	28.8
Transport, storage and communications	107.5	8.9	6.1	133.6	24.3	7.4
Other services	75.9	14.7	4.3	82.1	8.2	4.5
All other	180.7	8.8	10.2	138.2	-23.5	7.6
TOTAL LOANS AND ADVANCES [2]	**1,767.5**	**4.7**	**100.0**	**1,817.0**	**2.8**	**100.0**

[1] Claims on the private and parastatal sectors consist of loans and advances (including bills discounted) and holdings of securities, including equities, issued by the private sector and public non-financial corporations. Interbank claims are excluded.

[2] Includes lending by international banking institutions licensed under the MFSC Act 1994, for which no sectoral distribution is available.

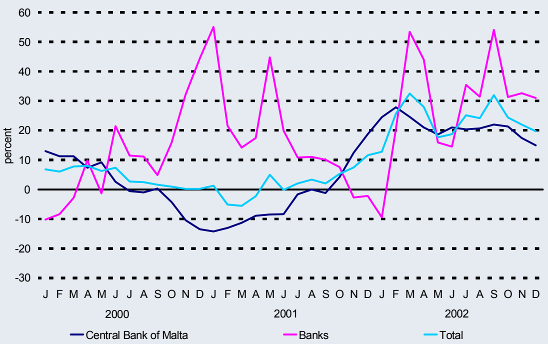
of the banking system's net foreign assets made a significant contribution during 2002, as Table 5.3 reveals.

The strong capital inflows recorded during 2001 persisted throughout the year under review, as general economic and political uncertainty abroad and the interest differential in favour of the Maltese lira shifted investor demand towards domestic assets. Furthermore, some investors took the opportunity to repatriate their holdings of foreign assets under the Investment Registration Scheme. These factors, combined with a gradual build-up in the banks' foreign portfolios, drove the net foreign assets of the banking system higher, with the annual growth rate climbing to 19.7% from 11.6% a year earlier, as Chart 5.3 shows.

The Central Bank's net foreign assets added a further Lm113.4 million, or 14.9%, during the year to reach Lm873.9 million, which represents a slowdown from the 18.7% growth registered during 2001. Once again, the Bank boosted its reserves mainly through purchases of foreign exchange from the rest of the banking system.

Whereas the net foreign assets of the remainder of the banking system declined during 2001, they rose sharply during the year under review, putting on Lm100.1 million, or 31%, to reach Lm 423.2 million. The net foreign assets of the deposit money banks

Chart 5.3
NET FOREIGN ASSETS
(percentage changes on year earlier)



expanded strongly, reversing the sharp drop experienced in the previous year, while those belonging to the international banks grew at a slower rate. As explained in the following chapter, the domestic banks steadily built up their foreign asset portfolios during the year, reflecting to some extent the substantial rise in foreign currency deposits referred to earlier. Besides, the domestic banks regularly dealt in large amounts of foreign currency with corporate clients, which explains the volatility in the annual growth rate of the rest of the banking system's net foreign assets depicted in Chart 5.3.

Other items (net) dampened monetary growth to a lesser extent than in recent years, growing by just Lm5.5 million, or 0.8%, during 2002[2]. Contributing to this was an increase in most of the international banks' profits, which boosted their other liabilities, combined with a drop in their other assets. Meanwhile, a contraction in their capital was offset by an increase in that of the deposit money banks.

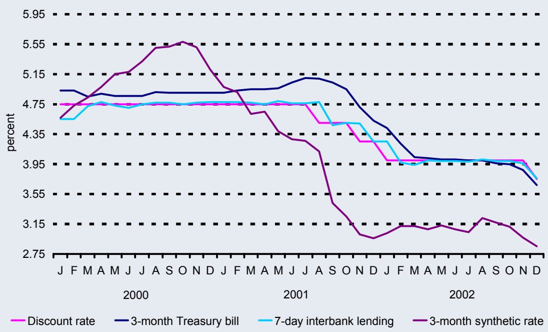
5.4 The Money Market

Securities with a term to maturity of less than one year are traded in the money market. The Central Bank operates in the money market to absorb or inject liquidity from or into the banking system, thereby influencing short-term interest rates. The Bank's open market operations are discussed elsewhere in this Report.

The Central Bank eased its monetary policy stance further during 2002, lowering interest rates on two occasions. Thus, in late January both the central intervention rate and the discount rate were reduced by 25 basis points to 4%, and this was followed by a similar cut in December. As a result, official interest rates ended the year at 3.75%. Yields on other domestic money market instruments reacted swiftly to these changes, as Chart 5.4 shows, ending the year generally lower.

[2] Other items (net) consist of the non-monetary liabilities of the banking system, such as debt securities issued and accrued interest payable, together with capital and reserves, less the banking system's other assets, including fixed assets and accrued interest receivable.

Chart 5.4
MONEY MARKET INTEREST RATES
(end of month)



In the interbank market, the interest rate charged on one week lending fell to 3.76% in December 2002 from 4.25% a year earlier.[3] Trading continued to be dominated by a few participants, with turnover falling to Lm98.1 million, or less than half the previous year's value. This reflects the high levels of liquidity that characterised the banking system throughout the year, as well as the small size of the market. Most interbank loans had terms to maturity ranging from seven to fourteen days, which contrasts with the previous year when the majority of transactions had a term to maturity of one week or less.

The Treasury made more extensive use of short-term debt to finance its operations, issuing Lm720.3 million worth of Treasury bills during 2002, compared with Lm477.7 million during 2001.[4] Over four-fifths of the bills issued had a term to maturity of three months, with the rest having maturities of between one month and one year from the date of issue. Banks subscribed to just over three-quarters of the Treasury bills issued, while other investors, including Malta Government Sinking Funds, took up the remainder. On several occasions, the Treasury conducted fixed-rate auctions of bills, taking advantage of excess liquidity in the banking system and lower interest rates to reduce its borrowing costs. In fact, the primary market three-month Treasury bill yield, shown in Chart 5.4, fell to 3.7% in December, from 4.5% a year earlier.

In spite of the increased activity on the primary market, turnover in the secondary market for Treasury bills, at Lm123.6 million, was Lm30.3 million lower than that

Table 5.5
ISSUES OF LONG-TERM DEBT SECURITIES [1]

Lm millions

	2000	2001	2002
Government			
Total issues	87.0	153.9 [2]	66.7 [3]
Redemptions	86.5	53.8	66.5
Net issues	0.5	100.1	0.2
Corporate			
Total issues	65.3	4.5	50.5
Redemptions	-	30.0	3.0
Net issues	65.3	-25.5	47.5
Total net issues	**65.8**	**74.6**	**47.7**

[1] Includes public issues of debt securities by residents in Maltese liri and foreign currencies, with the spot rate at time of issue used for conversion of foreign currencies to Lm. Banks and State-owned enterprises are included with corporate issuers. Long-term securities are those with an original term to maturity exceeding one year, and include preference shares.

[2] Includes Lm125,000 worth of stocks that were issued directly to the Foundation for Church Schools through Legal Notice 154 in June.

[3] Includes Lm176,200 worth of stocks that were issued directly to the Foundation for Church Schools through Legal Notice 118 in June.

Sources: Central Bank of Malta, The Treasury

[3] Since September 2002, when no interbank deals for a particular maturity take place during a month, the official fixed rate is quoted instead.

[4] The Treasury also bought back Lm15.9 million of the total amount issued during the year.

recorded in the previous year. Trading involving the Central Bank fell by almost a third, to Lm53 million, while deals not involving the Bank also declined. In the latter category, banks were net purchasers, dealing mainly with local investment funds, including Malta Government Sinking Funds. Yields in the secondary market followed those in the primary market downwards.

Chart 5.4 also shows the synthetic three-month yield, which is a weighted average of money market yields on the three currencies that make up the Maltese lira basket. After falling sharply in the previous year, the synthetic rate levelled out during 2002, ending the year just 11 basis points lower, at 2.85%. Since domestic yields declined by a larger amount, the gap between the domestic three-month Treasury bill yield and the synthetic yield narrowed during the year.

5.5 The Capital Market

Net public issues of long-term debt securities amounted to Lm47.7 million during 2002, and were practically all private corporate bonds, as net Government issues remained relatively unchanged. The rebound in private sector bond issues, indicated by Table 5.5, should be seen against the background of lower interest rates and a recovery in economic growth, although firms might also have resorted to the capital market for financing in response to tighter lending policies by banks.

As set out in the indicative calendar for Government securities early in the year, all new issues of Government debt, which totalled Lm66.7 million, were intended to roll over maturing debt. Stocks were issued in April, June and September, with terms to maturity of between five and thirteen years. The coupon rates offered were somewhat lower than in the previous year, ranging from 5.6% on bonds maturing in 2007 to 5.9% on stock maturing in 2015. Banks took up a quarter of the total amount issued, with the rest being allocated to the non-bank public, including households, insurance companies and collective investment schemes - reflecting the growing importance of these sectors as holders of Government debt.

In 2002 net corporate bond issues of Lm47.5 million were made, as against net redemptions of Lm25.5 million in the previous year. Eight firms from various industrial sectors, notably tourism, manufacturing and retail, issued bonds that in most cases were subsequently listed on the Malta Stock Exchange. The majority of these issues received a favourable reception from investors, so that many companies exercised their over-allotment option to increase their offerings. Meanwhile, one firm redeemed Lm3 million worth of preference shares.

Turnover in the secondary market for Government bonds declined sharply to Lm44.8 million, which is about a third of that recorded in 2001, as Table 5.6 indicates. Central Bank participation was minimal, so that most deals were between other investors. In a somewhat illiquid market, where trading in a narrow range of securities accounted for a substantial amount of total volume, investors tended to prefer the longer end of the market. Despite the many new listings referred to earlier, the value of corporate bonds,

Table 5.6

SECONDARY MARKET TRADING IN GOVERNMENT STOCKS

Lm millions

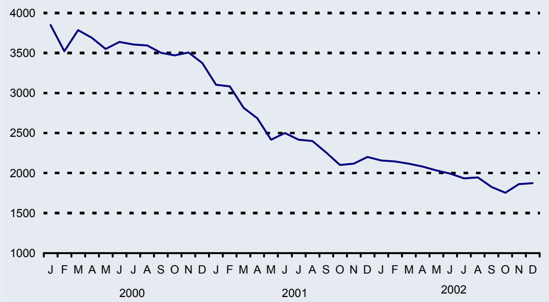
	2000	2001	2002
Central Bank purchases	7.7	10.3	0.2
Central Bank sales	4.2	8.8	0.9
Other deals[1]	49.4	114.4	43.7
Total	**61.2**	**133.5**	**44.8**

[1] Including deals effected by the Central Bank's broker on behalf of Government Sinking Funds, the Maltese Episcopal Conference and the Malta Stock Exchange.

Sources: Central Bank of Malta, Malta Stock Exchange

Chart 5.5
GOVERNMENT BOND YIELDS
(end of month)

Chart 5.6
MALTA STOCK EXCHANGE SHARE INDEX
(end of month)



Source: Malta Stock Exchange

including preference shares, traded on the secondary market fell to Lm10.3 million in 2002, from Lm15.1 million in the previous year.

Yields on Government bonds traded in the secondary market fell to their lowest level in almost a decade during 2002, as strong demand drove prices higher. The benchmark rate for the 5-year bond rose during the first quarter but declined thereafter, ending the year 25 basis points lower, at 5.15%. Other benchmark rates, illustrated in Chart 5.5, also declined, as cuts in money market rates were slowly transmitted to the capital market. Bond yields might also have been influenced by the persistent weakness of the stock market, which would have switched investors' attention towards less volatile Government securities. Meanwhile, corporate bond yields also ended the year generally lower.

Only one company, namely Malta International Airport (MIA), was admitted to the official list of the Malta Stock Exchange during 2002. Shares in MIA started trading during the last quarter of the year, following a two-stage privatisation process whereby the Government sold shares to the general public as well as to a private investor. Other companies already listed on the Exchange raised finance through rights issues that subsequently increased their issued share capital. Secondary market trading on the Exchange involved a broad range of equities, but the value of turnover remained broadly unchanged from the previous year's level, at Lm20.5 million.

Equity prices declined for the third consecutive year, with the Malta Stock Exchange Share Index, depicted in Chart 5.6, shedding 15% to end the year at 1871. Prices fell throughout most of the year, although a sharp rebound in November extended into December, offering some respite in an otherwise bleak year for investors.

6. The Banking System

During 2002 the banking scene was marked by a further drop in the number of offshore banks operating under the special regime and the concurrent alignment of the country's financial legislation with international standards. In this regard, the business of HSBC Overseas (Malta) Limited was integrated into that of its parent bank, following the expiry of its offshore licence in November. The Malta Financial Services Authority also approved the conversion of the offshore banking licence held by Volksbank Malta Limited into a licence to operate as a credit institution under the Banking Act, 1994.

The deposit money banks' aggregate balance sheet expanded markedly in 2002, driven by the integration of Volksbank into the sector and savers' continued preference for bank deposits instead of riskier financial products. On the other hand, the underlying slowdown in bank credit persisted, amid signs of growing financial disintermediation, with corporate borrowers issuing debt securities to raise long-term funds and repay bank loans. Consequently, the banks sought investment opportunities overseas and augmented their term deposits with the Central Bank. The banks continued to strengthen their capital base, while their overall liquidity position remained healthy. At the same time, the deposit money banks reported an increase in pre-tax profits for 2002 on account of an improvement in their net interest income and lower provisioning charges.

6.1 Deposit Money Banks' Balance Sheet

As Table 6.1 shows, the deposit money banks' aggregate balance sheet grew by Lm662.8 million, or 18.1%, to Lm4,333.4 million, the largest percentage increase since 1995. Most of this expansion took place in the final quarter of the year, when Volksbank was incorporated into the sector. In contrast, HSBC's absorption of its international banking subsidiary had no effect on the size of the aggregate balance sheet. This is because, as a result of the takeover, HSBC Malta cancelled its liabilities to its subsidiary and assumed the latter's deposit liabilities instead.

Table 6.1
DEPOSIT MONEY BANKS' BALANCE SHEET

Lm millions

	2001	2002	Change
ASSETS			
Cash and deposits with the Central Bank of Malta	180.3	294.8	114.5
Foreign assets	791.8	1,299.4	507.6
Loans and advances	1,866.4	1,899.2	32.8
Local investments	663.0	667.1	4.1
Fixed and other assets	169.0	173.0	4.0
LIABILITIES			
Capital and reserves	190.9	272.8	81.9
Foreign liabilities	601.0	1,038.4	437.4
Other domestic liabilities	566.2	414.6	-151.6
Deposits	2,312.5	2,607.6	295.1
Time	1,432.3	1,648.3	216.0
Savings	667.3	714.1	46.8
Demand	212.9	245.2	32.3
AGGREGATE BALANCE SHEET	**3,670.6**	**4,333.4**	**662.8**

Chart 6.1
EFFECTS OF INSTITUTIONAL CHANGES ON DEPOSIT MONEY BANKS' AGGREGATE BALANCE SHEET

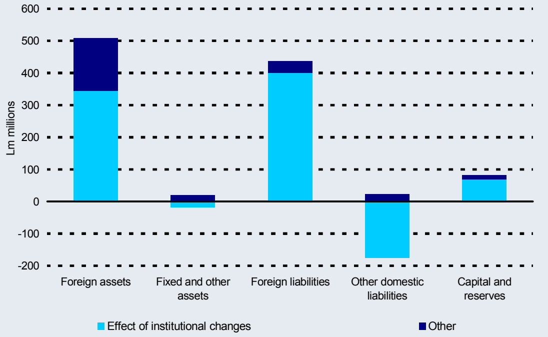
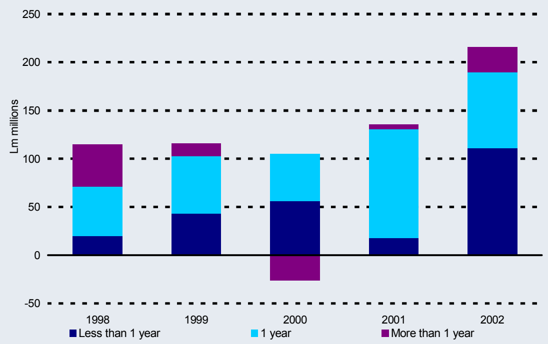


Chart 6.1 illustrates the combined effects of the inclusion of Volksbank and HSBC Overseas on selected components of the deposit money banks' aggregate balance sheet. As shown, these institutional changes mainly led to a sharp increase in the sector's foreign assets and liabilities. In contrast, the deposit money banks' other domestic liabilities fell as a result, whereas the combined value of their capital and reserves increased.

