Central Bank of Malta

THIRTY-SEVENTH ANNUAL REPORT

AND

STATEMENT OF ACCOUNTS

2004

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Our Mission

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

We 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

To achieve the above objectives, the Bank is committed to providing effective support functions through a sound financial control system and appropriate information systems, and through the development of competent and qualified staff.

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Deputy Governor

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Philomena Meli	*Director*
Charles J. Falzon	*Director*

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Senior Manager
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Manager
Middle Office

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Investments and Reserves Office

*As at 30 March 2005

THE BOARD OF DIRECTORS

(Left to right)
Philomena Meli (Director), Charles J. Falzon (Director), Joseph V. Gatt (Director), Michael C. Bonello (Governor & Chairman), David A. Pullicino (Deputy Governor), Bernadette Muscat (Secretary)

Philomena Meli was appointed as Director of the Central Bank of Malta for a period of five years with effect from 21 January 2003. She is a trade policy expert and is currently a consultant in the Economic Policy Division at the Ministry of Finance.

Charles J. Falzon was appointed as Director of the Central Bank of Malta for a period of five years with effect from 7 February 2004. He is an economist and management consultant and is currently a Senior Lecturer in the Faculty of Economics, Management and Accountancy at the University of Malta.

Joseph V. Gatt was appointed as Director of the Central Bank of Malta for a period of five years with effect from 1 January 2003. He is an economist and a retired banker.

Organisation Chart*

- Governor
  Michael C. Bonello
  - Deputy Governor
    David A. Pullicino
    - Director
      Economics & External Relations Division
      Alfred Demarco
      - Economic Research Department
        - Economic Analysis Office
        - Research Office
        - Statistics Office
        - External Transactions Data Office
      - Library & External Relations Department
        - Library
        - External Relations Office
    - Director
      Finance & Banking Division
      Godfrey Huber
      - Banking & Issues Department
        - Retail Banking Office
        - Payment Systems Office
        - Currency Issue Office
      - Financial Control Department
        - Finance Office
    - Director
      Financial Markets Division
      René G. Saliba
      - Domestic Markets Department
        - Monetary Operations Office
        - Money & Capital Markets Office
        - Government Debt Analysis Office
      - Reserve Management Department
        - Investments & Reserves Office
        - FX Market Analysis Office
        - Middle Office
    - Director
      Financial Stability Division
      Herbert Zammit LaFerla
      - Financial Stability Department
        - Financial Stability Office
      - Internal Audit & Risk Assessment Department
        - Risk Assessment Office
        - Internal Audit Office
    - Director
      Resource Management Division
      John Agius
      - Resources Department
        - Human Resources Office
        - Administration Office
        - Security
      - Information Systems Department
        - IT Services Office
        - Software Development Office
        - Records Management Services Office
  - Legal Office

*As at 30 March 2005

LETTER OF TRANSMITTAL

CENTRAL BANK OF MALTA
VALLETTA

30th March 2005

Dear Prime Minister,

In accordance with Article 23(1) of the Central Bank of Malta Act (Cap. 204), 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 2004, 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

ABBREVIATIONS

BIS	Bank for International Settlements
ECB	European Central Bank
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
EMU	Economic Monetary Union
ETC	Employment and Training Corporation
EU	European Union
GDP	Gross Domestic Product
IMF	International Monetary Fund
MFSA	Malta Financial Services Authority
MHRA	Malta Hotels and Restaurants Association
MSE	Malta Stock Exchange
NSO	National Statistics Office
OECD	Organisation for Economic Co-Operation and Development
OPEC	Organisation of Petroleum Exporting Countries
RPI	Retail Prices Index
WTO	World Trade Organisation

Governor's Statement

Malta's accession to membership of the European Union on 1 May 2004 has opened up new opportunities for economic and social development. The economy now enjoys wider access to export markets, increased competition at home and a greater availability of external financial resources under EU funding programmes. The successful exploitation of the Single Market, however, requires the adjustment of institutional structures and operating practices to this novel environment. This challenge, moreover, has coincided with the intensification of competition in world markets and the growing diversion of both consumption demand and investment to lower-cost countries.

These factors weighed heavily on the performance of the Maltese economy in 2004. While the removal of the remaining trade restrictions in anticipation of EU membership produced a steady increase in imports, the response of exporters was slower. At the same time, critical areas of export activity such as electronics and tourism continued to be faced with unfavourable external demand conditions. As a result, although real GDP grew by 1.5%, which represented a marked turnaround from the decline registered in 2003, this was low compared to the rates achieved by the other new EU Member States, particularly those whose level of development is comparable to Malta's.

A similar picture emerges when the economy's performance is viewed in a medium-term perspective. The annual average rate of GDP growth between 2000 and 2004, about 1.5%, was around half that registered in the new Member States with a similar level of development and also lower than the overall EU average of 1.9%. Malta's position in terms of per capita GDP relative to that of other EU countries has weakened as a result.

The persistence of sluggish growth in the domestic economy cannot be explained exclusively in terms of a cyclical downturn, as the world economy posted strong growth in 2004, though the recovery in the EU remained modest. While the global economic environment is clearly becoming more difficult, there is, however, evidence that the delay in implementing effective competitiveness-enhancing reforms is also an important factor in Malta's case. This, together with the fact that the relationship between productivity and costs has tended to deteriorate compared to that in competitor countries, partly explains why Malta does not appear to be capitalising on the new opportunities to the same extent as most of the other new EU Member States.

An important cause, and indeed also an effect, of the slow pace of economic growth is the relatively low level of investment activity. Whereas the proportion of GDP allocated to private investment in Malta averaged 16% over the five years to 2003, the figure for the new Member States with a comparable level of development was closer to 20%. At the same time, however, consumption in Malta was around five percentage points higher than in these countries at 82% of GDP. Apart from putting further downward pressure on the national saving ratio, this sustained level of consumption at a time of weak growth is tending to accentuate the imbalance in the external accounts. The deficit in the balance on goods and services averaged over 5% of GDP during the past five years and widened to around 7% in 2004, as the demand for imports was sustained while exports showed virtually no growth.

Trends in monetary aggregates during the year mirrored these developments. The increase in bank credit was directed almost exclusively to the personal, and particularly the housing sector, rather than the corporate sector, a phenomenon which is generating undesirable upward pressure on property prices; and the fall in the Central Bank of Malta's external reserves towards the end of the year reflected developments in the balance of payments position.

Another important factor underlying the economy's poor growth record is the relatively large fiscal deficit, which over the past five years averaged 6.8% of GDP. As I have often had occasion to point out, a persistent fiscal imbalance of this size implies inefficiencies in the allocation of resources and constitutes a source of uncertainty for potential investors regarding the future direction of taxation policy.

The Bank, therefore, welcomes the reduction in the fiscal deficit to 5.2% of GDP in 2004. The achievement of this Convergence Programme target is an important first step towards the realisation of the Government's medium-term fiscal consolidation plan, which aims to narrow the deficit further to around 1.4% of GDP by 2007. This is an ambitious objective whose attainment, as indicated in the Programme, is predicated initially on containing growth in public expenditure and subsequently on reducing it in absolute terms. The completion of major infrastructure projects will contribute significantly to this objective, but consistent cuts in recurrent expenditure in real terms will also be needed. And since the latter is largely composed of non-discretionary spending, including welfare payments, wages and salaries and debt-servicing costs, reaching the fiscal targets will require measures aimed at reforming the health and pension systems, reducing the size of the public sector and eliminating waste and tax evasion.

It is clear that in the recent past the economy has been growing at well below its potential rate. The fact that low investment and growth rates coexist with high levels of consumption and, therefore, also of imports, is a source of concern because such trends reflect imbalances that are not sustainable in the medium term. In this regard, the high fiscal and current account deficits and uncompetitive cost structures are major obstacles to the attainment of a higher growth rate.

The discussions aimed at the conclusion of a social pact that were launched last year held out the hope that these issues would be meaningfully addressed. Indeed, the measures proposed in the course of this exercise, such as fiscal consolidation with an accent on pruning public spending; boosting competitiveness through the achievement of slimmer cost structures; and the development of human resources through investment in education and training, are indispensable components of any economic recovery plan. Similar policy orientations are indeed being adopted in several countries, including some of the more advanced economies. While it is encouraging to note, therefore, that some of the measures contained in the Government's Budget for 2005 were inspired by these proposals, the inability of the social partners to reach agreement suggests that there is as yet an insufficient understanding of global economic realities and of the threat they represent for Malta's small economy, and more specifically for employment levels.