6.1.1 Liabilities

The continued preference of savers for low-risk financial products, which could have been shaped by falling equity prices, contributed to a surge in deposits of Lm295.1 million, or 12.8%. The repatriation of funds that had been previously held abroad also boosted deposits. Time deposits accounted for most of the overall rise, expanding by Lm216 million, or 15.1%, though depositors favoured maturity periods of one year or less given the current low-interest-rate environment, as Chart 6.2 shows. Meanwhile, higher personal deposits pushed the level of savings balances

Chart 6.2
ANNUAL CHANGES IN DEPOSIT MONEY BANKS' TIME DEPOSITS BY MATURITY



up by Lm46.8 million. Current deposits, of which more than two-fifths belong to the corporate sector, increased by Lm32.3 million.

As explained above, the increase in the deposit money banks' foreign liabilities largely reflected a wider institutional base. Hence, foreign liabilities at end-December stood at Lm1,038.4 million, with balances due to other banks abroad and non-resident deposits accounting for about two-fifths and one-third of these liabilities, respectively. On the other hand, the banks' other domestic liabilities shrank by Lm151.6 million, largely because HSBC Bank Malta's liabilities to its former subsidiary were extinguished. Meanwhile, the banks' capital and reserves rose by Lm81.9 million, mainly representing the paid-up capital of Volksbank, though retained earnings for the year, realised gains on asset revaluation and an increase in paid-up capital also contributed.

6.1.2 Assets

Loans and advances grew by Lm32.8 million, or 1.8%. This was the smallest percentage increase in the banks' loan book recorded over the last decade. Balances due from the corporate sector declined, as the banks generally applied more rigorous credit risk assessment policies to improve the quality of their loan portfolios, and a particular bank also wrote off irrecoverable debts amounting to some Lm11 million. Corporate bond issues also dampened the demand for bank credit, as firms sought to profit from the low-interest-rate environment by securing long-term finance at a favourable cost as described in the previous Chapter. In contrast, lending to the personal sector, which carries a lower default risk, grew robustly.

Meanwhile, bank investments in local securities edged upwards by Lm4.1 million. The banks augmented their stock of Treasury bills, but faced intense competition from the non-bank public when bidding for new issues of Malta Government stocks (MGS) and corporate debt securities. The scope for adding to their portfolio of domestic securities was also curtailed by the fact that new issues of MGS on the primary market were limited to the replacement of maturing debt.

These constraints encouraged the deposit money banks to increase their participation in foreign financial markets. In fact, their holdings of foreign assets, excluding the part of the increase brought about by institutional changes, rose by a fifth during the year reviewed, mainly through the acquisition of non-Government securities. At the same time, the banks placed surplus funds in term deposits with the Central Bank, such that their reserve assets surged to Lm294.8 million, as can be seen in Table 6.1.

The value of fixed and other assets went up by Lm4 million over the previous year. The value of bank premises and equipment rose, while excess liquidity in the banking sector contributed to a significant increase in interbank claims[1]. The latter was partly offset by the fact that HSBC no longer held shares in its former international banking subsidiary.

6.1.3 Capital adequacy

The deposit money banks continued to strengthen their capital base in 2002. The aggregate capital adequacy ratio, a measure of own funds relative to risk-weighted assets, pursued its upward trend, as Chart 6.3 shows, rising from 13.8% in 2001 to 18% at end-December 2002. This reflected a surge in the banks' own funds, mainly in the form of higher paid-up capital, retained earnings and gains on the revaluation of assets, which outstripped a simultaneous increase in their risk-weighted assets. Most of the rise in the capital adequacy ratio resulted from the institutional changes mentioned above. Banks are statutorily required to maintain a capital adequacy ratio of not less than 8%.

CHART 6.3
DEPOSIT MONEY BANKS' CAPITAL ADEQUACY RATIO

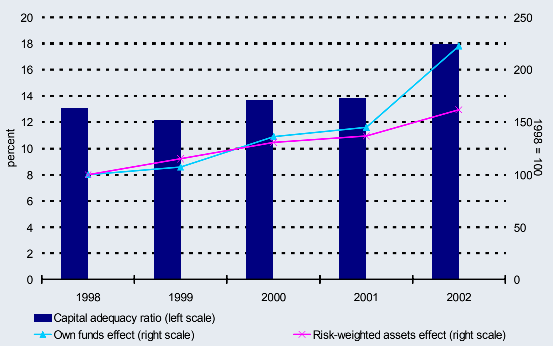
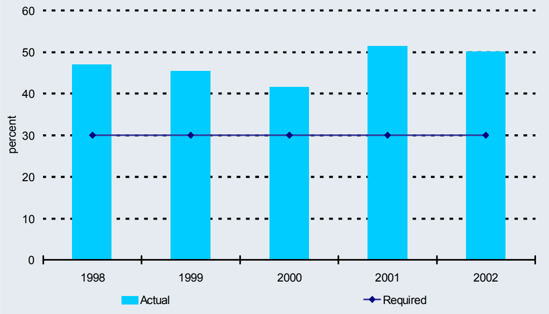


CHART 6.4
DEPOSIT MONEY BANKS' LIQUIDITY RATIO



6.1.4 Liquidity

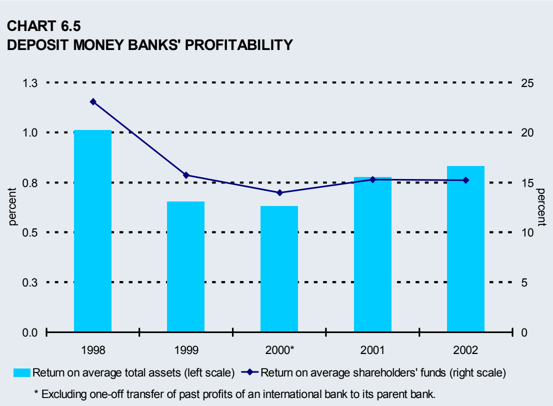
The banks' overall liquid position deteriorated slightly in 2002, though it remained healthy when compared to the mandatory minimum level, as Chart 6.4 shows. The banks' liquid assets rose by Lm84.2 million, or 9.4%, on account of the increase in balances with the Central Bank, additional holdings of Treasury bills and the rise in deposits held with other credit institutions. However, their net short-term liabilities grew at a faster pace, up by Lm213.6 million, or 12.2%, mainly reflecting the sharp increases in demand and savings deposits, as well as in term deposits with a remaining maturity period of three months or less. Consequently, the liquidity ratio, a measure of total liquid assets relative to net short-term liabilities, fell from 51.4% to 50.1% at end-December 2002.

6.2 Deposit Money Banks' Performance

6.2.1 Profitability

The deposit money banks' pre-tax profits amounted to Lm32 million in 2002, up by Lm4.5 million when compared to the preceding year. As Chart 6.5 shows, the banks consolidated the gains in profitability registered in 2001, with the return on average total assets increasing to 0.83% and the return on average shareholders' funds stabilising at 15.2%. The banks reported an improvement in net interest income and lower provisioning charges, though non-interest income declined. Although the previous year's absorption of Bank of Valletta International Limited (BOVI) by its parent bank lowered dividend receipts, it led to a corresponding increase in other income items, such as foreign exchange gains previously

[1] Interbank claims are included with 'other assets'.



recorded as income by the subsidiary. Similarly, one bank's decision to write off irrecoverable debts had no effect on the sector's profitability, as these had already been extensively provided for.

As may be seen from Table 6.2, the banks' net interest income rose by Lm5.4 million, with its share in total operating income rising to almost 70%. Limited opportunities for credit growth and falling interest rates led to a decline in interest receipts on loans and advances, though the drop in interest receivable was curtailed to Lm8 million through a rise in revenue on balances held with the Central Bank and interbank deposits. At the same time, in spite of the expansion of the banks' deposit base, interest payable fell by Lm13.4 million, on account of the downward trend in interest rates in Malta and abroad during 2002.

Higher net interest income was, however, partly offset by a drop in non-interest income of Lm4.8 million. Fees and commissions produced Lm1.5 million more, in part reflecting higher fees on investment banking services and an increase in commissions from the sale of bonds. Meanwhile, the banks' earnings on foreign exchange transactions, boosted by income that had been previously earned by BOVI, were up by Lm1.9 million. In contrast, other non-interest income fell from Lm11 million in 2001 to Lm2.8 million, mainly on account of lower dividends. This partly reflected Bank of Valletta's absorption of its international banking subsidiary in September 2001, as well as the performance of some of the banks' subsidiaries, especially those involved in fund management and stockbroking services, which were adversely affected by conditions in local and international equity markets.

The banks' operating expenses surged by Lm12.6 million, though this largely reflected a particular bank's decision to write off bad debts that had already been provided for. Consequently, the increase in operating

Table 6.2

DEPOSIT MONEY BANKS' INCOME AND EXPENDITURE STATEMENT

Lm millions

	2001	2002	Change
Interest income	201.1	193.1	-8.0
Interest expenses	136.5	123.1	-13.4
Net interest income	**64.6**	**70.0**	**5.4**
Fees and commissions	11.9	13.4	1.5
Foreign exchange gains	12.8	14.7	1.9
Other non-interest income	11.0	2.8	-8.2
Non-interest income	**35.7**	**30.9**	**-4.8**
GROSS INCOME	**100.3**	**100.9**	**0.6**
Wages	34.7	35.0	0.3
Rent and similar expenses	11.9	13.6	1.7
Other expenses	13.1	23.7	10.6
Operating expenses	**59.7**	**72.3**	**12.6**
Provisions	**13.0**	**-3.4**	**-16.4**
PROFITS BEFORE TAX	**27.5**	**32.0**	**4.5**

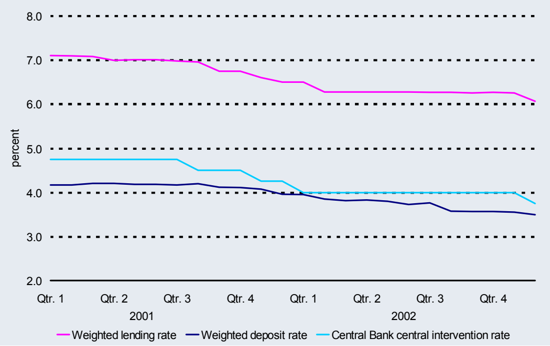
expenses was matched by a reversal of the bank's provisions on these specific debts. In addition, the banks' provisioning charges on their remaining credit facilities were lower than those recorded in the preceding year, when more stringent criteria on the classification of non-performing loans had been introduced.

6.2.2 Retail lending and deposit rates

Responding to cuts in official interest rates, the banks lowered their retail interest rates. Consequently, the weighted average rate on loans to residents fell from 6.5% in December 2001 to 6.1% at the end of 2002. At the same time, the weighted average rate on Maltese lira deposits fell by 47 basis points to 3.5%.

As Chart 6.6 shows, the average lending rate closely tracked changes in the central intervention rate and remained constant at 6.3% for most of the year under review. In contrast, the average rate on deposits adjusts with a lag to official rate cuts, as lower rates on time deposits may only be applied when existing term deposits mature. In fact, around half the drop in the average rate on deposits observed during 2002 resulted from the Central Bank's decision to lower official rates in November 2001. The cut effected in December 2002 is expected to influence the weighted average deposit rate during 2003. As a result, the annual average interest-rate spread narrowed from 2.8% in the preceding year to 2.6%.

Chart 6.6
RETAIL LENDING AND DEPOSIT RATES

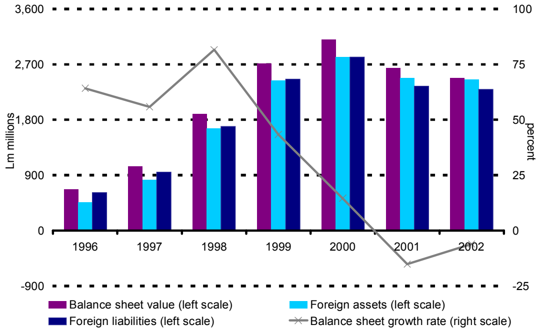


Box 1

International Banking Institutions

The aggregate balance sheet of the international banking sector contracted moderately in 2002, mostly as a result of a reduction in the number of institutions in the sector. However, the effects of the conversion of Volksbank's licence and the merger of HSBC Overseas with its parent bank were largely offset by robust growth reported by other international banks. The voluntary withdrawal of Finansbank (Malta) Limited from the Maltese international banking scene in February, which reflected a strategic decision by its parent bank in the light of banking reforms in Turkey, had a negligible effect on the sector's aggregate balance sheet. Meanwhile, the international banks reported a drop in pre-tax profits.

Chart 1
DEVELOPMENTS IN THE INTERNATIONAL BANKING INSTITUTIONS' BALANCE SHEET



International Banking Institutions' Balance Sheet

In general, international banks can only carry out transactions with non-residents and in currencies other than the Maltese lira. As a result, their operations are mainly financed through foreign sources and their funds are largely channelled towards foreign assets, as Chart 1 shows. During the year under review, their aggregate balance sheet contracted by 6.1% to Lm2,477.5 million. As the Chart also shows, the

Table 1
INTERNATIONAL BANKING INSTITUTIONS' BALANCE SHEET

Lm millions

	2001	2002	Change
ASSETS			
Cash and money at call	1.4	1.1	-0.3
Foreign assets	2,481.1	2,457.4	-23.7
Foreign securities	1,007.5	811.0	-196.5
Loans and advances to non-residents	1,196.1	1,201.8	5.7
Other foreign assets	277.4	444.6	167.2
Loans to residents	5.9	5.7	-0.2
Local investments	137.2	8.9	-128.3
Other domestic assets	13.0	4.4	-8.6
LIABILITIES			
Capital and reserves	256.7	158.0	-98.7
Foreign liabilities	2,348.8	2,295.2	-53.6
Balances due to other banks abroad	858.9	524.5	-334.4
Non-resident deposits	692.1	575.0	-117.1
Other foreign liabilities	797.7	1,195.7	398.0
Other domestic liabilities	-	18.0	18.0
Resident deposits	32.8	6.4	-26.4
AGGREGATE BALANCE SHEET	**2,638.4**	**2,477.5**	**-160.9**

downward trend in the balance sheet growth rate was stemmed.

Assets and liabilities

The international banks' foreign liabilities stood at Lm2,295.2 million at end-December 2002, down by Lm53.6 million when compared to the previous year, as Table 1 shows. As the Table also shows, balances due to other banks abroad fell, largely on account of the reclassification of Volksbank. The merger of HSBC Overseas with its parent bank contributed to a fall in non-resident deposits, though an increase in time deposits placed with another bank partly cushioned the drop. In contrast, the international banks' other foreign liabilities expanded vigorously, as securities sold under repurchase agreements and inter-branch balances rose sharply.

Meanwhile, the absorption of HSBC Overseas also led to a Lm26.4 million drop in residents' deposits with international banks. However, the banks' other domestic liabilities, boosted by the profits for the year, rose to Lm18 million. The banks' capital and reserves fell by Lm98.7 million, largely mirroring the institutional changes mentioned above.

On the other hand, the international banks' holdings of foreign assets dipped by Lm23.7 million, or 1%. A fall in their portfolio of Treasury bills and non-Government securities outweighed an increase in their holdings of foreign Government long-term debt securities, such that their investments in foreign securities declined by Lm196.5 million. However, a rise in balances held with correspondent banks abroad pushed up their other foreign assets by Lm167.2 million. At the same time, loans and advances to non-residents, largely denominated in US dollars, remained practically unchanged when compared to the previous year.

The banks' local investments fell from Lm137.2 million at end-2001 to Lm8.9 million, as the cessation of operations of HSBC Overseas brought about a drop in deposits with domestic banks. A drop in interbank claims and trade debtors contributed to a decrease in the international banks' other domestic assets of Lm8.6 million.

Profitability[1]

As Table 2 shows, the international banks' pre-tax profits totalled Lm14.7 million in 2002, down by 18.3% when compared to the previous year. The reduction in the sector's profitability reflected lower non-interest income, higher operating expenses and additional

Table 2
INTERNATIONAL BANKING INSTITUTIONS' INCOME AND EXPENDITURE STATEMENT[1]

Lm millions

	2001	2002	Change
Interest income	180.5	222.7	42.2
Interest expenses	195.1	176.6	-18.5
Net interest income	**-14.6**	**46.1**	**60.7**
Non-interest income	**74.0**	**19.4**	**-54.6**
Non-interest expense	**40.6**	**45.0**	**4.4**
Provisions	**0.8**	**5.8**	**5.0**
PROFITS BEFORE TAX	**18.0**	**14.7**	**-3.3**

[1] Includes international banks that are licensed in terms of the Banking Act, 1994.

[1] The following profitability analysis covers the performance of the international banks that are licensed in terms of the Banking Act, 1994. As such, not all the balance sheet developments described above have had an influence on these banks' income sources and their overall profitability.

provision charges that offset a remarkable increase in net interest income.

The international banks' interest income rose by Lm42.2 million, on account of a steep increase in interest receivable on long-term Government securities and on balances due from credit institutions overseas. At the same time, lower interest payable on time deposits belonging to foreign banks translated into a fall in interest expenses of Lm18.5 million. Consequently, their net interest income swung from a negative Lm14.6 million in 2001 to Lm46.1 million.

In contrast, the international banks' non-interest income decreased by Lm54.6 million, as the banks reported lower dividend receipts while the previous year's gains on foreign exchange instruments by a particular institution were not repeated. Meanwhile, their operating expenses, driven by an increase in fees and commissions payable, rose by Lm4.4 million. Provision charges went up by Lm5 million, mainly in the form of higher specific provisions on debt.

Part II

CENTRAL BANK POLICIES,

OPERATIONS AND ACTIVITIES

1. Monetary and Exchange Rate Policy

1.1 Policy Overview

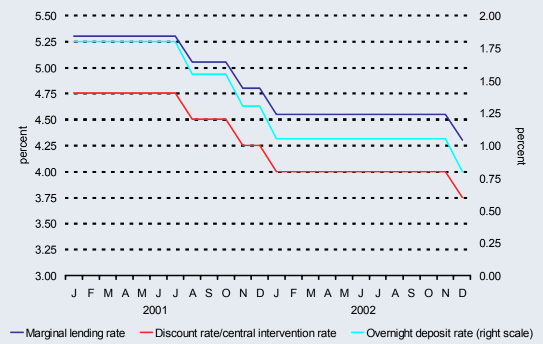
The Central Bank is responsible for the conduct of monetary policy in Malta. It also plays an important role in the formulation of exchange rate policy, which is the joint responsibility of the Bank and the Government. Following amendments to the Central Bank of Malta Act, which entered into force on October 1, 2002, the primary objective of the Bank was defined as the maintenance of price stability. Without prejudice to this objective, the Bank is also responsible for promoting orderly and balanced economic development.

The Bank's monetary policy strategy remained unchanged: that is, to achieve price stability by pegging the Maltese lira to a basket of three low inflation currencies - namely the euro, the US dollar and sterling - with shares that broadly reflect Malta's external trading patterns. In this way, the Bank limits imported inflation - which, in a small, open economy is an important concern. The exchange rate peg thus acts as a nominal anchor for domestic inflation, restraining growth in domestic prices and wages.

On August 23, 2002 the Monetary Authorities revised the weights of the basket currencies to reflect current trends and likely future patterns in Malta's external trade more closely. The revision resulted in a larger weight being given to the euro at the expense of the US dollar and, to a lesser extent, the pound sterling. The euro was allocated a weight of 70%, with the weights of the pound sterling and the US dollar being adjusted to 20% and 10%, respectively.

The amendments to the Central Bank of Malta Act vested the sole authority to take decisions regarding monetary policy in the Governor. The Monetary Policy Advisory Council, which was given a statutory basis, is responsible for advising the Governor on matters relating to monetary policy. The Council, which is chaired by the Governor and made up of the other members of the Board and three senior Bank officials,

Chart 1.1
TRENDS IN OFFICIAL INTEREST RATES



replaced the Monetary Policy Council. The Monetary Policy Council met eight times between January and September, whereas the Monetary Policy Advisory Council held four meetings between the beginning of October and the end of the year.

After having lowered official interest rates during 2001, the Bank again cut the discount rate and the central intervention rate by 50 basis points to 3.75% during 2002. The Bank's decisions to ease the monetary policy stance reflected economic and financial developments in Malta and abroad. As Chart 1.1 indicates, the Bank cut official interest rates by 25 basis points on January 31 in response to weak global economic conditions and subdued domestic demand, but left the monetary policy stance unchanged until December. On December 20, however, following reductions in interest rates abroad and a period of sustained expansion in the external reserves the Bank cut official interest rates by another 25 basis points.

1.2 The Implementation of Monetary Policy

The Central Bank uses a number of tools to maintain the exchange rate peg. First, the Bank supports the official exchange rate by buying or selling foreign exchange in response to market conditions. Second, the Bank adjusts official interest rates to dampen upward or downward pressures on the exchange rate. Changes in official interest rates influence yields in domestic money and capital markets as well as retail bank deposit and lending rates. As a result of the progressive liberalisation of capital movements and given the exchange rate peg, domestic interest rates are increasingly influenced by rates abroad.

The Bank uses open market operations to inject or absorb liquidity and, hence, ensure that money market interest rates are consistent with the monetary policy stance. These operations are carried out during weekly auctions with the banks. In a reverse repo, the Bank buys Government securities from the banking system and agrees to sell them back fourteen days later, thus injecting liquidity temporarily into the banking system. Conversely, to absorb liquidity temporarily from the banking system, the Bank offers deposits with a term to maturity of fourteen days. Interest rates used in open market operations are determined within a narrow band around the Bank's central intervention rate.

To limit the effects of fluctuations in bank liquidity on interest rates, the Bank also provides overnight lending and deposit facilities. Finally, banks are obliged to hold required reserves with the Central Bank. Reserve requirements generate a shortage of liquidity in the banking system and limit the potential for credit expansion in the economy. Since they are required to be held on an averaging basis, reserve requirements also contribute to the stability of money market rates.

1.2.1 External reserves management

According to the Central Bank of Malta Act, the Bank is obliged to hold external reserves in proportion to its currency and deposit liabilities. This proportion, which had been set at a minimum of 60% in 1968, was confirmed at that level in the amended Act.

In line with this legal obligation, and to be able to support the exchange rate peg, the Bank manages a portfolio of external reserves, which consist mainly of deposits with banks abroad and investment grade securities issued by non-residents[1]. The reserves are managed to ensure that funds in various currencies are always available to meet market needs and to generate income. The Bank's Investments Policy Committee, which is chaired by the Governor and includes the Deputy Governor and senior officials, sets the policies governing the management of the reserves. The Committee also reviews the performance of the Bank's portfolio and lays down the parameters within which the Bank's dealers have to operate.

The Bank's portfolio is structured to limit exposure to foreign exchange risk. The Bank also monitors its exposure to any credit risk that may arise in its dealings with foreign counterparties and is developing a comprehensive market risk model in line with international best practice in order to safeguard the value of its reserves.

The Bank computes and publishes spot exchange rates for the Maltese lira against major currencies daily. Spot exchange rates for the lira are updated throughout the day on Reuters. Forward rates are also computed on the basis of spot rates and interest rate differentials and quoted daily. The Bank trades daily in the spot foreign exchange market with credit and financial institutions in the euro, the pound sterling and the US dollar. It also trades in the forward foreign exchange market from time to time. During the year, the Bank stopped importing gold grain to meet the needs of local goldsmiths, leaving this function to the private sector.

During 2002 the Bank continued to be a net buyer of foreign exchange from the market. In fact, during the year, the Bank bought Lm187.7 million worth of foreign exchange from banks and financial institutions in the spot market and sold Lm65.4 million worth to them. The Bank also entered into forward contracts for the purchase of foreign exchange worth Lm43.3 million, most of which matured before the end of the year. On the other hand, the Bank opened swap contracts, worth an aggregate of Lm122.5 million, in which it sold foreign currency in the spot market and simultaneously agreed to buy it back again in the

[1] A statement of the Bank's investments is included with the Financial Statements that are shown elsewhere in this Report.

Chart 1.2
THE CENTRAL BANK'S FOREIGN ASSETS

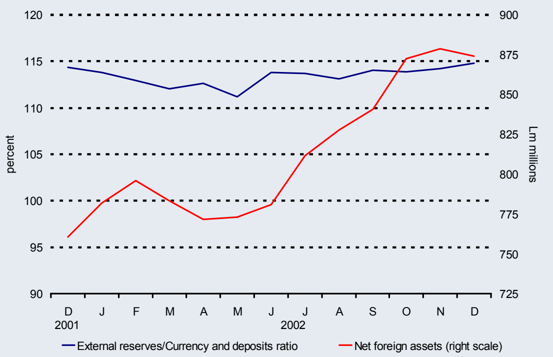
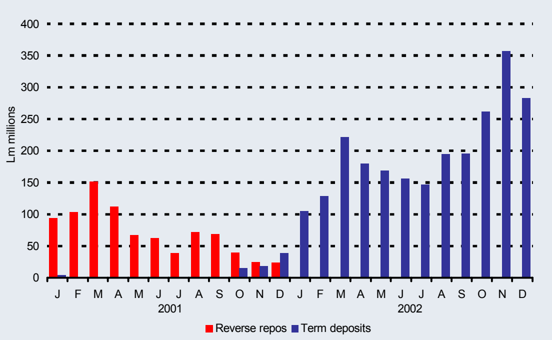


Chart 1.3
OPEN MARKET OPERATIONS
(monthly flows)



forward market. By the end of the year, in fact, swaps worth Lm97.2 million had matured. In addition, the Bank made net payments in foreign currency on behalf of the Government and other customers.

The Central Bank's net purchases of foreign exchange in the market were the major factor behind the rise in its external reserves and, hence, in its net foreign assets[2]. The latter expanded for the second consecutive year, rising by Lm113.4 million to Lm873.9 million. Given that the Bank's currency and deposit liabilities also expanded during the year, the statutory ratio between them and its external assets remained stable, as can be seen in Chart 1.2, ending the year at 114.8%.

The Bank monitors developments in the Maltese foreign exchange market closely. Banks and financial institutions inform the Central Bank daily about transactions involving foreign exchange with their customers above a threshold value. The value of transactions in the foreign exchange market, excluding interbank deals and deals between the Central Bank and credit and financial institutions, amounted to Lm2,440 million, up from Lm2,170 million in 2001. Activity in the interbank foreign exchange market remained low, however, with transactions dropping from Lm14.4 million to Lm12.4 million.

1.2.2 Open market operations

During 2002 the banking system had excess liquidity, which the Central Bank absorbed through regular auctions of fourteen-day term deposits. On aggregate, the Bank absorbed Lm2,399.4 million in such deposits during the year, compared with just Lm77.2 million during 2001. In contrast with the previous year, when the Bank had mainly used reverse repos to inject liquidity into the banking system, no reverse repo auctions were held during the year reviewed.

Interest rates paid on term deposits are determined in weekly auctions within a range of up to 5 basis points below the Bank's central intervention rate. Within these parameters, banks with excess liquidity bid to place funds on deposit with the Central Bank. The term deposit rate fell during the year, in line with changes in the central intervention rate, dropping from 4.22% at the end of 2001 to 3.7% twelve months later.

During the year the Bank continued to strengthen its risk control measures relating to open market operations, with the initial margin on reverse repos being raised from 1% to 2%. During 2003, the Bank intends to enhance its risk control mechanisms regarding the management of collateral and to review the criteria it uses to determine which assets may be used as collateral in open market operations.

1.2.3 The discount window and other standing facilities

Although the Central Bank may discount Treasury bills and other eligible securities to provide liquidity to the banking system, the discount window remained unused during 2002. The Bank also offers a marginal lending facility, granting overnight loans secured by pledges of collateral to individual banks on request. Given the excess liquidity that characterised the

[2] The Central Bank's net foreign assets are its external reserves net of its foreign liabilities. The latter amounted to Lm7 million at the end of 2002.

banking system throughout the year, however, banks did not use this facility either during 2002. The interest rate quoted on these loans remained set at 55 basis points above the central intervention rate. As part of the Bank's programme to tighten risk controls, an initial margin of 1% was introduced on this facility during the year.

The Bank also provides banks with an overnight deposit facility. Overnight deposits placed with the Central Bank rose from an aggregate of Lm120.2 million during 2001 to Lm175.7 million during the year reviewed. The Bank paid interest on these deposits at a rate 295 basis points below the central intervention rate.

1.2.4 Reserve requirements

In terms of the Central Bank of Malta Act, the Bank may require banks to maintain reserve deposits with it. In October, following the amendments to the Act, the Bank issued a Directive on minimum reserve requirements explaining how the reserve requirement ratio was to be determined, defining the reserve base and addressing issues relating to remuneration and non-compliance. The reserve requirement ratio, which had been lowered to 4% of the banks' specified liabilities in September 2001, was left unchanged at that level during 2002.

As in the past, banks were permitted to meet their reserve requirements on an averaging basis. This means that they were allowed to go below the required amount at times as long as the requirement was met on average during each maintenance period. The reserve requirement is calculated monthly, with the maintenance period running from the 15th day of each month to the 14th day of the following month. The Bank continued to pay interest at 2.7% per annum on required reserves.

1.2.5 Exchange controls

The Central Bank continued to administer exchange controls as the agent of the Minister of Finance in terms of the Exchange Control Act. However, the Authorities intend to remove all remaining controls, except those that apply to capital transactions with a maturity period of less than six months, in the period up to Malta's EU accession.

As part of the programme adopted by the Government to remove most exchange controls by the beginning of 2003, a number of liberalisation measures came into effect in January 2002. These included increased travel and portfolio investment allowances, the removal of quantitative restrictions on investment in real estate abroad and a further easing of restrictions on the operation of foreign currency accounts. In addition, locally registered companies were permitted to seek a listing for certain securities on recognised international money and capital markets.

Given that the authority to approve almost all

Table 1.1

TRANSACTIONS UNDERTAKEN IN TERMS OF THE EXCHANGE CONTROL ACT

Lm millions

	2001	2002
Cash gifts	8.0	7.8
Portfolio investments in foreign currency	35.8	23.7
Borrowing by local companies owned by non-residents		
From domestic banks	11.1	1.8
From foreign shareholders	0.8	2.0
Borrowing by resident companies from overseas lenders	86.5	44.9
Borrowing by resident persons from overseas lenders	0.5	1.4
Borrowing by non-residents from domestic banks	2.4	3.6

Note: The definition of residency used in compiling these data is the one given by the Exchange Control Act. Borrowings for a period of under 1 year require Central Bank approval.

transactions in terms of the Exchange Control Act has been delegated to authorised dealers in foreign exchange, the Central Bank undertakes a largely surveillance role. The Bank monitors transactions between residents and non-residents on the basis of information provided by authorised dealers. Table 1.1 summarises this information, which supplements data on the balance of payments gathered from other sources. As the Table shows, during 2002 reported portfolio investment outflows declined, while borrowing by resident companies from overseas lenders halved - after having increased sharply during the previous year.

In his latest Budget Statement, the Minister of Finance announced a further package of liberalisation measures, which came into force in January 2003. The purchase of foreign currency for travel purposes was completely liberalised, while cash gift allowances were raised further. Personal portfolio investment allowance limits were doubled and restrictions on holding foreign currency and operating bank deposits denominated in foreign currency were eased. Loans between residents and non-residents for periods of six months and over were also liberalised, while fund investment schemes were allowed to invest a greater proportion of their portfolios in foreign assets.

The Minister also announced that the Exchange Control Act would be abrogated in 2003 and replaced by a new piece of legislation entitled the External Transactions Act. This Act would provide the infrastructure for the total liberalisation of capital controls but would also give the Government the authority to impose controls in the event of a financial or balance of payments crisis.

1.3 Money and Capital Markets

On September 18, 2002 the Central Bank launched the official fixing of interbank rates for the Maltese lira. These rates - referred to as MIBOR (Malta Interbank Offered Rate) and MIBID (Malta Interbank Bid Rate) - are intended to serve as benchmark interest rates for interbank loans and deposits and for the pricing of money market and foreign exchange products.