That threat will not go away. In facing up to this challenge, moreover, it must be recognized that, in today's highly competitive environment, there are no painless options that will at once produce more rapid growth, enhanced welfare benefits and higher living standards.

If it is to succeed, the quest for greater competitiveness should, therefore, be pursued as a collective effort and perceived as being in the mutual interest of all the social partners. It must be premised on an acceptance of the need to raise output levels without increasing costs and to invest a larger proportion of available resources.

In the labour market there is a need for more flexible work practices and for wage increases to be matched by measurable productivity improvements, also bearing in mind developments in Malta's international competitiveness. The unemployment benefit system, moreover, should be further reformed so as to transform it into an effective instrument of employment creation rather than of social dependence.

In the area of public health and welfare, the extensive range of services and benefits offered should be critically assessed with a view to ensuring their financial sustainability. Their provision at zero cost to the end user often induces excess demand and waste, and indirectly imposes a burden on the productive sectors of the economy, thereby compromising the very generation of income through which the welfare state is financed. It is, therefore, necessary to move away from universal schemes towards more focused programmes aimed at fulfilling genuine needs, because it is clear that the country can no longer afford to provide such a wide range of goods and services for free to all, irrespective of income levels. This should be complemented by the introduction of user fees designed to meet, at least in part, the cost of providing these benefits. The task of financing health and welfare programmes would also be facilitated through a more systematic effort to enforce tax compliance.

Sound public finances and macroeconomic fundamentals are critical to the role played by the Central Bank of Malta in the economy. The Bank operates a monetary policy aiming at achieving price stability through the maintenance of an exchange rate peg. Excessive fiscal deficits and uncompetitive cost structures thwart the attainment of price stability by contributing to inflationary and balance of payments pressures. This consideration will acquire even greater importance when Malta joins the ERM II, with the aim of satisfying the exchange rate stability criterion for adopting the euro. Failure to undertake the necessary fiscal and supply-side adjustments would, therefore, be likely to require a tighter monetary policy stance.

Financial stability is the Bank's other main objective. Due to the strong links between the financial system and the productive sectors of the economy, the soundness of the former is influenced by the competitive strength of the latter. The maintenance of financial stability could, therefore, be rendered more difficult by the misallocation of resources implicit in structural fiscal imbalances and by an insufficient ability to compete on world markets.

Sustainable and coherent fiscal and monetary policies also impinge crucially on the medium-term objective of adopting the euro as the national currency. I have already had occasion to explain the importance for Malta's small, open economy to lock in, at the earliest practical opportunity, the increased economic security and credibility which this step would imply. The economy is well suited to participate in the single currency area. It is already substantially integrated with it through trade and finance, the structures of the two economies bear marked similarities and the Maltese lira is closely pegged to the euro. As for the benefits of the euro, these are well documented. Most importantly, it facilitates the exploitation of the opportunities for increased trade in the Single Market by reducing transaction costs and by eliminating exchange rate risk and uncertainty.

While there are clearly short-term costs implied by the process of fiscal consolidation and structural reform, which must be undertaken nevertheless as a basis for sustainable economic growth, the prospect of securing the benefits of full participation in Economic and Monetary Union should, therefore, serve to motivate a common effort in support of policies aimed at ensuring a rapid and smooth transition to the euro.

Bank operations

In a major development in its history, following Malta's accession to the EU, the Central Bank of Malta became a member of the European System of Central Banks and took up a shareholding in the subscribed capital of the European Central Bank. Given that Malta joined the EU as a 'Member State with a derogation', monetary policy still remains the Bank's sole responsibility, though the Bank participates in regular discussions on monetary policy and general economic issues within the ESCB and in other EU fora.

During 2004 the Bank left its monetary policy stance unchanged, keeping the central intervention rate at 3%. The Bank's external reserves fluctuated during the year, rising for most of the period to September before falling in the final quarter, reflecting a combination of seasonal factors and structural influences, including the liberalization of trade and higher oil prices. Nevertheless, the reserves continued to provide adequate support for the exchange rate peg, comfortably exceeding the monetary base and the statutory minimum level. An unchanged monetary policy stance was also considered appropriate in the absence of strong underlying inflationary pressures and in the context of subdued domestic aggregate demand.

As far as the implementation of monetary policy is concerned, in January the Bank adjusted its operational framework. It revised its overnight lending and deposit rates by setting a symmetrical band around the central intervention rate. At the same time, it linked the remuneration applied to reserve deposits, which previously was a fixed rate, to the central intervention rate. These changes were carried out to remove possible distortions to the Bank's interest rate structure. Later in the year, the Bank also amended its directive on reserve requirements, so as to enable it, under certain conditions, to exempt credit institutions from holding reserve deposits on a non-discriminatory basis.

In April, ahead of Malta's accession to the EU, virtually all remaining restrictions on external transactions were removed, ensuring the free movement of capital between residents and non-residents. The process of gradual liberalisation of exchange controls, which had been under way for a number of years, was thereby completed.

In exercising its statutory responsibility for financial stability, the Bank continued to monitor the domestic financial system to identify any structural weaknesses, while maintaining close contact with the Malta Financial Services Authority, the single financial regulator. The Bank also continued to regulate and supervise the domestic payment and settlement systems. The Bank's overall assessment of the domestic banking system, which is the dominant component of the financial system, appears favourable, particularly because of the banks' robust levels of capital. At an institutional level, on Malta's joining the EU, the Governor and the Chairman of the MFSA, together with their counterparts from the other new Member States, signed two Memoranda of Understanding, one on co-operation in crisis management and the other on co-operation and the exchange of information regarding the operation of payment systems.

In line with its new status in the ESCB, the Bank took its place on the General Council of the ECB as a member and on the system's twelve committees. Links with the ECB deepened across the entire range of the Bank's operations, including statistics, currency and market operations, information technology and payment and settlement systems. The Bank also kept the Government regularly informed on its policies and on matters related to the eventual adoption of the euro, and began practical preparations in this direction.

The Bank's net operating profits amounted to Lm14.9 million in 2004 as against Lm18.2 million the previous year. The reduction was mainly driven by lower income on the Bank's external reserve portfolio.

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

The world economy

In 2004 the global economy posted its strongest growth rate in decades, estimated at 3.9%, compared to 2.4% in 2003. In fact, many regions recorded an improved economic performance, supported by exceptionally robust international trade. The US economy was the primary driver of this activity, although the Chinese economy expanded rapidly and even Japan recorded its strongest performance in several years. In contrast, the euro area economy continued to grow at a lacklustre pace. Meanwhile, rising energy prices and the US current account deficit were considered potential sources of instability in 2005.

The US economy expanded by 4.4% in 2004 after registering a healthy upturn in 2003. Monetary policy remained supportive and this, together with government consumption, provided added stimulus to the economy. Private consumption expenditure - which accounts for around two-thirds of economic activity - grew by 3.8%, while investment rose by an extraordinary 13.2%. This strong growth was accompanied by a reduction in the unemployment rate to 5.5%, while the rate of inflation averaged 2.7% over the year. On the other hand, the excessive budget deficit, coupled with a low saving rate, continued to have a negative impact on the external balance of the US economy.

The euro area's economic performance was characterised by slow growth and high unemployment. The second quarter national accounts data were relatively encouraging, as exports accelerated sharply, but in the second half of the year the strength of the euro and higher oil prices dampened the area's competitiveness. These developments increased pressures to speed up structural reforms, especially to improve labour market flexibility. Meanwhile, unemployment in the euro area remained high at 8.9%, while consumer price inflation was estimated to average 2.1% over the year.

The UK economy is estimated to have grown by 3.1% in 2004, led primarily by government expenditure and household consumer spending. In the first half of the year the economy sustained its dynamic momentum but activity slowed down later in the year. Nevertheless, unemployment remained at record-low levels, falling to 4.7% in November. Consumer price inflation accelerated slightly in the last few months of the year, but it remained below the government's 2% target level.

The Japanese economy responded to strong external demand, notably from China, which continued to exert increasing influence on economic activity in the region. Business investment expanded in line with increasing corporate profits and strong exports. Thus,

Table 1.1
INTERNATIONAL ECONOMIC INDICATORS
% change from previous year

	Real GDP			Consumer prices		
	2003	2004	2005[1]	2003	2004	2005[1]
United States	3.0	4.4	3.5	2.3	2.7	2.4
Euro area	0.5	2.0	1.7	2.1	2.1	1.8
United Kingdom	2.2	3.1	2.5	1.3	1.4	1.7
Japan	1.4	2.6	1.1	-0.3	0	0
World total	2.4	3.9	3.0	2.4	2.5	2.3

[1] Forecasts

Sources: Consensus Forecasts; ESRI, Japan.

although the pace of growth weakened later in the year, the Japanese economy managed to achieve a better overall growth rate of 2.6% in 2004, compared to 1.4% in 2003. The general improvement in the economy helped to further reduce unemployment to 4.7%. Meanwhile, deflationary pressures moderated and the consumer price level, which had been on a downward trend in previous years, remaining stable over the year as a whole.

Interest rates and exchange rates

In the first half of 2004, the Federal Reserve kept its target for the federal funds rate at the historically low level of 1% despite the US economy's strong performance. In June, however, the target rate was raised by 25 basis points in response to continued strength in output and productivity growth. The Federal Reserve then continued to gradually tighten monetary policy, raising the federal funds rate by quarter percentage points on four occasions in the following six months. Thus, at the end of the year the federal funds rate stood at 2.25% (see Chart 1.1).

In the euro area, the ECB left its minimum bid rate unchanged at 2% throughout the year, even though it periodically cited inflationary pressures as a concern. To a certain extent, however, the strength of the euro prevented rising dollar-quoted oil prices from having any further effect on the general price level in the region.

In the UK, the Bank of England raised its repo rate by 25 basis points on four occasions during the first eight months of 2004, anticipating emerging price pressures along with improvement in the economic scenario. But from August onwards, the Bank left the repo rate unchanged at 4.75%, as inflation remained below the 2% target level and several indicators pointed towards a deceleration in property market activity.

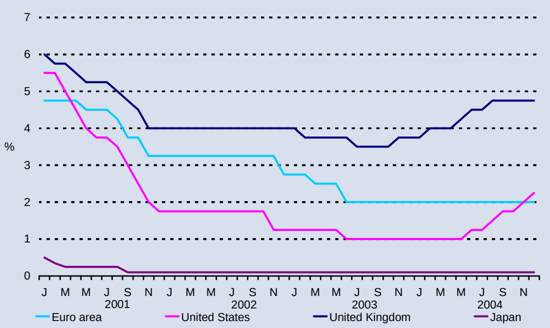
Meanwhile, in Japan the Bank of Japan maintained its policy of quantitative easing throughout the year. Although consumer price inflation turned positive at the end of the year, the Japanese central bank maintained its current stance as it remained concerned about a re-emergence of deflation.

US three-month interest rates firmed throughout the year in line with the evolving outlook for monetary policy, while in the euro area they rose only marginally. Short-term rates in the UK edged upwards towards August but fell slightly thereafter. In Japan, meanwhile, money market rates remained stable throughout the year, reflecting the unchanged official rates.

Long-term interest rates rose significantly in the major economies between March and June, principally due to improvements in global economic conditions and concerns about the inflation outlook. Yet ten-year bond yields generally declined in the second half of the year (see Chart 1.2). In the US, however, yields began to rise again in November, against the general trend, following positive employment data and higher-than-expected inflation.

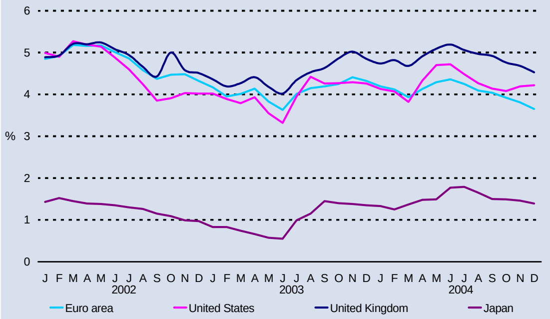
Growing concern about the deteriorating US trade deficit was the main influence on foreign exchange markets in 2004. Sharp movements in exchange rates led to statements, mainly by euro area officials, expressing the need for more flexibility in exchange

Chart 1.1
OFFICIAL INTEREST RATES
(end of period)



Source: Central banks.

Chart 1.2
LONG-TERM INTEREST RATES*
(monthly averages)



** Long-term interest rates refer to yields on ten-year government bonds.*
Source: Reuters.

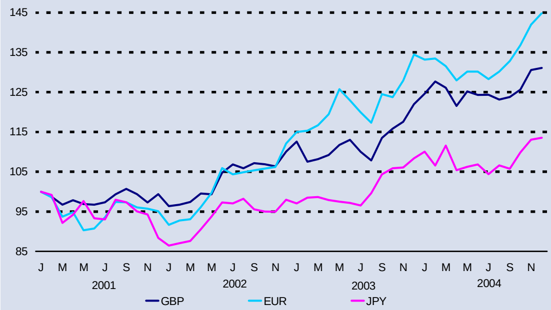
markets in order to reflect economic fundamentals and to avoid excessive volatility in rates. Such comments became more vociferous in the fourth quarter of the year, as the euro's persistent appreciation against the dollar became a cause for concern.

The general decline of the dollar that began in 2002 was interrupted in the first half of 2004, as encouraging data about the US economy in the first quarter gave support to the US currency. In April and May the dollar then strengthened against the other major currencies after more positive economic data - particularly a surge in US employment figures - prompted the market to anticipate a rise in US interest rates.

In the last quarter of the year, however, the dollar was undermined by mounting concerns about the persistent US current account deficit. In November these concerns were further exacerbated after comments by Federal Reserve Chairman Alan Greenspan highlighted the unsustainable nature of the deficit. Another factor behind the dollar's sharp decline towards the end of the year was the belief among market participants that the US wanted to see its currency weaken, despite political statements backing a strong dollar policy.

As the dollar declined during the year, the euro strengthened sharply against the US unit and

Chart 1.3
EXCHANGE RATE MOVEMENTS OF SELECTED MAJOR CURRENCIES AGAINST THE US DOLLAR
(index of end-of-month rates, Jan 2001=100)



Source: Reuters.

registered gains against the Japanese yen and the pound sterling. The weakening of the pound vis-à-vis the euro over much of the second half of the year was principally associated with signs that the UK monetary stance would not be tightened further in the light of easing house price inflation and slower growth. A factor which also contributed to the persistent broad-based appreciation of the euro, especially towards the end of the year, was the lack of flexibility in Asian currencies, particularly the Chinese yuan. Against this background, euro area officials urged the Asian countries to let their currencies rise to share the burden of the dollar's weakness.

Commodities

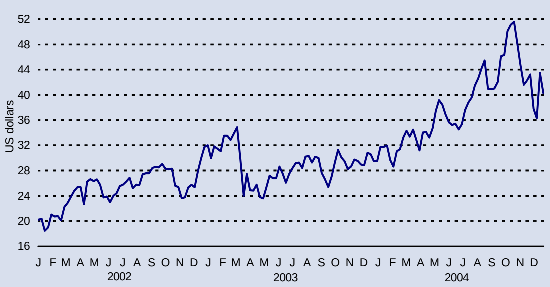
During 2004 the price of Brent crude oil followed a sustained rising trend, with sharp erratic movements in the second half of the year (see Chart 1.4). A surge

Table 1.2
EXCHANGE RATES OF SELECTED MAJOR CURRENCIES AGAINST THE US DOLLAR - 2004

	USD/EUR	USD/GBP	JPY/USD
Closing rate on 31.12.04	1.3645	1.9295	102.53
Closing rate on 31.12.03	1.2570	1.7802	106.92
High for the year	1.3645 (31 Dec.)	1.9482 (07 Dec.)	114.56 (14 May)
Low for the year	1.1797 (26 Apr.)	1.7603 (14 May)	102.15 (02 Dec.)
% appreciation (+)/depreciation (-) of the currency vs the US dollar from closing rate on 31.12.03 to closing rate on 31.12.04	8.6	8.4	4.1

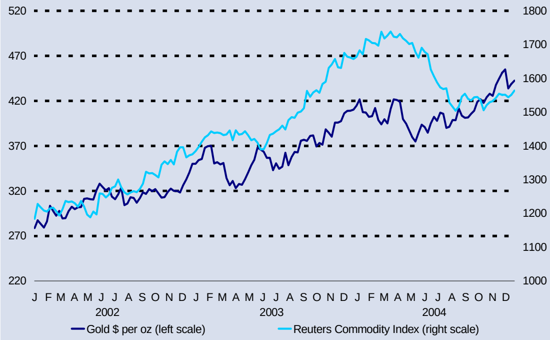
Source: Reuters.

Chart 1.4
OIL ($/BARREL)*
(end of week)



* Brent Blend.
Source: Reuters.