The interbank fixing was conducted weekly in the overnight, one week, one month, two month, three month, six month, nine month and twelve month tenors. An interbank fixing was also held on the working day following the cut in official interest rates in December. The Central Bank collects rates quoted by credit institutions that are active in the interbank market for Maltese liri and computes and publishes the resultant average interbank rates.

During 2002 the Central Bank refrained from participating in the primary markets for Treasury bills and Malta Government stocks in line with the policy adopted in recent years. This practice was confirmed by the amendments to the Central Bank of Malta Act, which prohibit the Bank from purchasing debt instruments directly from the Government or from the public sector in general. The Bank can still, however, act as market maker in the secondary markets for Maltese Government securities, contributing to the liquidity of the market and, thus, helping to enhance investor confidence.

In the secondary Treasury bill market, the Bank regularly quoted selling and buying rates both for retail and wholesale amounts. These prices were based on primary market yields, official interest rates and secondary market developments. The value of transactions involving the Bank fell from Lm77.7 million during 2001 to Lm53 million in 2002, and accounted for around two-fifths of the secondary market turnover. The Bank continued to be a net buyer of bills in the secondary market, making purchases and sales worth Lm35 million and Lm18 million, respectively. During 2001 the Bank had bought and sold bills worth Lm60.5 million and Lm17.2 million, respectively. Most of the Bank's trades were conducted with credit and financial institutions.

The Bank also continued to trade in Malta Government stocks on the Malta Stock Exchange and quoted buying and selling rates for listed stocks. In contrast with the previous year, when the Bank had traded Lm19.2 million worth of stocks, turnover involving the Bank during 2002 amounted to a mere

Lm1.1 million, or 2.5% of the total. In addition, however, the Bank's broker also traded in a nominal Lm6.9 million worth of stocks on behalf of Malta Government Sinking Funds and the Maltese Episcopal Conference.

During 2002 the Bank set up the Government Debt Analysis Office in order to carry out research on sovereign debt management so as to be better able to fulfil its function of advisor to the Government. Research was also carried out on developments in foreign financial markets, including an overview of primary dealer systems implemented abroad. The Bank is also reviewing and upgrading available information on domestic Government debt.

The Financial Markets Committee, which includes representatives of the Central Bank and the domestic banks, met regularly in 2002 and continued to provide a forum for members to discuss possible improvements in the operation of the local markets. The Committee also worked closely with the Treasury Department on areas relating to the primary and secondary markets for Government securities.

The Committee also took a number of initiatives that are expected to bring greater depth and efficiency to the local markets. In particular, the Committee discussed and agreed on the introduction of fixing sessions for interbank rates (mentioned above). Other projects being promoted by the Committee included the dematerialization of Treasury bill certificates and the setting up of a working group to study the introduction of a primary dealer system in Government securities.

1.4 Economics and Statistics

In order to carry out its functions effectively, the Bank monitors and analyses economic and financial developments both in Malta and abroad. The Bank's economists prepare policy papers for the Governor, senior management and the Government. In particular, regular assessments of economic developments are carried out as part of the monetary policy process.

Furthermore, Bank staff undertake research in fields that are deemed important for the conduct of monetary policy, including the development and maintenance of econometric models of the Maltese economy to produce medium-term forecasts and simulations. During 2002, research focused on the development of measures of core inflation and the construction of an econometric model of the Maltese economy based on quarterly data. The Bank also contributed to the Pre-Accession Economic Programme (PEP) that was submitted by the Ministry of Finance to the European Commission.

The Bank publishes its views on economic and financial developments, as well as statistical information, in its regular publications, namely the *Annual Report,* the *Quarterly Review* and the monthly release of monetary statistics. In addition, the Bank uses the services of a private marketing agency to conduct a quarterly survey on business perceptions. The survey results are published in the *Quarterly Review*.

The Bank compiles and publishes a wide range of statistics. It meets the requirements set by the International Monetary Fund's General Data Dissemination System (GDDS) and regularly provides monetary and exchange rate data to the National Statistics Office (NSO) and to the Economic Policy Division of the Ministry of Economic Services. Such data are also made available to international institutions, including the European Central Bank (ECB), the International Monetary Fund (IMF), the World Bank, Eurostat and the leading credit rating agencies. During the year, the Bank contributed to an ECB publication entitled *Bond Markets and Long-term Interest Rates in European Union Accession Countries* and provided updates to the ECB with respect to the compilation of the *Money and Banking Statistics Methodological Manual Volume II.*

During 2002 the Bank stepped up work to align the compilation of money and banking statistics with ECB and IMF standards. The main emphasis was on the construction of a revised set of banking returns that are expected to be introduced in the second half of 2003, which will provide the Bank with better quality statistical information. In this respect, discussions with credit and financial institutions, the

Malta Financial Services Authority (MFSA) and the NSO through the Technical Committee on Financial Statistics continued throughout the year. The imminent introduction of the new statistical returns also entails the setting up of the appropriate IT infrastructure, including a common database for all users and systems to support the electronic transmission of statistical information.

In conjunction with the NSO, the Bank, during 2002, embarked on a project to compile Malta's Financial Accounts. Work on this project is expected to be finalised during 2003, with data being released and transmitted to Eurostat. Meanwhile, the Bank, together with the NSO, participated in the IMF's Co-ordinated Portfolio Investment Survey (CPIS) and submitted the requested data by the end of September 2002. New monthly balance of payments questionnaires and guidelines were drawn up in line with a new direct reporting data collection system that is being set up. During the coming year, it is envisaged that monthly direct reporting forms on balance of payments transactions, consistent with the new monetary schedules, will be introduced for credit institutions.

2. Financial Stability

The Central Bank of Malta is responsible for ensuring overall stability in the financial system in terms of the Central Bank of Malta Act. In this regard, the Bank during the year strengthened its capacity to monitor local and international developments with a view to detecting possible weaknesses in the structure and functions of the domestic financial system. The responsibility for ensuring financial stability is indeed broad-based and encompasses the assessment of risks to the banking sector, non-bank financial intermediaries, the money and capital markets, payments systems and other areas that may have an impact on the soundness of the financial system. The Bank also assessed developments in international standards that could affect the Maltese financial system.

As from January 1, 2002 the Central Bank's responsibility for the supervision and regulation of credit and financial institutions was transferred to the Malta Financial Services Authority (MFSA). In October, moreover, when the new Financial Markets Act came into force, the Bank's responsibility for monitoring the Malta Stock Exchange (MSE) was also transferred to the MFSA. In the early part of the year the Financial Intelligence Analysis Unit (FIAU) was set up in terms of the Prevention of Money Laundering Act, and this became wholly responsible for the formulation and implementation of policies aimed at combating money laundering.

To ensure the smooth transfer of the regulatory and supervisory function to the MFSA, senior officials from the Bank and the Authority co-operated actively throughout the year. The two institutions also drew up the final draft of a Memorandum of Understanding designed to set the parameters for co-operation in the area of financial services. In particular, the Memorandum, which was signed by both parties at the beginning of 2003, includes provisions to facilitate the exchange of information between the two institutions to enable them to better fulfil their respective statutory responsibilities.

During the year the Bank monitored the stability of the financial system by drawing on data from prudential returns submitted by credit and financial institutions, focusing in particular on the credit risk inherent in the banks' aggregate lending portfolio. Stress testing was also carried out to assess the potential effects of specified changes in risk factors on the banking sector's financial soundness. The tests examined market risks arising from credit institutions' foreign currency, interest rate and equity price exposures as well as liquidity and credit risk.

In 2002 the Bank also assessed the Malta Real-time Interbank Settlement (MaRIS) System against the *Core Principles for Systemically Important Payment Systems* drawn up by the Committee on Payment and Settlement Systems set up by the central banks of the Group of Ten (G10) countries. Additionally, together with the MFSA, the MSE and the FIAU, the Bank evaluated Malta's compliance with the criteria laid down by international standard-setting bodies. This evaluation was included in a report, which was also forwarded to the International Monetary Fund (IMF).

2.1 Financial Sector Assessment Programme (FSAP)

In October 2002 Malta underwent an extensive assessment of its financial system by an IMF/World Bank Mission under the FSAP. The latter, a joint IMF and World Bank initiative, aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries. Supported by experts from a range of national agencies and standard-setting bodies, the programme seeks to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritise policy responses. Detailed assessments of the observance of relevant financial sector standards and codes, which are contained in Reports on Observance of Standards and Codes

(ROSCs), are a key component of the FSAP. The FSAP also forms the basis of Financial System Stability Assessments (FSSAs), in which IMF staff address issues relevant to IMF surveillance, including risks to macroeconomic stability stemming from the financial sector and the capacity of the sector to absorb macroeconomic shocks.

Preparatory work for the FSAP began in late 2001. Through extensive discussions with, and contributions by, the Malta Financial Services Authority (MFSA), the Malta Stock Exchange (MSE) and the Financial Intelligence Analysis Unit (FIAU), the Bank drew up a self-assessment Report on Observance of Standards and Codes. This addressed the twelve key international Standards and Codes under the three main headings - macroeconomic fundamentals, institutional and market infrastructure and financial regulation and supervision - drawn up by the Financial Stability Forum in March 2002 and adopted by the IMF/World Bank for the FSAP. During 2002 the Bank's Financial Stability Office also co-ordinated the submission of data requested by the IMF for the Fund's preparatory work.

An eleven-member IMF/World Bank team visited Malta between October 15 and October 25, 2002. The Mission held a number of meetings with the Authorities and the industry across all sectors of the local financial system. It also held discussions with the FIAU and the Malta Police to evaluate Malta's efforts in combating money laundering and the financing of terrorism and thus assess the integrity of the domestic financial system. The IMF/World Bank Mission submitted a draft FSAP Report to the Authorities in December 2002.

3. Banking and Currency Operations

As banker to the Government and to the rest of the domestic banking system, the Central Bank provides a range of banking services to the public sector and to credit and financial institutions. In addition, as sole issuer of the domestic currency, the Central Bank must ensure that the supply of notes and coins is at all times sufficient to meet the demand, that the notes and coins in issue are fit for circulation and that any counterfeits are quickly detected.

3.1 Banker to the Public Sector

The Central Bank maintains accounts for the Treasury and other Government departments, the Malta Government Sinking Funds and a number of public corporations. It also offers foreign exchange services to public sector entities and Government departments.

During 2002 the Central Bank cashed 1.9 million cheques drawn on it by Government departments, 7.5% less than in the preceding year. Accordingly, the total value of such cheques fell to Lm412.7 million, from Lm434.1 million in 2001. The growing use of the direct credit system was the main factor behind this decline.

In fact, the Bank continued to promote the merits of using this more cost-efficient system for effecting Government payments. As a result, the number of direct credit payments rose from 0.5 million to 0.7 million during the year, while their value grew by 38% to Lm171.3 million. These increases reflected the growing willingness on the part of public sector employees, social security beneficiaries and Malta Government Stock holders to receive payment of salaries, social security benefits and interest, respectively, by direct credit to their bank accounts.

The foreign exchange services provided by the Bank include the use of documentary letters of credit, inward and outward bills for collection, inward transfers, guarantees, and sales of foreign exchange cash and travellers' cheques. The bulk of foreign exchange transactions are carried out through the use of SWIFT and bank drafts. During the year, the value of foreign exchange receipts processed on behalf of the Government and public corporations amounted to Lm64 million, while foreign exchange payments totalled Lm104.3 million.

The Central Bank is also responsible for effecting payments in connection with the Government's external debt servicing. During 2002 these payments were broadly in line with those made in the previous year. Capital repayments declined slightly, to Lm5.3 million, whereas interest payments on outstanding foreign loans amounted to Lm1.5 million. A further Lm4 million were transferred to sinking funds earmarked for foreign debt servicing.

The Bank continued to administer the Foreign Pension Subsidy Scheme on behalf of Government. Under this scheme, Maltese nationals (including persons holding dual citizenship) who receive a pension in foreign currency from Australia, Canada, the United Kingdom and the United States are entitled to a means-tested subsidy when they suffer losses due to unfavourable exchange rate movements. The amount paid under the scheme dropped to Lm21,851 in 2002 from Lm24,105 in the previous year.

The Bank also administers trade-related banking transactions between Malta and Libya. Under an existing arrangement between their respective central banks, outstanding balances arising from trade transactions between the two countries are settled at the end of each quarter.

3.2 Banker to the Banking System

The Central Bank offers local and foreign currency deposit facilities to domestic credit institutions[1]. The latter maintain balances at the Bank to comply with statutory reserve requirements, to settle interbank transactions and to carry out daily operations in the

[1] The Bank also offers deposit facilities to some financial institutions, particularly foreign exchange bureaux.

domestic financial markets. The Bank also maintains settlement accounts for the Malta Stock Exchange so as to enable brokers to settle trades in securities that are listed on the exchange.

3.2.1 Payment system

The Central Bank plays a central role in the management of the local payment and settlements system. This role was strengthened further during the year under review following the entry into force, on October 1, of amendments to the Central Bank of Malta Act. As a result, the first formal payment system compliant with international standards, the Malta Real-Time Interbank Settlement System (MaRIS), became fully operational. This is described in more detail in Box 2 below.

The payment system infrastructure was subject to two independent assessments by international organisations during the year. The European Central Bank (ECB) conducted an assessment as part of the European Commission's Peer Review, while the IMF did so as part of its Financial Sector Assessment Programme (FSAP).

Box 2
MaRIS: The Malta Real-Time Interbank Settlement System

The year 2002 marked a watershed in the development of the payment systems infrastructure in Malta. Through the amendments to the Central Bank of Malta Act that entered into force on October 1, the legislative framework governing payment systems was put in place. The amended Act enables the Central Bank to regulate, oversee and, where necessary, operate payment systems in Malta. Furthermore, it provides for finality of payment when settlement is passed through a systemically important payment system, which may, by definition, include a securities settlement system. The Act places the responsibility for the efficiency and safety of payment systems in Malta on the Central Bank.

The Bank, together with the domestic commercial banks, was instrumental in establishing the first formal payment system in Malta compliant with international standards, the Malta Real-Time Interbank Settlement System, or MaRIS. MaRIS started operating fully on October 1, 2002 and the system is today handling more than 95% of all interbank payments. The Central Bank operates the system and provides participants with the information and risk management features required of such systems today. Messaging within MaRIS is based on SWIFT standards and the system is 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.

Worthy of mention, also, have been two market driven developments in the area of the automation of payments, namely the agreement reached between the banks in the course of the year to give their customers joint use of the two major ATM networks and the increased use of electronic direct credits.

Developments anticipated during 2003 will focus mainly on payment and securities settlement system policy and the establishment of a framework to regulate such systems. Further work will also be undertaken on consolidating the settlement infrastructure for retail payment instruments to ensure that these comply with the Core Principles established for payment systems by the Committee on Payment and Settlement Systems (CPSS), a committee set up by the central banks of the Group of Ten (G10) countries. The Central Bank will, during 2003, further its work in the area of retail payments, e-commerce and e-payments, which will become increasingly important as Malta's financial system develops further.

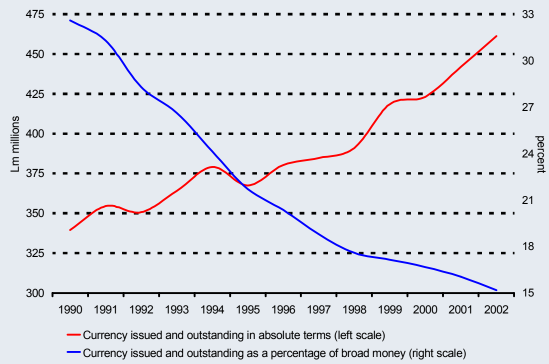
The Central Bank also manages the Malta Clearing House, through which most cheques issued are settled. The number of cheques cleared continued to decline, falling from 7.3 million in 2001 to 6.9 million in 2002, as both the number of cheques drawn on the Central Bank and those drawn on the deposit money banks contracted. However, the value of these cheques increased by 4.6% to Lm2.6 billion.

Domestic banks are also eligible for short-term credit from the Central Bank, either through the discount window or through the marginal lending facility. The operation of these facilities is discussed in Chapter 1 of Part II of this Report.

3.3 Currency Operations

At the end of 2002, the stock of currency notes and coins issued and outstanding amounted to Lm461.2 million, up by 4.4% from the end of the previous year. This was identical to the percentage increase recorded in 2001, as can be seen from Chart 3.1. As the Chart also shows, however, the share of currency in broad money, which at the beginning of the 1990s stood at over 30%, declined further, to 15.2%, from 16% at the end of 2001.

Chart 3.1
CURRENCY ISSUED AND OUTSTANDING



Movements in the amount of currency in circulation, displayed in Table 3.1, continued to exhibit the usual seasonal pattern. In January there was a Lm8.5 million drop, as credit institutions disposed of excess holdings accumulated during the festive season. A seasonal contraction also occurred in November, at the end of the tourist season, but this was reversed in December, when buoyant Christmas spending led to a Lm9.3 million increase in notes and coins outstanding.

At the end of December 2002 the value of notes in issue amounted to Lm443.9 million, up by 4.7% from the previous year's level. Their composition,

Table 3.1

CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE CENTRAL BANK OF MALTA IN 2002

Lm thousands

	Notes and Coins			
	Issued	Paid-In	Net Issue	Issued and Outstanding[1]
January	13,969	22,512	-8,543	433,286
February	15,502	15,376	126	433,412
March	19,059	15,476	3,583	436,995
April	23,833	19,269	4,564	441,559
May	22,728	19,656	3,072	444,631
June	22,215	16,959	5,256	449,887
July	26,013	20,558	5,455	455,342
August	21,176	23,308	-2,132	453,210
September	24,202	20,964	3,238	456,448
October	23,693	23,572	121	456,569
November	16,755	21,373	-4,618	451,951
December	22,916	13,619	9,297	461,248
2002	**252,061**	**232,642**	**19,419**	**461,248**
2001	218,996	200,355	18,641	441,829

[1] Includes currency in circulation and currency held by banking system.

Chart 3.2
COMPOSITION OF CURRENCY NOTES ISSUED AND OUTSTANDING
AS AT END-2002

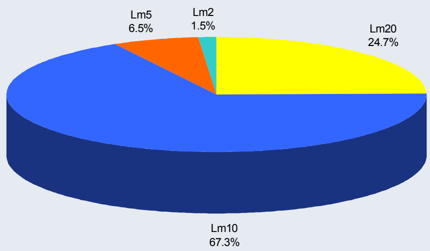
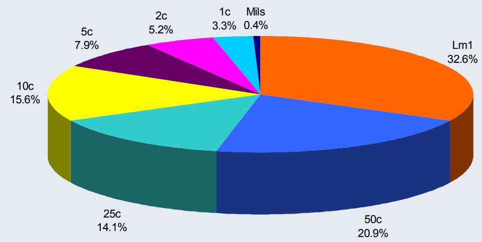


Chart 3.3
COMPOSITION OF COINS ISSUED AND OUTSTANDING
AS AT END-2002



however, remained practically unchanged, with the Lm10 note remaining by far the most popular currency note. In fact, the share of the Lm10 note increased slightly, to 67.3% of the total, from 66.2% at the end of 2001. This was almost entirely at the expense of the Lm20 note, whose share declined accordingly.

Meanwhile, the value of the outstanding stock of coins declined by 3.6% to Lm17.3 million during the year, though here too the shares of the various denominations in the total remained broadly unchanged. The Lm1 coin remained the most popular, as Chart 3.3 illustrates, followed by the 50c coin, despite the latter losing almost 4 percentage points from the share it had at the end of 2001.

In December the 4th series of the Lm20 note was withdrawn from circulation, while in June the 25 cents and 50 cents coins of the 1st series were demonetised. No new issues were made during the year.

3.4 Commemorative Coins

On July 1 the Central Bank of Malta issued a gold commemorative coin with the maritime theme "Xprunara". The coin, which was the first gold coin issued by the Central Bank since 1994, was struck at the Royal Mint in the United Kingdom and forms part of the Royal Mint Precious Fine Gold Collection. It is legal tender in Malta for the value of Lm10, weighs 1.24 grams, has a finesse of 0.999 and a diameter of 13.92 millimetres. The reverse side of the coin, which was designed by the Maltese artist Joseph Muscat, depicts an eighteenth century "Xprunara" – a locally-developed sailing vessel which was an important means of transport and communication between Malta and the rest of the world for nearly four centuries. The obverse shows the coat of arms of Malta and the year of issue.

3.5 Anti-Counterfeit Measures

Throughout 2002, as in past years, the Central Bank continued to monitor closely all reports of counterfeit currency. From October 1, when the amendments to the Central Bank of Malta Act entered into force, it became obligatory for credit institutions to surrender any counterfeit currency, whether local or foreign, to the Central Bank. Meanwhile, a Currency Surveillance Unit was set up at the Bank to examine and report on suspected counterfeits.

4. Internal Management

4.1 Administration

4.1.1 The Board of Directors

The Board of Directors is responsible for the policy and general administration of the affairs of the Central Bank of Malta, except in relation to matters of monetary policy, where responsibility is vested solely in the Governor.

During 2002 the Board of Directors was composed of Mr M C Bonello, Governor and Chairman of the Board, together with Mr D A Pullicino, Deputy Governor, and Mr S Falzon, Mr A F Lupi and Professor E Scicluna as members. Mr H Zammit LaFerla was Secretary to the Board. During the year the Board held 11 scheduled meetings and five *ad hoc* meetings.

Mr A F Lupi was reappointed to serve as director for a further year with effect from January 21, 2002. On November 14, Professor E Scicluna's appointment as a director expired. Mr J V Gatt was appointed as a new director for a period of five years with effect from January 1, 2003.

4.1.2 Management

The Executive Management Committee is the body responsible for the execution of the policies laid down by the Board. It also takes most decisions related to the Bank's internal management and daily administration. The Committee, which is composed of the Governor (as Chairman), the Deputy Governor, and the five Deputy General Managers held 48 meetings during the year.

With effect from January 1, 2002, responsibility for banking supervision and regulation was transferred from the Central Bank to the Malta Financial Services Authority (MFSA). Consequently, in order to be able to fulfil its statutory responsibility for ensuring financial stability, the Bank set up the Financial Stability Division. This Division is headed by Mr H Zammit LaFerla, and is made up of the Financial Stability Office, the Risk Assessment Office and the Audit Office.

4.1.3 Official activities in Malta

The Bank continued to act as advisor to Government on economic and financial matters, with the Governor making two presentations to Cabinet during the year. The Governor is also a member of the Board of Governors of the MFSA, and in this capacity regularly attended meetings of the Board. The Governor and, in his absence, the Deputy Governor, continued to participate in meetings of the Malta Council for Economic and Social Development (MCESD).

The Governor addressed a number of seminars organised by constituted bodies and professional organisations on economic and financial issues during the year.

4.1.4 Official representation overseas

In April, the Governor attended the Spring Meetings of the International Monetary Fund (IMF) and the World Bank in Washington DC.

In May, the Governor was a member of an official delegation led by the Minister of Finance which was invited to visit Luxembourg by the Central Bank of Luxembourg. During the visit, the Governor and the Chairman of the MFSA gave a presentation on Malta's economy and its financial sector at a seminar organised by the Central Bank of Luxembourg. During the same month the Deputy Governor accompanied the Minister of Finance to the Annual Meeting of the European Bank for Reconstruction and Development (EBRD) which was held in Bucharest, Romania.

In June, the Governor attended a conference organised by the Bank of Estonia to celebrate the tenth anniversary of the launching of the Estonian currency.

In the following month, the Governor attended the

Central Bank Governors' Symposium hosted by the Bank of England. He was also invited to address the Second International Financial Summit, held in Madrid, on the challenges and emerging risks facing the financial industry.

During September the Governor was a member of a delegation led by the President of Malta to Cyprus and Greece on a state visit. He also attended the Annual Meetings of the IMF and the World Bank in Washington DC, as well as the Meetings of the Commonwealth Secretariat in London. Subsequently, the Governor participated in a seminar organised by a Maltese bank for businessmen and financial operators in Canada, where he delivered a speech on the Maltese economy.

In November the Deputy Governor was a member of a ministerial delegation to Brussels that took part in the European Union–Malta Association meeting. In December the Governor attended the Annual Seminar for the central banks of the European System of Central Banks (ESCB) and accession countries, which was organised jointly by the European Central Bank (ECB) and the National Bank of Belgium.

4.2 Human Resources

The full-time staff complement at the Central Bank at the end of 2002 stood at 302. In addition, the Bank employed 16 staff members on a part-time basis. During the year the Bank recruited seven trainee economic officers, ten clerks and a part-time gardener. Two staff members retired on medical grounds, one employee opted for voluntary severance, while seventeen others joined the MFSA as a result of the transfer of responsibility for banking regulation and supervision from the Bank to the Authority.

As in previous years, the Bank offered temporary employment to six university students during the summer and participated in a traineeship scheme administered by the Employment and Training Corporation (ETC). The Employee Assistance Programme launched with the help of Caritas – Malta in 1999 was renewed. The Bank participated in the Human Resource Awards organised by the Foundation for Human Resource Development.

4.2.1 Training and development

As in previous years, the Bank provided staff members with extensive training both through in-house programmes and through external courses organised by local and foreign institutions. Further details are given in Table 4.1.

As the table shows, a large number of staff attended training programmes organised by local and foreign institutions. Local training courses were mainly in the field of information technology, industrial relations, law, the European Union and economic developments. Foreign programmes, which were mostly organised by European central banks, tended to focus on subjects related to a central bank's core functions and operations. The areas covered included monetary and economic policies, currency issues, financial stability, statistics and payment and settlement systems.

In-house training courses organised by the Bank focused on various topics, including management and supervisory development, information technology and a code of conduct regarding e-business. A more specialised in-house course, which all management staff attended, covered the amendments to the Central Bank of Malta Act. In May, the language courses in French and German organised by the Bank came to an end.

4.2.2 International exchange programme

The international exchange programme for clerks, which was introduced in 2000, was extended to include the exchange of technical experts as well. Two

Table 4.1
STAFF TRAINING

Type of Training Courses	No. of courses	No. of participants
Overseas courses	47	44
In-house training	23	480
Local external courses	58	97

clerks from the Bank visited the Czech National Bank and the Bank of Estonia, respectively. A Bank official also visited the Central Bank of Cyprus. Meanwhile, two officials from the Central Bank of Cyprus and another from the Czech National Bank visited the Bank on short-term attachments. As part of the same scheme, the Bank also hosted an official from the Bank of Estonia on a one-week assignment.

4.2.3 Academic and professional courses

An increasing number of employees made use of the Bank's Study Scheme while pursuing self-development opportunities during 2002. A number of them successfully completed their programmes. Details of the type of programmes offered and the number of staff pursuing them are shown in Table 4.2. Specialised areas of study included economics, accountancy, finance, management, law and human resources.

4.2.4 Gender equality

The Bank continued to give due importance to gender equality. Throughout the year members of an internal Bank committee that monitors this issue attended various meetings held by the Department for Women in Society of the Ministry for Social Policy to keep abreast of developments in this area.

During the year, the proportion of female members in the Bank's full-time staff rose slightly, to 35%. Furthermore, 43% of staff members pursuing self-development programmes on a part-time basis were women.

Table 4.2
ACADEMIC AND PROFESSIONAL COURSES

Type of Programme	No. of employees who successfully completed programmes during 2002	No. of employees pursuing programmes
Postgraduate courses	2	15
Honours first degree courses	8	1
General first degree courses	2	32
Diploma courses	5	1
Certificate courses	4	1

4.3 Premises

Work related to office structures and refurbishment at both premises was carried out during 2002, while the process of upgrading of the Banks' security system continued throughout the year. The Bank also finalised plans to implement, in collaboration with the Valletta Local Council, an extensive renovation of the area in front of the Bank's main building. The objective is to enhance the Bank's security, to improve traffic management in the area, and to embellish the site.

4.4 Information Technology

During the year the Central Bank began to use a computer system that allows the exchange of encrypted information between the Bank and the ESCB. This system, CEBAMAIL, became operational in November.

A new module to handle the Real Time Gross Settlement (RTGS) payments system was introduced in the Bank's accounting system. This module provides the participating banks with the means to effect payments in accordance with the RTGS directives and also with the means to manage their accounts. To guarantee a more secure environment for payment instruction deliveries the banks using RTGS formed a Closed User Group within SWIFT.

The Bank also continued to develop a number of software applications to meet its own needs. In particular, one application is designed to provide the Bank with the capacity to populate a database with balance sheet and profit and loss data received from credit and financial institutions and the facilities to issue analytical reports thereon.

4.5 Risk Assessment and Audit

During 2002 the Bank finalised a new internal Policies and Procedures Manual which describes the policies and procedures followed in each area of the Bank's operations. The work related to the Bank's Risk Matrix was still under way during 2002. As part of this project, the Risk Assessment Office, together with the Audit Office, carried out inherent risk assessments on all business processes identified in the Policies and

Procedures Manual. Further analysis to identify and assess specific risks and their corresponding controls will be carried out in 2003.

In the course of the year the Bank also launched a new project to draw up a Business Continuity Plan, which will help the Bank to recover its critical business processes and market-wide systems in the event of a disruption in business activity. The Bank also explored the implications of the introduction of data protection legislation in Malta.

The Audit Committee, which was established by the Board of Directors in 2001, met three times during 2002, once with the Bank's external auditors. The Committe was set up to strengthen the independence of the audit function, to improve the quality of the internal control, audit and accounting functions, and to strengthen the objectivity and credibility of financial reporting. A non-executive director chairs the Committe, which also includes the Deputy Governor and another non-executive director as members.

During the year the Bank's Audit Office performed several assurance audits in line with the Audit Programme. In addition, the Office conducted various audits on an *ad hoc* basis. These audits helped evaluate the Bank's risks, controls and monitoring procedures and provided the Board of Directors and the Audit Committee with the necessary assurance regarding the internal controls of the Bank. Furthermore, in preparation for the eventual introduction of risk-based auditing, the Audit Office enhanced its reporting procedures. These new procedures will enable managers to focus on strengths and weaknesses in their respective areas of responsibility.

4.6 Legal Issues

During the year the Bank's Legal Office finalised the draft amendments to the Central Bank of Malta Act. These were presented to the Ministry of Finance and were debated in Parliament during the early summer months. Following Parliamentary approval, the amendments entered into force on October 1, 2002. The amendments were aimed at:

- defining more clearly the Bank's principal objectives. Price stability is thus established as the Bank's primary objective;

- strengthening the Bank's independence and thus enabling it to formulate and implement monetary policy without external interference;

- providing the Bank with the necessary operational flexibility to carry out its tasks and responsibilities in a more liberalised and deregulated financial environment[1].

In terms of the amended Central Bank of Malta Act, the Bank issued two directives towards the end of the year. A directive on minimum reserve requirements was issued on October 1, while one on payments and securities settlement systems came into effect on November 1. Two other directives, one on cross-border credit transfers and the other on electronic payment services, were expected to become effective as from January 2003 and January 2004, respectively. A legal notice was drafted providing, *inter alia*, for administrative penalties against non-compliance on the part of reporting agents and payment system participants.

In addition a new piece of legislation entitled the External Transactions Act was drafted to replace the current Exchange Control Act.

During the year the Bank continued to work closely with the Directorate General - Legal Services of the ECB, the legal offices of central banks of EU member states and those of the accession countries. Meetings were also held at the ECB to draw up the Accession Country Legal Report, which examines the legal position in the accession countries and the measures

[1] A fuller explanation of the amendments to the Act and their underlying economic rationale may be found in the December 2002 issue of the Bank's *Quarterly Review.*

taken by them to bring their national legislation on financial matters in line with Community law, including the ECB Statute.

4.7 Information Services

During the year the Bank brought a number of issues to the attention of the public through the media. The Bank published an information booklet about the Investment Registration Scheme launched by the Government, and ran information campaigns in connection with the demonetisation of coins and the withdrawal of currency from circulation. In addition, in the light of the amendments to the Central Bank of Malta Act, the Bank started issuing regular press releases to inform the public about the decisions taken by the Governor after each meeting of the Monetary Policy Advisory Council.

4.7.1 Publications

The Bank continued to publish four issues of the *Quarterly Review*. These focused on economic and financial development in Malta and abroad. They also included statistical tables with updated data on the economy and the financial system.