Chart 1.5
COMMODITY PRICES



Source: Reuters.

in global demand, boosted by increased consumption in China and the US and supply-side factors, such as the ongoing Yukos affair in Russia, concerns of attacks on the oil infrastructure in Iraq and Saudi Arabia, and political unrest in Nigeria and Venezuela contributed to this upward pressure on oil prices. In October Brent crude peaked at record levels of over $51 per barrel amidst concerns of tight winter supplies, before easing to $40.38 at the end of December. On average, Brent oil prices during 2004 were up by 33% on the year.

Movements of the US dollar on foreign exchange markets continued to be the primary driver of the gold market in 2004, with the gold price rising as the dollar weakened. In April, the price of gold fell sharply as the market anticipated US interest rate hikes, and reached its lowest level for the year in May. However, the price of bullion picked up strongly in June and continued to rise thereafter, reaching 16-year highs in early December, principally on the back of the dollar's depreciation (see Chart 1.5). Thus, the price of gold in dollar terms rose by 7.8% over the year, to reach $442 per ounce at the end of December.

In the first half of the year, the Reuters Commodity Index[1] reached its highest levels in many years as supportive global economic conditions increased the demand for raw materials. But prices of non-oil commodities eased in the second half of the year, mainly due to a decline in food prices. As a result, the index fell by 5.6% over the year, as can be seen in the Chart.

[1] The Reuters Commodity Index is a weighted index of the prices of 17 commodities including food, beverages, vegetable oils, agricultural raw materials and metals, excluding gold.

2. Monetary and Financial Developments

During 2004 the Central Bank of Malta kept its monetary policy stance unchanged, after having reduced the central intervention rate by 75 basis points to 3% in 2003. Money market rates and Government bond yields remained stable throughout the year, while corporate bond yields generally moved slightly lower. The recovery in equity market prices that started towards the end of 2002 gathered pace in the year under review, with the MSE share index surging by over 40%.

Monetary growth remained subdued in 2004, reflecting further portfolio shifts into alternative assets, especially newly issued Government bonds. The moderate increase in broad money (M3) was broadly in line with nominal economic growth. The main counterpart to monetary expansion was a rise in domestic credit, most of which reflected borrowing by households to finance house purchases. The net foreign assets of the banking system also expanded, although at a slower pace than in the previous year.

The monetary base[1]

The monetary base (M0) expanded by Lm28.2 million, or 4.6%, during 2004, largely as a result of further growth in currency in issue (see Table 2.1).[2] In addition, bank deposits with the Central Bank of Malta also moved higher, offsetting most of the previous year's decline.

The monetary base was boosted by a substantial drop in the Bank's other liabilities, which was attributable to a decrease in outstanding term deposits held by credit institutions at the Bank. On the other hand, growth in M0 was dampened both by an increase in Government deposits and by a drop in the Bank's

Table 2.1
THE MONETARY BASE AND ITS SOURCES

Lm millions

			Change	
	2003	2004	Amount	%
Currency in issue	485.4	506.4	21.0	4.3
Bank deposits with the Central Bank of Malta[1]	137.9	145.3	7.4	5.4
Monetary base (M0)	**623.3**	**651.7**	**28.4**	**4.6**
Central Bank of Malta assets				
Foreign assets	935.5	860.6	-74.9	-8.0
Claims on Government	7.8	21.3	13.5	+
Fixed and other assets	49.7	54.3	4.6	9.3
less:				
Remaining liabilities				
Private sector deposits	2.8	5.6	2.8	100.0
Government deposits	83.2	115.7	32.5	39.1
SDR allocations	5.7	5.6	-0.1	-1.8
Foreign liabilities	25.5	0	-25.5	-100.0
Other liabilities	164.3	71.6	-92.7	-56.4
Capital and reserves	88.2	86.0	-2.2	-2.5

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

[1] Information on the monetary base and its sources is derived from the Bank's financial statements, which are compiled in accordance with International Financial Reporting Standards. These data may differ from data on monetary aggregates and their counterparts.

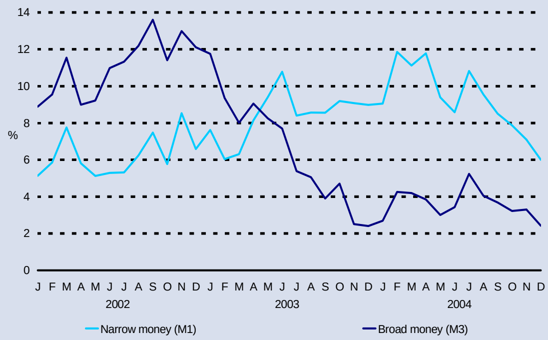
[2] M0 is a measure of the Central Bank of Malta's monetary liabilities and consists of currency in issue and bank deposits with the Bank, excluding term deposits.

foreign assets, the latter mainly reflecting payments for oil imports on behalf of customers. Meanwhile, a contraction in the Bank's foreign liabilities was largely due to maturing repos with foreign counterparties, which also reduced the Bank's foreign assets and thus had no effect on the monetary base.

Monetary aggregates[3]

Monetary growth remained somewhat subdued during 2004, with M3 expanding by Lm69.1 million, or 2.4%, in line with the previous year's growth (see Table 2.2). Monetary growth continued to be dampened by portfolio shifts into alternative assets such as Government bonds, partly reflecting a gradual unwinding of the notable switch into monetary assets that occurred in 2002. In addition, the wider deficit on the current account was not matched by additional capital inflows resulting in slower growth in the net foreign assets of the banking system (see Table 2.3). On the other hand, a pick-up in lending, fuelled by buoyant activity in the housing market, exerted a positive impact on monetary expansion.

Chart 2.1
MONETARY AGGREGATES
(% change on previous year)



Whereas M3 has been growing relatively slowly over the past two years, narrow money (M1) has been increasing at a solid pace, supported by the low returns on other deposits with longer-term maturities. Narrow money increased by Lm90 million, or 6%, in 2004, mainly as a result of further growth in deposits withdrawable on demand, although currency in circulation also contributed. The increase in M1 was, however, smaller than that seen in 2003, reflecting a small drop in deposits withdrawable on demand in the second half of the year, which led to a decline in the aggregate's annual growth rate (see Chart 2.1).

Table 2.2
MONETARY AGGREGATES

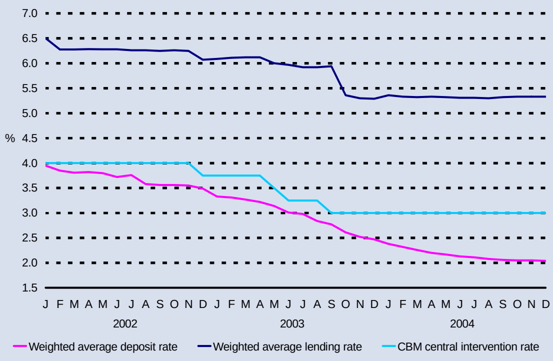
Lm millions

	Annual growth rates (%)			Amount outstanding	Change
	2002	2003	2004	2004	2004
NARROW MONEY (M1)	**6.6**	**9.0**	**6.0**	**1,580.9**	**90.0**
Currency in circulation	4.3	5.4	5.6	486.0	25.6
Deposits withdrawable on demand	7.7	10.7	6.3	1,095.0	64.4
INTERMEDIATE MONEY (M2)	**12.1**	**2.4**	**2.4**	**2,918.3**	**69.1**
Narrow money (M1)	6.6	9.0	6.0	1,580.9	90.0
Deposits redeemable at notice up to 3 months	6.2	3.0	4.4	30.0	1.3
Deposits with agreed maturity up to 2 years	18.3	-4.1	-1.7	1,307.3	-22.1
BROAD MONEY (M3)[1]	**12.1**	**2.4**	**2.4**	**2,918.3**	**69.1**
of which FCDs[2]	17.1	4.0	4.4	336.1	10.8

[1] Since the amount of marketable instruments issued by the MFI sector is negligible, at present M2 is equal to M3.
[2] Foreign currency deposits, including external Maltese lira deposits.

[3] In October 2003 the Central Bank of Malta revised its definitions of the main monetary aggregates and their counterparts to bring them in line with the standards laid down in ECB Regulation 2001/13. Data shown in this chapter for the period before October 2003 are estimates based on these standards. For further information see "Changes in the Compilation of Money and Banking Statistics in Malta", *Central Bank of Malta Quarterly Review* 36:4 (2003), pp. 53-60.

Chart 2.2
RETAIL DEPOSIT AND LENDING RATES



Intermediate money (M2) expanded by Lm69.1 million, or 2.4%, during 2004, as the increase in M1 was partly offset by a contraction in deposits with an agreed maturity of up to two years (see Table 2.2).[4] These deposits fell by Lm22.1 million, or 1.7%, after having decreased by 4.1% in the previous year as investors continued to shift funds into other assets such as Government bonds and investment funds. For instance, shareholders' funds in locally based collective investment schemes increased by Lm47.1 million, or 10.3% during 2004, after surging by over 30% in 2003.

The weighted average interest rate on Maltese lira deposits continued to decline, falling from 2.47% at the end of 2003 to 2.04% in 2004 (see Chart 2.2). Average interest rates on current and savings deposits remained broadly unchanged during this period, ending October at 0.47% and 0.95%, respectively (see Chart 2.3). The average interest rate on time deposits, on the other hand, extended its downward trend, falling by 58 basis points to 2.87% during the year. The narrowing gap between the rates offered on time deposits and the more liquid current and savings deposits continued to be a key factor behind the preference for the more liquid instruments. Whereas deposit rates fell, the weighted average lending rate remained stable, ending the year at 5.33%.

Counterparts to monetary growth

The main counterpart to monetary growth during 2004 was domestic credit expansion, which was mostly driven by further growth in loans for house purchases. Domestic credit had a greater impact on monetary growth than in 2003, when most of the rise was due to an exceptional factor that had a neutral impact on the aggregate (see Chart 2.4). The rise in the net foreign assets of the banking system during 2004 was influenced by an increase in the capital base of a foreign-owned bank, retained earnings by international banks and asset revaluation adjustments, which had no influence on broad money.

Domestic credit increased by Lm136.2 million, or 5.1%, during 2004 compared with growth of 10.3% in the previous year (see Table 2.3). However, if an adjustment is made for the exceptional transaction that boosted domestic credit in November 2003, domestic credit expanded at a faster pace than in 2003, reflecting mainly a pick-up in claims on the private sector. By contrast, net claims on central Government decreased modestly during 2004.

Chart 2.3
INTEREST RATES ON DEPOSITS

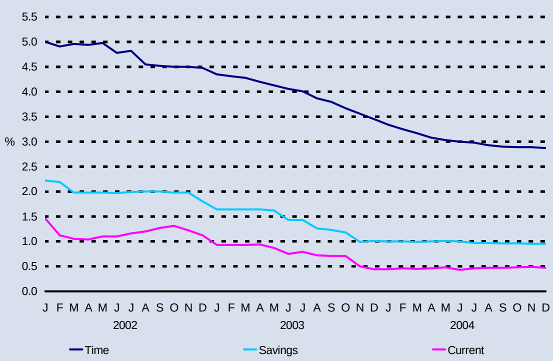
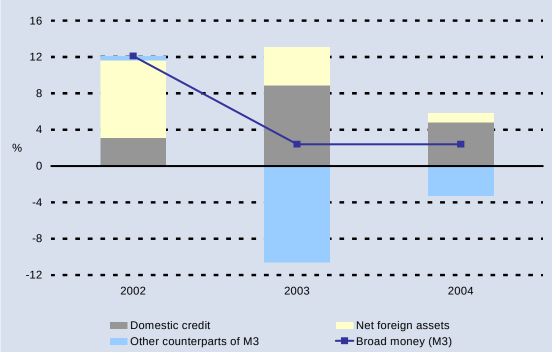


Chart 2.4
CONTRIBUTIONS TO MONETARY GROWTH



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[4] Since the amount of marketable instruments is negligible, at present M2 is equal to M3.

Table 2.3
BROAD MONEY AND ITS COUNTERPARTS

Lm millions

	Annual growth rates (%)			Amount outstanding	Change
	2002	2003	2004	2004	2004
Broad money (M3)	**12.1**	**2.4**	**2.4**	**2,918.3**	**69.1**
Domestic credit	**3.3**	**10.3**	**5.1**	**2,785.0**	**136.2**
Net claims on central Government	5.4	5.4	-4.1	545.1	-23.3
Claims on other residents	2.8	11.7	7.7	2,239.9	159.5
Net foreign assets	**19.4**	**8.9**	**2.0**	**1,445.9**	**28.9**
Central Bank of Malta	15.0	4.3	-5.4	870.3	-49.5
Banks	29.9	18.4	15.8	575.6	78.5
less:					
Other counterparts of M3[1]	**-1.2**	**32.0**	**7.9**	**1,312.5**	**96.0**

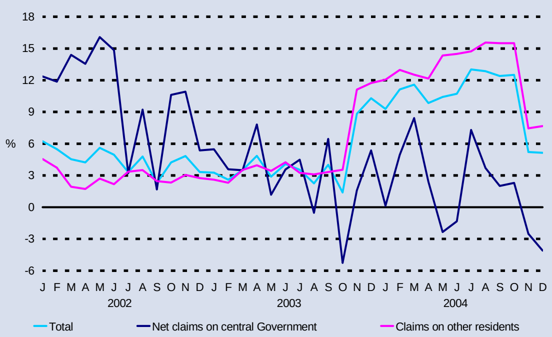
[1] Other counterparts of M3 include the capital base of the MFI sector, longer-term financial liabilities, provisions, interest accrued and unpaid and other liabilities, less fixed and other assets. They are equal to the difference between M3 and the sum of domestic credit and net foreign assets.

Claims on other residents, which mostly include the private sector, expanded by Lm159.5 million, or 7.7%, with almost all of this increase being due to loans and advances, which account for almost 90% of total claims. The annual growth rate of these claims, which is somewhat distorted by the previous year's extraordinary transaction, continued to recover from the lows reached in 2002 (see Chart 2.5). Lending may have been supported by a decline in the real interest rate, as the weighted average nominal lending rate remained largely unchanged (see Chart 2.2) while inflation moved higher.[5]

Loans and advances to other residents expanded by Lm156.9 million, or 8.6%, during 2004, up from 2.6% in 2003 (see Table 2.4). While the reclassifications in banks' loan portfolios resulted in significant shifts between categories of borrower in both 2003 and 2004, underlying lending to both the non-bank public sector and the private sector picked-up during the year under review. Loans to the non-bank private sector rose by Lm137 million, or 7.1%, mainly reflecting further lending to households and individuals, most of which was intended for house purchases. In addition, lending to the construction industry, as well as to firms involved in real estate, renting and business activities, also increased noticeably. Loans to the non-bank public sector added Lm23.6 million, or 17.4%. Most of this rise, however, reflected a reclassification in the loan portfolio of a major bank, which adjusted upwards the amount of loans to the electricity, gas and water supply sector and simultaneously reduced its net claims on central Government. Similarly, the fall in loans and advances to the manufacturing industry was partly due to loan reclassifications.

Net claims on central Government contracted by Lm23.3 million, or 4.1%, during 2004, mainly reflecting an increase in Government deposits held with the

Chart 2.5
DOMESTIC CREDIT
(% change on previous year)



[5] Inflation is measured as the annual change in the 12-month moving average Harmonized Index of Consumer Prices (HICP).

Table 2.4
CLAIMS ON OTHER RESIDENTS[1]

Lm millions

	Annual growth rates (%)			Amount outstanding	Change
	2002	2003	2004	2004	2004
Claims on the non-bank private sector	1.7	19.3	7.1	2,057.3	137.0
of which loans and advances	1.4	8.7	7.9	1,820.2	133.2
Claims on the non-bank public sector	9.7	-36.5	14.0	181.8	22.4
of which loans and advances	12.4	-40.0	17.4	159.2	23.6
Claims on other general government[2]	0	-0.6	19.5	0.7	0.1
of which loans and advances	0	-0.6	19.5	0.7	0.1
TOTAL CLAIMS	**2.8**	**11.8**	**7.7**	**2,239.9**	**159.5**
of which loans and advances					
Electricity, gas & water supply	N/A	N/A	55.9	95.3	34.2
Transport, storage & communication	N/A	N/A	-7.3	125.5	-10.0
Agriculture	N/A	N/A	13.4	8.2	1.0
Fishing	N/A	N/A	-14.7	1.7	-0.3
Manufacturing	N/A	N/A	-6.7	121.9	-8.7
Construction	N/A	N/A	7.9	217.0	15.9
Hotels & restaurants	N/A	N/A	-0.6	205.6	-1.3
Wholesale & retail trade; repairs	N/A	N/A	0.7	290.3	2.1
Real estate, renting & business activities	N/A	N/A	6.9	125.4	8.0
Households & individuals	N/A	N/A	17.8	720.7	108.7
Other[3]	N/A	N/A	11.8	68.6	7.2
TOTAL LOANS AND ADVANCES	**2.6**	**2.6**	**8.6**	**1,980.1**	**156.9**

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

[2] In Malta, this refers to the local councils.