It also published its *Annual Report* for 2001, which included an account of the Bank's policies, operations and activities as well as its financial statements for the year ending December 31, 2001. As usual, the Report also included an extensive analysis of economic and financial developments during that year.

During the year the Bank continued to publish a monthly statistical release, which showed the latest monetary data together with a short commentary highlighting the main developments. A weekly money market report was also published.

The Bank's publications were regularly posted in the Central Bank's own website, *www.centralbankmalta.com*. During 2002 the website was upgraded to facilitate navigation and to incorporate new features so as to enable users to obtain a wider range of information and services.

4.7.2 Library

The Bank's Library serves as an important source of information on economic and financial matters in Malta. During 2002 the Bank further upgraded the Library's collection with acquisitions of books, periodicals, specialised publications related to the Banks' functions and operations, and databases on CD-ROM, while the newspaper clipping and the cataloguing of journal articles services were expanded.

Meanwhile, several publications issued by international organisations, such as the International Monetary Fund, the World Bank Group, the European Bank for Reconstruction and Development and other institutions continued to be kept in a separate depository.

4.8 Social, Cultural and Educational Activities

During 2002 the Bank organised various activities of a social, cultural and educational nature. In April, as part of its anniversary celebrations, the Bank held a one-day international seminar on World Economic Prospects and Financial Stability with the participation of several distinguished guests including Paul A Volcker, former Chairman of the Federal Reserve System of the United States. As part of the festivities commemorating the Bank's anniversary, the Bank also put on a concert of classical music at the Mediterranean Conference Centre.

During the year the Bank also organised several educational visits for local and foreign visitors, who were given an overview of the Bank's functions and its role in the Maltese economy. The Bank supported the publication of the book *Currency in Malta,* written by Chev J C Sammut, and was also instrumental in the production of an educational television programme about money for young children.

As in previous years the Bank continued to give financial assistance to a number of organisations working in the educational and social fields. The Bank also instituted a monetary prize for the best dissertation presented by a student in partial fulfilment of the requirements of the B Com (Hons) Economics degree. It also provided support to its Staff Social Club, which on its part organised various social, cultural and philanthropic activities. Through the Staff Contributions Fund, the Bank also provided assistance to charitable institutions.

5. Relations with International Institutions

During the year, the Central Bank continued to maintain close relations with international organisations of which Malta is a member. These include the International Monetary Fund (IMF), the World Bank and the European Bank for Reconstruction and Development (EBRD). The Minister of Finance is the Governor for Malta on the Boards of the World Bank and the EBRD, while the Governor of the Central Bank is the Governor for Malta on the Board of the IMF. Additionally, the Governor is Alternate Governor on the Board of the EBRD.

During the year, the Central Bank also continued to collaborate with the Bank for International Settlements (BIS) on matters relating to banking supervision and financial stability. In addition, as Malta's EU accession process continued to gain momentum, the Central Bank increased its contacts with key EU institutions, particularly the European Central Bank (ECB). The Bank, in fact, continued to collaborate closely with the ECB and the national central banks of the current Member States, as well as with central banks in the other accession countries.

Meanwhile, the Bank continued to liaise with the Malta Financial Services Centre (later the Malta Financial Services Authority) and with the Ministry for Economic Services and the EU Directorate on matters related to Malta's commitments to the World Trade Organisation with respect to financial services.

5.1 International Monetary Fund (IMF)

As the institution representing Malta on the Board of Governors of the IMF, the Central Bank voted, in consultation with the Minister of Finance, on a number of resolutions proposed by the Executive Board of the Fund. During 2002, the Bank did not effect any payments in relation to the operational budget of the Fund, although it continued to co-operate with the Fund in budgetary matters. Malta's quota in the Fund remained unchanged at SDR 102 million (approximately Lm55.4 million[1]). As a result, the Fund's holdings of Maltese currency and Malta's reserve position in the Fund also remained unchanged from the levels reported at the end of 2001. These stood at SDR 61.74 million and SDR 40.26 million (around Lm33.5 million and Lm21.9 million), respectively.

In the absence of further allocations from the IMF, Malta's allocation of SDRs also remained unchanged at SDR 11.29 million (around Lm6.1 million). The Bank, however, remained an active participant in transactions through the Fund's SDR Department. During 2002 these transactions resulted in net receipts of approximately SDR 2.6 million, which consisted mainly of income on Malta's excess holdings of SDRs and the repayment of credit which Malta had extended to the Fund under the Enhanced Structural Adjustment Facility. Consequently, Malta's total holdings of SDRs, which include its SDR allocation and its net excess holdings of SDRs, increased from SDR 26.4 million (around Lm15 million) in 2001 to SDR 28.9 million (around Lm15.7 million) at the end of 2002.

At the end of May an official from the Fund's Statistics Department visited the Bank to review Malta's commitments under the General Data Dissemination System (GDDS) and to examine its preparations for acceptance of the more demanding Special Data Dissemination Standard (SDDS) at a future date.

5.2 International Bank for Reconstruction and Development (IBRD/World Bank)

Although Malta's representation on the IBRD rests with the Ministry of Finance, the Central Bank regularly monitors developments related to the World Bank and consults with the Minister of Finance on matters relating to Malta's membership in this institution. During the year, the Bank monitored

[1] On the basis of exchange rates prevailing at the end of each year for stock data.

closely the proceedings of the International Conference on Financing for Development, which was convened by the United Nations and the World Bank in Monterrey, Mexico.

5.3 European Bank for Reconstruction and Development (EBRD)

During 2002 the Central Bank continued to liaise with the Ministry of Finance on issues related to Malta's membership of the EBRD. In particular, the Bank advised the Ministry on a number of resolutions which the Board of Directors of the EBRD put forward for the approval of the Governors of member countries.

In March, the Central Bank effected the fifth annual payment of euro 28,750 (about Lm11,500) in respect of Malta's contribution to the general capital increase of the EBRD on behalf of the Government.

5.4 European Union (EU)

As in previous years, the Bank collaborated with the EU Directorate of the Ministry of 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 in this regard was related to the areas of the free movement of services, the free movement of capital, Economic and Monetary Union (EMU) and statistics. The Bank was also involved in the preparation of the 2002 Pre-accession Economic Programme (PEP) together with the Ministry of Finance and the Ministry for Economic Services. This report was submitted to the EU Commission in August 2002. In addition, senior officials from the Bank and the Ministry of Finance participated in discussions with an EU Technical Consultation Mission that visited Malta in January to review progress on Malta's commitments under the chapters of the *acquis* related to the free movement of capital and banking services. Senior officials from the Bank and the Ministry of Finance also participated in high-level meetings which the Economic and Financial Committee (EFC) organised for EU and candidate countries, to discuss the candidate countries' Pre-accession Economic Programmes and other general economic issues.

5.5 European Central Bank (ECB)

Meanwhile, the Bank continued to strengthen its relationship with the European Central Bank (ECB) and the other national central banks of the European System of Central Banks (ESCB). Further to an invitation by the ECB, the Bank also nominated officials to represent it on the twelve committees of the ECB, with effect from April 2003, in an observer capacity.

As in recent years, various members of the Bank's staff participated in seminars organised by the ECB for accession countries, particularly those relating to payment systems, the operating framework used for monetary and foreign exchange operations, the Bank's communication strategy and audit. Meanwhile, the Bank continued to make use of technical assistance from the ECB and the Member States' central banks, notably the Central Bank of Ireland, the Netherlands National Bank and the Bank of Greece.

In the area of payment systems, a delegation from the ECB visited the Bank to assess the legal and operating framework governing the settlement of payments and securities in Malta. In the meantime, with the assistance of the ECB and a number of national central banks of EU Member States, the Bank also established an electronic information exchange system. During the year, an ECB official visited the Bank to acquire additional information about the adaptation of the local banking sector to the changeover to euro notes and coins. Meanwhile, the Bank also started work on the exchange of information about counterfeit euro notes with the ECB. In this regard, mechanisms were established, with the collaboration of the Malta Police, to facilitate the detection and recording of counterfeits and the exchange of related information with the ECB. In November a delegation from the ECB visited the Bank to advise on the accounting and reporting standards used by the ESCB.

During the year, discussions with the ECB were also held on the changes that needed to be made to the administrative set-up of the Bank to enable its smooth integration with the ESCB. In November two senior officials from the Secretariat and Language Studies of the ECB visited the Bank to discuss the preparations that needed to be made to adopt the communication strategy of the ESCB.

During the year, the ECB extended its recruitment process to nationals of the EU candidate countries. Following an invitation from the ECB, the Bank started advertising ECB vacancies to its own staff.

5.6 European Investment Bank (EIB)

Although Malta will only become a member of the European Investment Bank (EIB) upon EU membership, it has already benefited from a number of loans from the EIB. As the body responsible for administering receipts and payments relating to foreign loans/grants on behalf of the Government and other borrowing institutions, the Central Bank continued to monitor Malta's financial position vis-à-vis the EIB. During the year, as the EIB broadened the scope of loans available to accession countries, the Bank assessed the adequacy of its operating framework to ensure that it would be able to handle the larger volume of transactions envisaged in the event of EU membership. In the meantime, the Bank started to analyse the financial obligations that Malta would have to assume as a member of the EIB, particularly its capital contribution.

Part III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2002

Directors' report

The Directors present their report and the audited financial statements of the Bank for the year ended 31 December 2002.

Principal activities and review of operations

The Central Bank's Mission and Objectives are set out on page 3. The Governor's Statement on pages 12 to 16 and the Bank's Policies, Operations and Activities on pages 63 to 85 give a detailed account of the Bank's activities and operations during 2002.

Presentation of the financial statements

These financial statements have been prepared so as to give a true and fair view of the state of affairs of the Bank as at 31 December 2002, and of its profit, its changes in equity and its cash flows for the year to that date. The financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards issued by the International Accounting Standards Board in so far as these standards are appropriate to a central bank and applicable in terms of the Central Bank of Malta Act, 1967.

Financial results

The Bank's financial statements for the year ended 31 December 2002 are set out on pages 92 to 116 and disclose an operating profit of Lm19.8 million (2001: Lm26.1 million). The amount payable to Government is Lm24.8 million (2001: Lm25.7 million).

Directors' report – continued

Board of Directors

The members of the Board of Directors during the year were:

Mr Michael C Bonello - Governor
Mr David A Pullicino - Deputy Governor
Mr Alfred F Lupi (reappointed on 21 January 2002; term of office expired on 20 January 2003)
Mr Saviour Falzon
Prof Edward Scicluna (whose term of office expired on 14 November 2002)
Mr Joseph V Gatt (appointed on 1 January 2003)
Ms Philomena Meli (appointed on 21 January 2003)

Dr Bernadette Muscat is the Secretary to the Board with effect from 1 January 2003. During the financial year under review, Mr Herbert Zammit LaFerla was the Secretary to the Board.

Auditors

Our joint auditors MSD & Co informed us that with effect from 1 September 2002 they have combined their practice with Ernst & Young.

Ernst & Young and PricewaterhouseCoopers have signified their willingness to continue in office.

By order of the Board

M C Bonello
Governor

D A Pullicino
Deputy Governor

Castille Place
Valletta
Malta

20 February 2003

Statement of Directors' responsibilities in respect of the financial statements

The Central Bank of Malta is governed by the provisions of the Central Bank of Malta Act, 1967. The Bank has also chosen to prepare financial statements in accordance with the requirements of International Financial Reporting Standards, modified as set out in Note 1(a) to the financial statements to take cognisance of the role of a central bank. The Board of Directors is responsible for ensuring that these financial statements give a true and fair view, on the basis referred to above, of the state of affairs of the Bank as at 31 December 2002, and of the profit, changes in equity and cash flows for the year to that date. The Board of Directors is also responsible for ensuring that the financial statements are drawn up in accordance with the requirements of the Central Bank of Malta Act, 1967.

The Board of Directors is responsible for ensuring that proper accounting records are kept, which disclose at any time the financial position of the Bank and enable the Board of Directors to ensure that the financial statements comply with the requirements set out above. The Board of Directors is also responsible for safeguarding the assets of the Bank and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Board of Directors confirms that suitable accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, have been used in the preparation of the financial statements of the Bank.

Report of the auditors

We have audited the financial statements set out on pages 92 to 116. As described in the statement of Directors' responsibilities on page 90, these financial statements are the responsibility of the Bank's Board of Directors. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. These Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Directors, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of the financial position of the Bank at 31 December 2002 and its profit, its changes in equity and its cash flows for the year then ended, in accordance with the basis of preparation set out in Note 1(a) on page 96, and have been properly prepared in accordance with the Central Bank of Malta Act, 1967.

Ernst & Young

Malta

20 February 2003

PricewaterhouseCoopers

Malta

20 February 2003

Profit and loss account

	Notes	**2002 Lm'000**	2001 Lm'000
Profit for the financial year	3	**19,782**	26,054
Transfer from reserves for risks and contingencies to profits payable to Government	22	**5,000**	-
Transitional adjustment attributable to the remeasurement of derivative financial instruments to fair value on adoption of IAS 39 on 1 January 2001		**-**	(372)
Payable to the Government of Malta in terms of Section 24(4) of the Central Bank of Malta Act, 1967		**24,782**	25,682

Balance sheet

	Notes	**2002 Lm'000**	2001 Lm'000
Assets			
Cash and balances with banks	4	**8,737**	17,885
Gold balances		**473**	629
Placements with banks	5	**600,236**	511,367
Available-for-sale investment securities	6	**233,045**	189,359
Claims on the International Monetary Fund	7	**37,512**	37,863
Other foreign currency assets	8	**844**	3,325
Total external assets		**880,847**	760,428
Available-for-sale local assets:			
Treasury bills	9	**2,177**	969
Domestic debt securities	10	**2,112**	4,804
Derivative financial instruments	11	**610**	1,616
Other assets	12	**37,314**	44,000
Tangible fixed assets	13	**4,936**	4,843
Prepayments and accrued income		**7,946**	10,681
Total assets		**935,942**	827,341
Liabilities and equity			
Liabilities			
Notes and coins in circulation	14	**461,247**	441,829
Deposits by:			
Banks	15	**255,558**	146,789
Government	16	**42,961**	69,080
Others	17	**7,595**	7,644
Profits payable to Government		**24,782**	25,682
Foreign liabilities	18	**6,987**	-
Derivative financial instruments	11	**604**	-
Other liabilities	19	**35,889**	37,478
Accruals and deferred income		**4,978**	3,770
		840,601	732,272
Capital and reserves			
Capital	20	**5,000**	5,000
General reserve fund	21	**23,000**	23,000
Special reserve fund	21	**13,000**	13,000
Reserves for risks and contingencies	22	**43,050**	48,050
Fair value reserve	23	**11,291**	6,019
		95,341	95,069
Total liabilities and equity		**935,942**	827,341

The financial statements on pages 92 to 116 were approved for issue by the Board of Directors on 20 February 2003 and were signed on its behalf by:

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

Statement of changes in equity

	Capital Lm'000	General reserve fund Lm'000	Special reserve fund Lm'000	Reserves for risks and contingencies Lm'000	Fair value reserve Lm'000	Retained earnings Lm'000	Total Lm'000
Balance at 1 January 2001							
- as previously reported	5,000	23,000	13,000	48,050	-	-	89,050
Effect of adopting IAS 39							
- derivative instruments not qualifying as hedges remeasured at fair value	-	-	-	-	-	(372)	(372)
- available-for-sale assets remeasured at fair value	-	-	-	-	5,707	-	5,707
- as restated	5,000	23,000	13,000	48,050	5,707	(372)	94,385
Arising in the financial period:							
- net gains from changes in fair value of available-for-sale assets	-	-	-	-	1,176	-	1,176
Transfers:							
- net gains transferred to net profit on disposal of available-for-sale assets	-	-	-	-	(864)	-	(864)
Net gains not recognised in the profit and loss account	-	-	-	-	312	-	312
Profit for the financial year	-	-	-	-	-	26,054	26,054
Total recognised gains	-	-	-	-	312	26,054	26,366
Transfer to profits payable to Government	-	-	-	-	-	(25,682)	(25,682)
Balance at 31 December 2001	5,000	23,000	13,000	48,050	6,019	-	95,069
Balance at 1 January 2002	5,000	23,000	13,000	48,050	6,019	-	95,069
Arising in the financial period:							
- net gains from changes in fair value of available-for-sale assets	-	-	-	-	9,017	-	9,017
Transfers:							
- net gains transferred to net profit on disposal of available-for-sale assets	-	-	-	-	(3,745)	-	(3,745)
Net gains not recognised in the profit and loss account	-	-	-	-	5,272	-	5,272
Profit for the financial year	-	-	-	-	-	19,782	19,782
Total recognised gains	-	-	-	-	5,272	19,782	25,054
Transfer to profits payable to Government	-	-	-	(5,000)	-	(19,782)	(24,782)
Balance at 31 December 2002	**5,000**	**23,000**	**13,000**	**43,050**	**11,291**	**-**	**95,341**