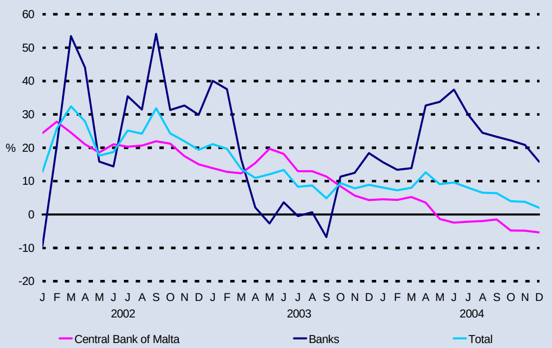
[3] Includes mining and quarrying, public administration, education, health and social work, community recreation and personal activities, extra-territorial organisations and bodies and non-bank financial institutions.

Bank. A drop in bank loans, mostly related to the loan reclassification mentioned earlier, also contributed. On the other hand, a rise in bank holdings of Government bonds and Treasury bills offset part of the drop in net claims on central Government.

Growth in the net foreign assets of the banking system continued to decelerate in 2004, falling to 2% from 8.9% in the previous year (see Chart 2.6). This slower growth was partly due to lower portfolio inflows as investors rebalanced their portfolios after having repatriated funds in connection with the Investment Registration Scheme in 2002.

The net foreign assets of the Central Bank of Malta shed Lm49.5 million, or 5.4%, during 2004 (see Table 2.3), mainly reflecting larger payments for oil imports by the national energy corporation. The Bank was also a net purchaser of foreign exchange from the rest of the banking system. Meanwhile, the net foreign assets of the rest of the banking system expanded by Lm78.5 million, or 15.8%, despite the net sales to the

Chart 2.6
NET FOREIGN ASSETS
(% change on previous year)



Central Bank. The domestic banks' holdings rose by Lm31.9 million, or 9.7%, boosted by a fresh injection of equity capital into a foreign-owned bank operating in Malta. The international banks' net foreign assets added Lm46.6 million, or 27.6%, reflecting profits made during the year, as well as revaluations of their portfolio holdings.

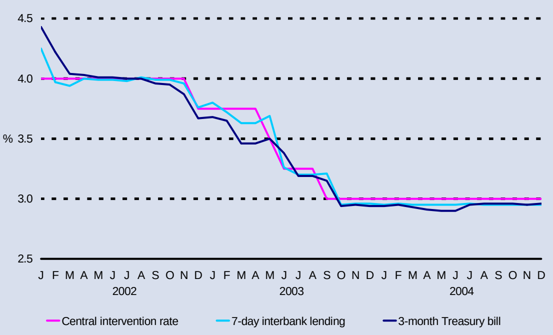
The other counterparts of M3 rose by a net Lm96 million, or 7.9%, dampening monetary growth. A significant part of this rise was due to the increase in bank capital referred to above. The rest mainly reflected the international banks' profits and additions to their reserves.

The money market

Activity in the interbank market recovered strongly during 2004, with the value of interbank deals rising to Lm256.3 million, after having fallen to below Lm100 million in 2003. The pick-up in activity reflected the increased participation of a number of banks as they used the market actively in order to manage their funds. Loans had terms to maturity of up to a month, although those maturing within 14 days remained the most popular. The interest rate on 14-day loans stood at 2.97% at the end of the year, while that on those with a maturity of one week ended the year unchanged at 2.95% (see Chart 2.7). The latter was in line with the rate offered on term deposits held at the Central Bank.

The Treasury continued to raise short-term funds on the money market, issuing Lm608.8 million worth of Treasury bills during 2004, slightly more than those maturing, which totalled Lm595.7 million. As a result,

Chart 2.7
MONEY MARKET INTEREST RATES
(end of month)



the amount of Treasury bills outstanding at the end of the year rose by Lm13.1 million to Lm245.4 million. The maturity structure of Treasury bills ranged from one to twelve months. While the three-month bill remained the most popular, accounting for just over half of total issues, the Treasury made increased use of bills with different maturities. As in previous years, banks dominated the Treasury bill auctions, purchasing over four-fifths of the total amount issued. Collective investment schemes and insurance companies took up most of the remainder. The yield on the three-month bill remained stable throughout 2004, ending the year at 2.96%.

Turnover in the secondary market for Treasury bills decreased from Lm142.8 million in 2003 to Lm116.5 million in 2004. Trading involving the Bank amounted to Lm54.5 million and mainly consisted of purchases by the Bank from other financial institutions, particularly banks. The remainder represented trade among the banks and with other financial institutions. As in the primary market, Treasury bill yields in the secondary market remained unchanged in 2004, with the yield on the three-month bill standing at 2.98% in December.

The capital market

Net issues of long-term debt securities in the primary market fell from Lm121.1 million in 2003 to Lm109.9 million in 2004, reflecting a further decline in issuance activity by the non-government sector (see Table 2.5). Net Government issues, on the other hand, remained unchanged as the Government continued to rely heavily on long-term debt to finance the fiscal deficit. Government bond issues continued to be well received by investors as they offered a higher yield than other local portfolio assets such as bank deposits. In addition, with the banking system characterised by excess liquidity, demand by banks for new Government bond issues remained strong.

The Government raised a total of Lm144.5 million in the primary market during 2004, issuing bonds on three occasions – in May, August and November. At the same time, a total of Lm44.6 million worth of Government bonds were redeemed, so that the total

Table 2.5

ISSUES OF LONG-TERM DEBT SECURITIES[1]

Lm millions

	2002	2003	2004
Government			
Total issues [2]	66.5	148.8	144.5
Redemptions	66.5	48.9	44.6
Net issues	0	99.9	99.9
Non-government sector			
Total issues	50.5	24.7	10.0
Redemptions	3.0	3.5	0
Net issues	47.5	21.2	10.0
Total net issues	**47.5**	**121.1**	**109.9**

[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 public non-financial companies are included with corporate issuers. Long-term securities are those with an original term to maturity exceeding one year, and include preference shares.

[2] Data excludes stocks that were issued directly to the Foundation for Church Schools. These issues amounted to Lm176,200 in 2002, Lm66,700 in 2003 and Lm1.7 million in 2004.

Sources: Central Bank of Malta; The Treasury.

amount of bonds outstanding increased by Lm99.9 million to Lm1,014.7 million over the year. Five different types of stocks were issued, having terms to maturity of between five and eighteen years and offering coupon rates that varied between 4.8% and 5.9%. Most of the bonds were sold by auction, with market interest rates determining the price paid by successful bidders. Banks and households purchased roughly equal amounts of these bonds, and together accounted for around three-quarters of the total take-up. The rest were mainly bought by collective investment schemes and insurance companies.

There was only one bond issue by the non-government sector during 2004, that of an international financial institution, the European Investment Bank, which in February sold Lm10 million worth of bonds maturing in 2009 and carrying a coupon rate of 3.8%. Demand for these triple-A rated bonds was strong and the issue was oversubscribed. The EIB is the first supranational institution to have launched a bond denominated in Maltese lira on the local capital market. There were no bond issues by domestic corporations during the year, after private-sector firms had made net issues of Lm21.2 million in 2003. Following the market listing of the EIB bonds, the market capitalisation of non-government bonds listed on the MSE rose to Lm188.8 million as at end-2004.

Table 2.6

SECONDARY MARKET TRADING IN GOVERNMENT STOCKS

Lm millions

	2002	2003	2004
Central Bank of Malta purchases	0.2	5.4	13.4
Central Bank of Malta sales	0.9	0	7.6
Other deals[1]	43.7	42.9	32.2
Total	**44.8**	**48.3**	**53.1**

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

Sources: Central Bank of Malta; MSE.

Chart 2.8
GOVERNMENT BOND YIELDS
(end of month)

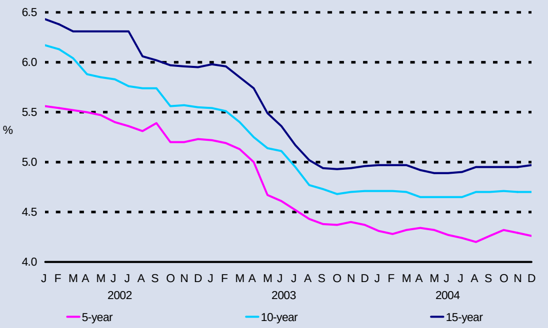


Chart 2.9
MALTA STOCK EXCHANGE SHARE INDEX
(end of month)

Source: MSE.

As regards the secondary market, turnover in Government bonds continued to edge higher, rising to Lm53.1 million in the year under review, from Lm48.3 million in 2003 (see Table 2.6). The Central Bank of Malta, acting as market-maker, made sales and purchases of Lm7.6 million and Lm13.4 million, respectively. Other investors accounted for the remaining activity. As in the previous year trading was mainly concentrated in a relatively small number of bonds at the longer end of the market. Bond yields remained generally stable throughout 2004, after having declined in the previous year (see Chart 2.8). The benchmark rate for the 10-year bond, for instance, ended the year virtually unchanged at 4.7%.

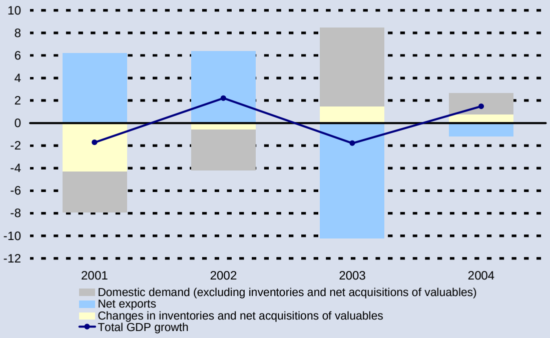
Trading activity in the secondary market for corporate bonds fell from Lm10.2 million in 2003 to Lm8.4 million in 2004. Thus, turnover remained low in comparison with the market capitalisation of the listed bonds, reflecting a general reluctance to sell among bondholders. Volume was, however, spread rather evenly among the listed securities. Developments in corporate bond yields were mixed, but they generally moved slightly lower over the year.

Turnover in the equity market recovered strongly during 2004, with the value of traded equities more than doubling to Lm32.2 million, from Lm15.2 million in the previous year. Trading in the largest three equities listed on the MSE accounted for around three-quarters of the total volume. The MSE share index climbed by 44.4%, to end the year at 3,069 (see Chart 2.9), with the prices of almost all equities increasing in value. Thus, the index extended the recovery that started towards the end of 2002, although by the end of the year it was still below the peak of almost 4,000 reached in the beginning of 2000.

3. Output, Prices and Employment[1]

After having contracted in 2003, the Maltese economy experienced a recovery during 2004, registering a growth rate of 1.5%. Growth was driven by domestic demand, as the positive impact of an increase in exports of goods and services was more than offset by a rise in imports. Reflecting these developments, labour market conditions were generally stable with the level of employment unchanged from the previous year, while the rate of unemployment was slightly lower. During the year, RPI inflation rose persistently, mostly under the impact of higher indirect taxes and oil prices.

Chart 3.1
CONTRIBUTIONS TO GROWTH
(percentage points)



Aggregate demand

Real GDP expanded by 1.5% in 2004, reversing in part the 1.8% downturn of the previous year, though still below the potential growth rate. For the second consecutive year, the external sector contributed negatively to growth, although to a lesser extent than in 2003, while higher domestic demand and inventory adjustments helped to sustain it (see Chart 3.1). Meanwhile, nominal GDP reached Lm1.85 billion (see Table 3.1), up by 3.2% from the previous year's level. As a result, the implicit GDP deflator was estimated to have risen by 1.7%. This was a slower rise than in 2003 and reflected a drop in export prices, particularly of electronic components, Malta's major export. The decline in export prices, which was mainly attributable to strong competition in international markets and technological advances, more than offset an acceleration in locally-determined prices.

Table 3.1
GROSS DOMESTIC PRODUCT

Lm millions

	2000	2001	2002	2003	2004
			Constant 2000 prices		
Household & NPISH final consumption expenditure	1,072.8	1,074.6	1,065.1	1,086.2	1,096.8
Government final consumption expenditure	323.1	324.1	336.4	346.5	348.7
Gross fixed capital formation	374.4	311.2	249.3	335.1	353.0
Changes in inventories & net acquisitions of valuables	65.1	-6.3	-15.7	9.0	21.9
Domestic demand	**1,835.4**	**1,703.6**	**1,635.1**	**1,776.8**	**1,820.3**
Exports of goods & services	1,572.8	1,526.3	1,593.2	1,532.0	1,570.8
Imports of goods & services	1,740.1	1,590.4	1,552.6	1,663.0	1,720.9
Net exports	**-167.3**	**-64.0**	**40.6**	**-131.0**	**-150.2**
GROSS DOMESTIC PRODUCT	**1,668.1**	**1,639.5**	**1,675.7**	**1,645.8**	**1,670.2**
			Market prices		
GROSS DOMESTIC PRODUCT	**1,668.1**	**1,694.3**	**1,741.6**	**1,796.3**	**1,854.3**

Source: NSO.

[1] This analysis is based on NSO data available up to 10 March 2005.

Table 3.2
GDP COMPONENT GROWTH RATES

% change

	2001	2002	2003	2004
Household & NPISH final consumption expenditure	0.2	-0.9	2.0	1.0
Government final consumption expenditure	0.3	3.8	3.0	0.6
Gross fixed capital formation	-16.9	-19.9	34.4	5.3
Exports of goods & services	-3.0	4.4	-3.8	2.5
Imports of goods & services	-8.6	-2.4	7.1	3.5
GROSS DOMESTIC PRODUCT	**-1.7**	**2.2**	**-1.8**	**1.5**

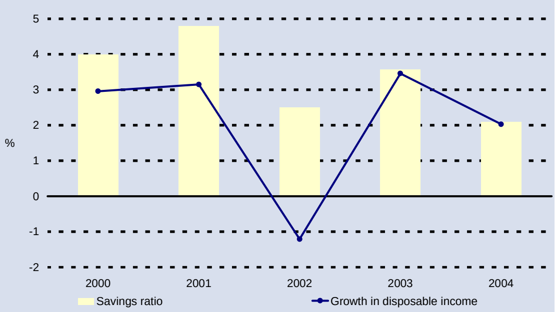
Source: NSO.

Growth in private consumption is estimated to have slowed down to 1% in 2004, from 2% in 2003 (see Table 3.2). This was due to lower growth in disposable incomes as the weak conditions in the labour market constrained wage increases in the private sector, while fiscal consolidation exerted a similar impact on public sector wages. The impact on consumption was, however, probably cushioned by a fall in the household savings ratio, which is estimated to have fallen from 3.6% to 2.1% in 2004 (see Chart 3.2).

Government consumption is estimated to have grown by around 0.6% in 2004, at a slower rate than in 2003 and less rapidly than GDP. Growth of this component of aggregate demand was likely to have been driven by the non-wage component of government consumption, reflecting the changing composition of fiscal expenditure, with greater reliance on outsourcing.

Meanwhile, gross fixed capital formation is estimated to have grown by 5.3%, compared with the double-digit growth recorded in 2003. The latter was however due to a base effect, since, as can be seen from the Table, gross fixed capital formation in 2002 had fallen significantly due to the exceptional sale of aircraft. In 2004 both private and public investment increased. In the private sector, a positive contribution stemmed from the expansion of the chemical industry and higher investment by textile and publishing firms. As regards public investment, developments largely reflected the work in progress on the new hospital, though the purchase of an embassy overseas also contributed.

Chart 3.2
HOUSEHOLD SAVINGS RATIO* AND DISPOSABLE INCOME



* Household savings as % of disposable income.
Source: Central Bank of Malta estimates.

Inventory adjustments, which reflect both the build-up of stocks by firms and the statistical adjustments necessary to reconcile the expenditure-based GDP with that based on the income method, were again a source of growth in 2004. In fact, in real terms inventory changes advanced to 1.3% of GDP during the year, from 0.5% a year earlier.

In the case of exports of goods and services, growth was estimated at 2.5% in real terms, as against negative growth of 3.8% in 2003, and was mainly driven by exports of electronic components and of pharmaceuticals, although tourism also contributed. In nominal terms, export turnover was less than in 2003, reflecting lower prices of exports overall.[2]

Meanwhile, imports advanced by 3.5% in 2004, faster than the growth in exports. The growth of imports was driven by higher domestic demand and increased export activity. Imports of consumer goods were also

[2] These data are taken from the NSO News Release No. 42/2005 on the national accounts, which incorporates an upward revision to nominal exports compared with the level shown in News Release No. 40/2005 on the balance of payments.

boosted by the complete liberalisation of trade from the beginning of May, following EU membership. However, although import prices dropped in 2004, they did so to a lesser extent than export prices. In fact, despite lower import prices, expenditure on imports in nominal terms increased, in contrast with the reduction in the value of exports.