Cash flow statement

	Notes	**2002 Lm'000**	2001 Lm'000
Cash flows from operating activities			
Profit for the financial year		**19,782**	26,054
Decrease in prepayments and accrued income		**2,735**	4,913
Increase in accruals and deferred income		**1,208**	3,139
Depreciation of tangible fixed assets	13	**348**	434
Amortisation of premiums and discounts on investments		**(252)**	(290)
Profit on sale of investments		**(3,745)**	(864)
Cash flows from operating profits before changes in operating assets and liabilities		**20,076**	33,386
Net changes in operating assets and liabilities:			
Placements with banks		**(62,945)**	115,132
Other foreign exchange assets		**1,312**	(1,091)
Treasury bills		**415**	(76)
Malta Government securities		**2,722**	1,667
Derivative financial instruments		**1,610**	(1,760)
Other assets		**1,686**	36
Deposits		**25,574**	(16,292)
Other liabilities		**(1,589)**	41
Net cash (used in)/from operating activities		**(11,139)**	131,043
Cash flows from investing activities			
Purchase of investment securities		**(380,700)**	(61,571)
Proceeds from sale and maturity of investment securities		**346,252**	78,591
Purchase of tangible fixed assets	13	**(441)**	(470)
Net cash (used in)/from investing activities		**(34,889)**	16,550
Cash flows from financing activities			
Net movement in currency in issue		**19,418**	18,641
Payment to the Government under Section 24(4) of the Central Bank of Malta Act, 1967		**(25,682)**	(25,902)
Net cash used in financing activities		**(6,264)**	(7,261)
Movement in cash and cash equivalents		**(52,292)**	140,332
Cash and cash equivalents at 1 January		**258,153**	117,821
Cash and cash equivalents at 31 December	24	**205,861**	258,153

Notes to the financial statements

1. Accounting policies

The principal accounting policies adopted in the preparation of these financial statements are set out below.

(a) Basis of preparation of financial statements

These financial statements have been drawn up so as to give a true and fair view of the state of affairs of the Bank and its profit, its changes in equity and its cash flows. They have been prepared under the historical cost convention as modified by the fair valuation of available-for-sale investments, all derivative contracts and other assets. The financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards issued by the International Accounting Standards Board in so far as they are appropriate to a central bank and applicable in terms of the Central Bank of Malta Act, 1967, as amplified below.

In exceptional circumstances, as part of its inherent responsibilities as a central bank, the Bank may intervene in the financial markets to help prevent a loss of confidence spreading through the financial system as a whole. Circumstances could arise where confidence can best be sustained if confidentiality is maintained with regard to the Bank's support, or the extent thereof. Accordingly, and as a matter of course, the Bank's financial statements disclose less detail of the constituent elements of the profit and loss account, particularly of interest income and expense and any provisions for bad and doubtful debts, than would be required under International Financial Reporting Standards, with consequential restrictions in related disclosures in the balance sheet, cash flow statement and the notes to the financial statements. Moreover, in view of its role as a central bank, the Bank's exposure to certain financial risks is significantly different from the risk exposure of commercial banks and similar financial institutions. Consequently, the degree of detailed information disclosed on such risks varies from that expected from banks and similar institutions under International Financial Reporting Standards.

The Bank adopted IAS 39 Financial Instruments: Recognition and Measurement in 2001. The financial effects of adopting IAS 39 were reported in the previous year's financial statements.

(b) Investment securities, Malta Government securities and Treasury bills

In accordance with the requirements of IAS 39, the Bank classifies its foreign currency investment securities, Malta Government securities and Treasury bills in the following categories depending on management's intent: trading assets, originated loans and receivables, held-to-maturity and available-for-sale financial assets.

1. **Accounting policies** - continued

(b) Investment securities, Malta Government securities and Treasury bills *- continued*

Securities which are either acquired for generating a profit from short-term fluctuations in price, or are included in a portfolio in which a pattern of short-term profit taking exists, are classified as instruments held for trading. Investments acquired by the Bank at original issuance directly from the issuer by transferring funds directly to the issuer are classified as originated loans and receivables, unless they are acquired with the intent to be sold immediately or in the short-term in which case they would be designated as held for trading. Securities and similar instruments with fixed maturity where management has both the intent and the ability to hold to maturity, other than instruments designated as originated loans and receivables, are classified as held-to-maturity. Investments intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates and exchange rates, are classified as available-for-sale assets. Essentially, available-for-sale financial assets are those financial assets that are not classified as held for trading, loans and receivables originated by the Bank or held-to-maturity investments.

Management determines the appropriate classification of the Bank's investments at the time of the purchase and re-evaluates such designation on a regular basis.

All investment securities, Malta Government securities and Treasury bills are initially recognised at cost (which includes transaction costs). Trading and available-for-sale financial assets are subsequently remeasured at fair value based on quoted market prices. All realised and unrealised gains and losses in respect of trading assets are recognised in the profit and loss account. Unrealised gains and losses arising from changes in the fair value of assets classified as available-for-sale are recognised in equity. When the available-for-sale securities are disposed of or impaired, the related accumulated fair value adjustments in equity, including the amount of adjustment on initial application of IAS 39, are transferred to the profit and loss account.

Investments designated as originated loans and receivables and held-to-maturity assets are subsequently remeasured at amortised cost using the effective yield method, less any provision for impairment. Amortised cost is the initial measurement amount adjusted for the amortisation of any difference between the initial and maturity amounts using the effective interest method.

In respect of available-for-sale investments, any difference between the initial measurement amount and the maturity amount (premium or discount) arising on financial assets that have a fixed maturity is amortised to the profit and loss account using the effective interest rate method over the period to maturity in accordance with the requirements of IAS 39. Fair value changes on available-for-sale assets are calculated as the differences between fair value and amortised cost of such instruments.

1. Accounting policies - continued

(b) Investment securities, Malta Government securities and Treasury bills *- continued*

A financial asset is impaired if its carrying amount is greater than its estimated recoverable amount. The amount of the impairment loss for assets carried at amortised cost is calculated as the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate. By comparison, the recoverable amount of an instrument measured at fair value is the present value of expected future cash flows discounted at the current market rate of interest for a similar financial asset.

Interest earned whilst holding investment securities, Malta Government securities and Treasury bills is reported as interest income.

All regular way purchases and sales of all foreign currency investment securities, Government securities and Treasury bills (transactions that require delivery within the time frame established by regulation or market convention) are recognised at settlement date which is the date on which an asset is delivered to or by the Bank. Any change in fair value for the asset to be received is recognised between the trade date and settlement date.

(c) Derivative financial instruments

Derivative financial instruments, including forward foreign exchange contracts and currency swaps, are initially recognised in the balance sheet at cost (including transaction costs) and subsequently are remeasured at their fair value. Fair values for derivative contracts are determined using forward exchange market rates at the balance sheet date. Discounting techniques are used to reflect the fact that the exchange will not occur until a future date, when the time value of money has a significant effect on the fair valuation of these instruments. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

The Bank uses derivatives principally for macro-hedging purposes so as to hedge foreign exchange risk on its net balance sheet exposure. Accordingly, these derivative transactions, while providing effective economic hedges under the Bank's risk management policies, do not qualify for hedge accounting under the specific rules in IAS 39 and are classified as instruments held for trading, together with other derivative instruments entered into for trading purposes. Changes in the fair value of all derivative instruments that do not qualify for hedge accounting under IAS 39 are recognised immediately in the profit and loss account.

1. Accounting policies - continued

(d) Gold balances

Gold balances are included at current market value which in the opinion of the Directors is fairly reflected by the Maltese lira average of the London fixings for the month of December.

(e) Claims on the International Monetary Fund

The International Monetary Fund Reserve Tranche Position and Special Drawing Rights are shown at the prevailing representative rate for the Maltese lira of SDR1.84467 to Lm1 as quoted by the Fund at the close of business on 31 December 2002.

The International Monetary Fund Maltese lira holdings, including the Non-Interest Bearing Notes, are revalued against the SDR at the representative rate for the Maltese lira quoted by the Fund at 31 December 2002. Adjustments on revaluations of the International Monetary Fund holdings are reflected in the corresponding asset - Currency Subscription.

(f) Sale and repurchase agreements and lending of securities

Securities sold subject to linked repurchase agreements (‘repos’) are retained in the financial statements in the appropriate classification and the counterparty liability is included in amounts due to banks or other customers as appropriate. Securities purchased under agreements to resell (‘reverse repos’) are recorded as advances to banks or other customers as appropriate. The difference between the sale and repurchase price is treated as interest and is accrued in the profit and loss account over the life of repo agreements using the effective yield method. Securities lent to counterparties are also retained in the financial statements.

(g) Other financial instruments

The Bank’s other financial assets, which have not been referred to in the accounting policies disclosed above, are classified as loans and receivables originated by the Bank in accordance with the requirements of IAS 39 and are measured at cost i.e. the face value of these assets. All regular way transactions in assets classified in this category are accounted for using settlement date accounting.

A credit risk provision for financial asset impairment is established if there is objective evidence that the Bank will not be able to collect all amounts due. The amount of the provision is the difference between the carrying amount and the recoverable amount, being the present value of expected cash flows, including amounts recoverable from guarantees and collateral, discounted based on the interest rate at inception.

1. Accounting policies - continued

(g) Other financial instruments *- continued*

The Bank's financial liabilities, other than those referred to in the accounting policies above, are classified as liabilities which are not held for trading ('other liabilities') under IAS 39, and are measured at cost i.e. the face value of such instruments.

(h) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(i) Foreign currency translation

Foreign currency transactions are accounted for at the exchange rates prevailing at the date of the transactions. Gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies at year end exchange rates are recognised in the profit and loss account.

(j) Tangible fixed assets

All tangible fixed assets are stated at historical cost less accumulated depreciation. Depreciation is calculated on the straight-line method to write off the cost of the assets to their residual values over their estimated useful life as follows:

Leasehold property	Over the remaining term of the lease
Computer equipment and other fixed assets	5 - 25%

Where the carrying amount of an asset is greater than its estimated recoverable amount, it is written down immediately to its recoverable amount. Gains and losses on disposal of tangible fixed assets are determined by reference to their carrying amount and are taken into account in determining operating profit.

(k) Leases

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. The total payments made under operating leases are charged to the profit and loss account on a straight-line basis over the period of the lease.

1. Accounting policies - continued

(l) Interest income and expense

Interest income and expense are recognised in the profit and loss account for all interest-bearing instruments on an accrual basis using the effective yield method based on the actual purchase price. Interest income includes coupons earned on fixed income securities and amortised discounts and premiums on Treasury bills and other instruments.

(m) Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition including: cash and balances with banks, Treasury bills, placements with banks, other foreign currency assets, deposits and foreign liabilities.

2. External reserve ratio

The ratio of external assets to notes and coins issued, excluding coins issued for numismatic purposes, and deposit liabilities is 114.78% (2001: 114.29%). In accordance with Section 19(1) of the Central Bank of Malta Act, 1967, the minimum ratio in this respect is 60%.

3. Profit for the financial year

The profit for the financial year is stated after charging:

	2002	2001
	Lm'000	Lm'000
Fees and salaries:		
Directors' remuneration	**50**	50
Staff costs	**2,545**	2,598
Depreciation of tangible fixed assets	**348**	434
Auditors' remuneration	**16**	16
Expenditure in connection with transfer of the functions of the Competent Authority under the Banking Act and the Financial Institutions Act to the Malta Financial Services Authority	**250**	-

4. Cash and balances with banks

	2002	2001
	Lm'000	Lm'000
Cash in hand	**451**	704
Balances with banks – repayable on call and at short notice	**8,286**	17,181
	8,737	17,885

Balances with banks are in the main secured by US Treasury bills which the Bank accepted as collateral under repurchase agreements.

5. Placements with banks

	2002	2001
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**172,153**	59,952
- Three months or less but over one month	**210,339**	217,595
- One month or less	**217,744**	233,820
	600,236	511,367

6. Available-for-sale investment securities

	2002	2001
	Lm'000	Lm'000
By remaining maturity		
- Over five years	**74,607**	75,450
- Five years or less but over one year	**137,332**	99,745
- One year or less but over three months	**15,404**	10,405
- Three months or less	**5,702**	3,759
	233,045	189,359

The Bank's portfolio of investment securities is composed of listed foreign currency debt securities issued mainly by foreign governments and international financial institutions. As at 31 December 2002, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of USD20 million or Lm8 million approximately (2001: USD15 million or Lm6.8 million approximately). No amounts were borrowed under these facilities at the balance sheet dates. At 31 December 2002, investment securities with a fair value of Lm552,000 (2001: Lm5,469,000) were lent out under a securities lending programme with a counterparty.

7. Claims on the International Monetary Fund

	2002	2001
	Lm'000	Lm'000
Reserve Tranche Position	**21,824**	22,869
Special Drawing Rights	**15,688**	14,994
	37,512	37,863

Malta's membership subscription to the International Monetary Fund amounts to SDR102,000,000 (2001: SDR102,000,000).

The Bank's position with the International Monetary Fund at 31 December 2002 is reflected in the balance sheet as follows:

(a) Reserve Tranche Position included above is equivalent to SDR40,258,283. This amount is a claim on the International Monetary Fund and represents the difference between the quota of SDR102,000,000 and the Fund's Maltese lira holdings.

(b) Special Drawing Rights included above are equivalent to SDR28,939,004. These represent the Special Drawing Rights allocated to Malta amounting to SDR11,288,000, to which a corresponding liability exists in the form of a restricted demand deposit of the Government of Malta included under "Other deposits" (see Note 17), together with other Special Drawing Rights acquired in accordance with International Monetary Fund requirements and procedures. Special Drawing Rights allocated to Malta cannot be withdrawn unless such advice is received from the Fund. Other Special Drawing Rights have no specified maturity.

(c) Currency Subscription included with "Other assets" (see Note 12) is stated at Lm33,470,332 and represents the balance of the quota paid in Maltese liri. A corresponding liability included with "Other liabilities" (see Note 19) exists in the form of Non-Interest Bearing Notes of Lm16,651,000 or SDR30,715,600 and IMF current accounts of Lm16,819,332 or SDR31,026,117.

8. Other foreign currency assets

	2002	2001
	Lm'000	Lm'000
Amounts receivable under banking arrangements		
- Repayable within three months	-	1,676
Others	**844**	1,649
	844	3,325

9. Treasury bills

The Bank's holdings of Malta Government Treasury bills include:

	2002 **Lm'000**	2001 Lm'000
By remaining maturity		
- One year or less but over three months	**-**	59
- Three months or less but over one month	**-**	162
- One month or less	**2,177**	748
	2,177	969

10. Domestic debt securities

	2002 **Lm'000**	2001 Lm'000
Malta Government Stocks	**2,112**	4,804

Malta Government Stocks are listed on the Malta Stock Exchange.

Amounts include:

	2002 **Lm'000**	2001 Lm'000
By remaining maturity		
- Over five years	**1,157**	1,387
- Five years or less but over one year	**763**	1,412
- One year or less	**192**	2,005
	2,112	4,804

11. Derivative financial instruments

At the balance sheet dates, the fair values of the Bank's derivative contracts, consisting of forward foreign exchange contracts and currency swaps, are as follows:

	Assets	
	2002	2001
	Lm'000	Lm'000
Foreign exchange derivatives held for trading:		
Contracts maturing within six months from the balance sheet date		
- forward purchase of EUR20 million against Lm	**49**	-
- forward purchase of USD15 million against Lm	**-**	3
- forward sale of EUR4 million against Lm	**-**	9
- forward sale of JPY200 million against USD	**-**	50
Contract expiring in 2010		
- forward sale of EUR39.9 million (2001: EUR47.4 million) against Lm	**561**	1,554
	610	1,616

Settlement of the forward contract expiring in 2010 is guaranteed by the Government of Malta.

	Liabilities	
	2002	2001
	Lm'000	Lm'000
Foreign exchange derivatives held for trading:		
Contracts maturing within six months from the balance sheet date		
- forward purchase of USD60 million against Lm	**416**	-
- forward sale of Lm11 million against GBP	**188**	-
	604	-

12. Other assets

	2002 Lm'000	2001 Lm'000
International Monetary Fund Currency Subscription	**33,470**	35,078
Amounts receivable under repurchase agreements	**-**	5,000
Others	**3,844**	3,922
	37,314	44,000

The Bank accepted listed Malta Government securities at fair value of Lm5,070,000 as collateral for amounts receivable under repurchase agreements as at 31 December 2001. These agreements matured within one month from the balance sheet date.

13. Tangible fixed assets

	Leasehold property Lm'000	Others Lm'000	Total Lm'000
Year ended 31 December 2002			
Opening net book amount	4,355	488	4,843
Additions	7	434	441
Depreciation charge for the year	(66)	(282)	(348)
Closing net book amount	**4,296**	**640**	**4,936**
At 31 December 2002			
Cost	4,493	2,296	6,789
Accumulated depreciation	(197)	(1,656)	(1,853)
Net book amount	4,296	640	4,936
At 31 December 2001			
Cost	4,486	1,862	6,348
Accumulated depreciation	(131)	(1,374)	(1,505)
Net book amount	4,355	488	4,843

14. Notes and coins in circulation

	2002 Lm'000	2001 Lm'000
Notes	**443,905**	423,835
Coins	**17,342**	17,994
	461,247	441,829

15. Bank deposits

	2002	2001
	Lm'000	Lm'000
Reserve deposits held in terms of Section 37 of the Central Bank of Malta Act, 1967	**151,558**	125,789
Liabilities arising from monetary policy instruments	**104,000**	21,000
	255,558	146,789

Liabilities arising from monetary policy instruments mature within one month from the balance sheet date.

Amounts include:

	2002	2001
	Lm'000	Lm'000
By currency		
Maltese liri	**250,256**	145,699
Foreign	**5,302**	1,090
	255,558	146,789

16. Government deposits

Amounts include:

	2002	2001
	Lm'000	Lm'000
Current accounts by currency		
Maltese liri	**19,067**	20,960
Foreign	**3,974**	4,680
Sinking fund accounts by currency		
Maltese liri	**9,479**	32,796
Foreign	**10,441**	10,644
	42,961	69,080
By remaining maturity		
- Repayable within three months	**-**	583
- Repayable on demand	**42,961**	68,497
	42,961	69,080

17. Other deposits

	2002 Lm'000	2001 Lm'000
Deposits by Public Sector Corporations and similar entities:		
- Repayable within three months	**-**	2
- Repayable on demand	**1,293**	810
	1,293	812
International Monetary Fund SDR allocation	**6,119**	6,413
Others:		
- Repayable on demand	**183**	419
	7,595	7,644

Amounts include:

	2002 Lm'000	2001 Lm'000
By currency		
Maltese liri	**454**	497
Foreign	**7,141**	7,147
	7,595	7,644

18. Foreign liabilities

	2002 Lm'000	2001 Lm'000
Amounts payable under banking arrangements		
- Repayable within three months	**6,987**	-

19. Other liabilities

	2002 Lm'000	2001 Lm'000
International Monetary Fund Non-Interest Bearing Notes	**16,651**	18,256
International Monetary Fund current accounts	**16,819**	16,822
Others	**2,419**	2,400
	35,889	37,478

20. Capital

The capital authorised by Section 18(1) of the Central Bank of Malta Act, 1967 is fully paid up and held by the Government of Malta.

21. Reserve funds

Reserves are maintained in terms of Section 18(2) and (3) of the Central Bank of Malta Act, 1967. The General Reserve is held to strengthen the capital base of the Bank and shall be available for any purpose as may be determined by the Board of Directors. In accordance with Section 24(2) of the Central Bank of Malta Act, 1967, profits or losses attributable to any revaluation of the Bank's net external assets or liabilities, arising from an adjustment of the external value of the Maltese lira, are accounted for in the Special Reserve. The balance of the Special Reserve fund shall be dealt with as determined by the Bank's Board of Directors.

22. Reserves for risks and contingencies

Reserves for risks and contingencies are maintained in terms of Section 24 of the Central Bank of Malta Act, 1967 to cover the broad range of risks to which the Bank is exposed. The major risks in this regard arise from: losses which could result from pursuing monetary policy objectives, potential movements in market values of the Bank's holdings of domestic and foreign securities and other investments, losses which could arise from support of the financial system in the Bank's role as a lender of last resort, and other non-insured losses.

23. Fair value reserve

Gains and losses arising from the change in the fair value of available-for-sale assets are recognised directly in equity through the fair value reserve following the accounting policy disclosed in Note 1(b) to the financial statements. When the assets are disposed of, the related accumulated fair value adjustments deferred in equity, including the amount of the adjustment on initial application of IAS 39, are transferred to the profit and loss account as gains and losses from available-for-sale assets.

	Available-for-sale investment securities Lm'000	Available-for-sale local assets Lm'000
On adoption of IAS 39 at 1 January 2001	5,675	32
Net gains/(losses) from changes in fair value	1,188	(12)
Net gains transferred to net profit on disposal	(815)	(49)
At 31 December 2001	6,048	(29)
Net gains from changes in fair value	8,987	30
Net (gains)/losses transferred to net profit on disposal	(3,797)	52
At 31 December 2002	11,238	53

This reserve is not considered to be available for distribution by the Directors.

24. Cash and cash equivalents

For the purposes of the cash flow statement, the year end cash and cash equivalents represent the following:

	2002	2001
	Lm'000	Lm'000
Cash and balances with banks (Note 4)	**8,737**	17,885
Treasury bills maturing within three months (Note 9)	**2,177**	555
Placements with banks maturing within three months (Note 5)	**340,210**	314,286
Other foreign currency assets maturing within three months (Note 8)	**-**	1,676
Other assets maturing within three months (Note 12)	**-**	5,000
Deposits maturing within three months (Notes 15, 16 and 17)	**(138,276)**	(81,249)
Foreign liabilities maturing within three months (Note 18)	**(6,987)**	-
	205,861	258,153

Treasury bills, placements with banks and deposits with a contractual period to maturity of less than three months are treated as cash equivalents as they represent the Bank's principal liquidity.

25. Financial instruments

The nature of the Bank's operations implies that financial instruments, including derivatives, are extensively used in the course of its activities. The Bank is potentially exposed to a range of risks and hence operates a risk management strategy with the objective of controlling its exposures. Besides the risks relating to a central bank's role which are referred to in Note 22 above, the principal categories of operational risk faced by the Bank are credit risk and currency risk.

Credit risk

The Bank has in place internal control structures to assess and monitor credit exposures and risk thresholds. The Bank places limits on the level of credit risk undertaken from the main categories of financial instruments, covering on and off-balance sheet exposures, in relation to individual financial institutions and groups of financial institutions classified by country of origin. These limits are approved by the Board of Directors and actual exposures are monitored against limits on a daily basis. Funds are placed with, and derivative instruments are entered with, financial institutions having a first class credit rating. The Bank invests only in first class quality paper. Credit risk with respect to guarantees and letters of credit is limited since the Bank's customers are mainly public sector corporations and other entities owned by the Government.

25. **Financial instruments** - continued

Currency risk

Investments and other instruments denominated in foreign currency are held in a mix of currencies which reflects, in the main part, their respective weighting in the Maltese lira basket. As a result, exposure to currency risk is managed within controlled parameters.

At 31 December, the Bank's net foreign currency holdings determined by reference to transaction amounts, including amounts arising under derivative financial instruments but excluding claims on the International Monetary Fund, were in the following currencies:

	2002	2001
	%	%
EUR	**70.82**	51.07
GBP	**19.72**	22.72
USD	**9.23**	25.99
Others	**0.23**	0.22
	100.00	100.00

Interest rate risk

Whilst the majority of the Bank's assets are interest-bearing, the Bank's main liabilities are not subject to interest. The Bank mainly invests in, and places funds under, instruments subject to fixed interest rates. However interest rate risk is considered to be quite limited by the Directors in view of the short periods to maturity or the realisable nature of the Bank's financial assets. Also, the Bank's interest-bearing liabilities mature or are repriceable within relatively short periods of time. Accordingly, the level of disclosure on such risks varies from that expected from banks and similar institutions under International Financial Reporting Standards.

Liquidity risk

The Bank's liquidity risk is relatively insignificant in view of the short-term maturities of the principal categories of its financial assets and due to the nature of the Bank's main liabilities. The Bank's assets and liabilities are analysed into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date in the respective Notes to the financial statements.

25. Financial instruments - continued

Fair values of financial assets and liabilities

The following financial assets and liabilities include the main categories of instruments not presented on the Bank's balance sheet at their fair value: cash and balances with banks, balances with the International Monetary Fund, placements with banks together with deposits by banks, the Government of Malta, public sector corporations and other similar entities, and currency in circulation. The carrying amount of these instruments approximates fair value due to their nature or short-term maturity. Deposits by banks mainly comprise reserve deposits. The face value of reserve deposits, balances with the International Monetary Fund and currency in circulation is essentially their fair value in view of the substance of the instruments or arrangements in place. Placements with banks mature principally within a period of six months from the financial year end. All deposit liabilities, excluding reserve deposits and International Monetary Fund SDR allocation, are repayable within one month from the balance sheet date.

26. Contingent liabilities and commitments

	2002 **Lm'000**	2001 Lm'000
Contingent liabilities		
Guarantees and letters of credit	**19,817**	24,391
Commitments		
Repayment of foreign loans received by the Bank on behalf of the Government under Financial Conventions	**15,275**	18,001
Total	**35,092**	42,392

By remaining maturity:

Guarantees and letters of credit

	2002 **Lm'000**	2001 Lm'000
- Five years or less but over one year	**-**	9,256
- One year or less but over three months	**15,698**	5,725
- Three months or less	**4,119**	9,410
	19,817	24,391

26. Contingent liabilities and commitments - continued

Commitments in respect of foreign loans received by the Bank on behalf of the Government under Financial Conventions and repayable in due course from funds to be made available by Government

	2002	2001
	Lm'000	Lm'000
- Over five years	**5,112**	7,014
- Five years or less but over one year	**7,954**	8,690
- One year or less but over three months	**2,055**	2,132
- Three months or less	**154**	165
	15,275	18,001

Also, the Bank has guaranteed the due performance of a local bank's financial obligations in respect of credit facilities granted by an international financial institution for an amount of EUR25 million or Lm10.5 million approximately (2001: EUR25 million or Lm10 million approximately). The Bank has granted this international institution an indemnity against all possible losses in connection with these facilities. No amounts were drawn under these facilities at the balance sheet dates. At 31 December 2002, the Bank has accepted as collateral listed Malta Government securities at fair value of Lm10,990,000 (2001: Lm10,547,000) which have been pledged in its favour by the local bank under these arrangements.

27. Related parties

In the course of its operations, the Bank conducts business with and provides several services to the Government of Malta, government departments, public sector corporations and other entities owned by the Government.

The main services are:-

- provision of banking services, including holding the principal accounts of the Government of Malta;
- management of the Note Issue, including printing of notes;
- money transmission services;
- provision of foreign exchange services and safe custody facilities;
- administration of the foreign pensions subsidy scheme on behalf of the Government of Malta.

28. General

(a) Demonetised currency notes and coins

Demonetised currency notes

In accordance with Section 42 of the Central Bank of Malta Act, 1967, after the expiration of one year following the end of the period established in the notice of demonetisation, any unpresented demonetised notes shall cease to be included in the Bank's currency liabilities. The value of such notes, after deducting therefrom the value of any notes which are subsequently redeemed, are apportioned to the profit and loss account of the Bank over the remaining period until the expiration of ten years from the end of the period above mentioned. After the expiry of ten years from the notice of demonetisation, demonetised currency notes not yet presented are no longer redeemed by the Central Bank of Malta.

During 2002, demonetised currency notes presented for redemption amounted to Lm680,932 (2001: Lm364,609). At 31 December 2002, the value of unpresented demonetised currency notes amounted to Lm4,047,488 (2001: Lm5,202,389) analysed as follows:

	2002	2001
	Lm'000	Lm'000
Ten year period expires in:		
- 2002	**-**	589
- 2003	**591**	597
- 2008	**1,009**	1,056
- 2010	**2,447**	2,960
	4,047	5,202

Demonetised coins

On 9 April 2002, in accordance with Section 43(6) of the Central Bank of Malta Act, 1967, notice was given in the Government Gazette to call in the 50c 1st series and 25c 1st series coins. With effect from 17 June 2002, amounts of Lm1,018,878 and Lm388,270 in respect of the above mentioned coins ceased to be legal tender.

After the expiration of six months following 17 June 2002, any coins not presented for redemption ceased to be included in the Bank's coin liabilities and the value of such coins, after deducting therefrom the value of any coins which are subsequently redeemed, shall be apportioned to the profits of the Bank over the remaining period until the expiration of two years from the date mentioned above. After the expiration of the two year period, coins are no longer redeemed by the Central Bank of Malta.

At 31 December 2002, the value of unpresented coins amounted to Lm999,431 and Lm383,998 in respect of the 50c 1st series and 25c 1st series coins respectively.

28. General - continued

(b) Average number of employees

The average number of persons employed by the Bank during the year was as follows:

	2002 **Number**	2001 Number
Governors and Deputy General Managers	**7**	7
Heads and Executives	**69**	75
Supervisory and clerical staff	**182**	185
Non-clerical staff	**47**	48
	305	315

(c) Assets held in custody

At 31 December 2002, assets held in custody by the Bank in terms of the Insurance Business Act amounted to Lm28,259,000 (2001: Lm30,382,000).

29. Statement of the Bank's investments

The statement of the Bank's external assets below is disclosed in accordance with the requirements of Section 23(1)(b) of the Central Bank of Malta Act, 1967.

The exposure country is essentially the country of location of the institution or entity with which the Bank's placements and other financial assets are held. The exposure country in respect of assets held with branches of international banks and financial institutions is usually deemed to be the country of location of the parent. In case of subsidiaries of banks and financial institutions, the exposure country is generally determined on the basis of the location of the subsidiary undertaking.

29. Statement of the Bank's investments - continued

	EUR Lm'000	GBP Lm'000	USD Lm'000	Others Lm'000	Total Lm'000
Cash in hand	333	32	72	14	451
Balances with banks repayable on call and at short notice by exposure country					
France	63	-	-	-	63
Germany	182	-	-	-	182
Italy	79	-	-	-	79
United Kingdom	9	597	258	218	1,082
United States of America	-	-	5,812	-	5,812
Other countries	66	3	-	61	130
International financial institutions	378	109	1	450	938
	777	709	6,071	729	8,286
Gold balances by exposure country					
United Kingdom	-	-	-	413	413
Others	-	-	-	60	60
	-	-	-	473	473
Placements with banks by exposure country					
Australia	20,911	4,501	-	-	25,412
Belgium	48,514	3,215	-	-	51,729
Canada	56,084	18,645	-	-	74,729
Denmark	21,748	6,429	-	573	28,750
France	35,968	-	-	632	36,600
Germany	56,461	-	-	-	56,461
Ireland	24,257	3,858	-	-	28,115
Italy	40,150	-	-	-	40,150
Netherlands	28,021	33,433	-	-	61,454
Sweden	28,021	-	-	-	28,021
Switzerland	24,257	-	-	-	24,257
United Kingdom	113,340	28,290	-	-	141,630
International financial institutions	2,928	-	-	-	2,928
	500,660	98,371	-	1,205	600,236
Available-for-sale investment securities by issuer category					
Corporate	782	-	-	-	782
International banks and financial institutions	45,811	49,825	32,589	-	128,225
Sovereign	59,429	5,683	15,411	-	80,523
Sovereign agencies	8,706	-	14,809	-	23,515
	114,728	55,508	62,809	-	233,045
Claims on the International Monetary Fund	-	-	-	37,512	37,512
Other foreign currency assets	-	-	-	844	844
Total external assets	**616,498**	**154,620**	**68,952**	**40,777**	**880,847**