Sectoral analysis

Manufacturing

The NSO survey of manufacturing firms shows that manufacturing turnover contracted by Lm12.7 million, or 1.2%, to Lm1,015.6 million during 2004. This was as a result of a decline in domestic sales (see Table 3.3).

According to the survey, exports were virtually unchanged. The radio, TV & telecom sub-sector, which includes electronics and accounts for over 60% of manufacturing exports, reported a small fall in foreign sales. This probably reflects the continuing decline in prices of electronic components. Meanwhile, exports of medical & precision equipment and of electrical machinery grew strongly. On the other hand, foreign sales of chemicals dropped, while a Lm14.6 million decline in exports of clothing was almost matched by a Lm13.7 million increase in exports of textiles.

Total domestic sales dropped by Lm12.9 million, or 5.6%, from the 2003 level. The food and beverages sub-sector, which is heavily dependent on the home market, reported lower sales thus reflecting a shift towards imports following the complete removal of

Table 3.3
MANUFACTURING PERFORMANCE - SELECTED INDICATORS[1]

Lm millions

	2002	2003	2004
Change in exports	**-8.4**	**36.6**	**0.2**
Chemicals	-0.4	2.1	-8.5
Clothing	2.2	-7.6	-14.6
Food & beverages	3.7	2.1	-1.2
Medical & precision equipment	4.5	4.2	8.4
Printing & publishing	9.0	5.4	-0.2
Radio, TV, telecoms, etc[2]	-18.9	28.3	-1.0
Textiles	3.9	1.3	13.7
Others	-12.4	0.8	3.6
Change in local sales	**9.5**	**0.2**	**-12.9**
Clothing	0.2	-0.2	2.7
Food & beverages	1.8	3.7	-7.2
Furniture	1.0	-4.8	-4.0
Tobacco	-2.2	0.4	3.4
Others	8.7	1.1	-7.8
Change in net investment	**4.6**	**4.8**	**1.5**
Chemicals	3.9	0.7	1.4
Food & beverage	-1.3	5.1	-3.3
Furniture	2.9	1.3	-0.8
Plastic & rubber	-0.1	-0.1	-1.2
Printing & publishing	2.9	-0.6	2.5
Textiles	1.1	-1.6	2.7
Others	-4.8	0	0.2

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

levies upon Malta joining the EU. Furniture makers continued to report lower sales, while tobacco sales in the home market increased, reflecting higher excise duties.

The survey also shows that, across manufacturing, investment during 2004 rose by 3.1%, or Lm1.5 million, as increased investment by the textiles, chemicals and printing & publishing industries outweighed lower investment by the food & beverages industry.

According to the survey, employment in manufacturing continued to contract, dropping by 1.9%. This reflected the restructuring process in a number of firms, particularly in the labour-intensive clothing and leather sub-sectors. Lay-offs were also recorded in the radio, TV & telecom industry as well as in the chemicals and furniture sub-sectors. On the other hand, the textiles, medical & precision equipment and plastic & rubber products sub-sectors added workers to their complement.

Tourism

The performance of the tourism sector in 2004 was mixed. The number of tourists visiting the island rose by 3.5% from the previous year's level, but the number of nights stayed declined marginally, while expenditure by tourists rose by just 0.6% to Lm432.3 million. At the same time, GDP data show that gross value added by hotels and restaurants declined by 1.1%, reflecting a drop in both operating surplus and in compensation to employees.

Tourist numbers increased across all major source markets except the United Kingdom (see Table 3.4). The number of British visitors, who account for two-fifths of the total, declined by 4.2% when compared with the previous year, possibly due to increased competition from other Mediterranean destinations. By contrast, the German, Italian and French markets grew strongly, compared with 2003. Other gains were recorded in the Scandinavian, Russian and US markets, which are captured under the "Others" category in Table 3.4.

The NSO departures survey indicates that during 2004 the average length of stay declined by 4.7%, year-on-year, to 9.7 days. As a result, despite the rise in tourist numbers, the overall number of days stayed decreased by 1.3%. All hotel categories experienced a drop in the average length of stay, with the sharpest decline recorded by two-star hotels. Other types of accommodation, except aparthotels and holiday complexes, also reported a contraction.

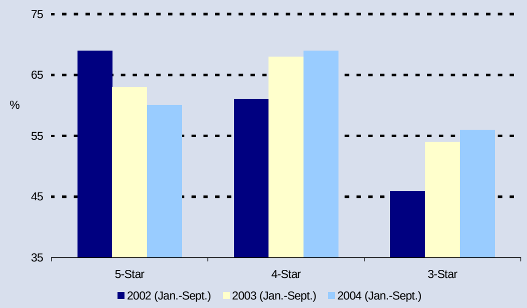
During the first nine months of the year, occupancy rates in five-star hotels continued to decline but four and three-star hotels reported significant gains (see Chart 3.3). Meanwhile, according to the December 2004 survey conducted by the MHRA, average achieved room rates, which represent the

Table 3.4
TOURISM ACTIVITY INDICATORS

	2003	2004	*% change* 2004
Tourist departures	**1,089,089**	**1,127,407**	**3.5**
UK	471,898	451,997	-4.2
Germany	124,773	134,758	8.0
Italy	78,366	80,991	3.3
France	77,029	86,061	11.7
Others	337,023	373,600	10.9
Days stayed (millions)	**11.1**	**11.0**	**-1.3**
Average length of stay (days)	**10.2**	**9.7**	**-4.7**
Expenditure (Lm millions)	**429.8**	**432.3**	**0.6**

Source: NSO.

Chart 3.3
AVERAGE OCCUPANCY RATES IN MAJOR HOTEL CATEGORIES



Source: Economic Survey, Ministry of Finance.

accommodation revenue net of VAT per room night sold, increased in all hotel categories except four-star hotels during the first three quarters of the year.

During the year, cruise passenger arrivals fell by 25.7% as the number of visiting liners dropped, probably because the additional attraction that Malta offered in terms of duty-free facilities diminished substantially following Malta's entry into the EU in May. There were also shifts in market sources of cruise passengers, with a decline in the number of Spanish and British visitors outweighing an increase in the number of Italian and French passengers.

Construction

During 2004 gross value added by the construction sector expanded by 2.5%. Employment income rose by 5.8% from the corresponding level a year earlier, while the operating surplus fell by 0.7%. Growth in employment income partly reflected an increase in the labour complement of the sector. At the same time, a lack of skilled labour willing to take up construction work may have pushed up average wages, leading to higher operating costs. Increased costs of labour and building materials, as well as higher fees for construction waste disposal, dented the sector's operating surplus.

Data for the first nine months of 2004 show that turnover in the construction sector rose by 3.7% over the corresponding period in 2003, a slower rate than that recorded in the previous four years. These data also indicate that, in line with recent trends, private sector construction activity, which expanded by 3%, accounted for most of this increase, with growth picking up during the third quarter. Construction work by Government also rose, gathering momentum in the six months to September 2004 (see Table 3.5).

The labour market

According to the Labour Force Survey (LFS), compiled on the basis of definitions used by the International Labour Organisation and methodologies outlined by Eurostat, the labour force contracted during 2004 as a number of unemployed persons opted out of the formal labour market.[3] Employment remained broadly unchanged compared to 2003, with jobs in

Table 3.5
CONSTRUCTION ACTIVITY INDICATORS

Lm millions

	2002	2003	2004
	January-September		
Total sales	**95.3**	**99.1**	**102.7**
Private sector	85.1	88.8	91.5
General government	10.2	10.3	11.3
Value added	**49.0**	**52.7**	**53.6**
Share of value added in GDP (%)	3.7	3.9	3.8
Private employment (as at September)	**6,373**	**6,417**	**6,617**
Share in gainfully occupied (%)	4.6	4.7	4.8

Source: NSO.

[3] Given that quarterly LFS data are volatile, this analysis is based on annual averages for the respective aggregates. Data for 2004 are based on the average of the first three quarters unless otherwise indicated. As from 2004 the LFS exercise was carried out on an ongoing basis rather than in a specific week and hence results may not be strictly comparable to those for the previous years.

Table 3.6
KEY LABOUR MARKET INDICATORS BASED ON THE LABOUR FORCE SURVEY[1]

	2002 Jan. - Dec.	2003 Jan. - Dec.	2004 Jan. - Sept.
Labour force	158,588	159,913	159,382
Employed	147,571	147,815	147,769
By type of employment			
Full-time	135,311	134,271	135,051
Part-time	12,260	13,544	12,719
By economic sector			
Private sector	96,911	98,354	99,041
Public sector	50,660	49,461	48,728
Unemployed	11,017	12,098	11,613
Unemployment rate (%)	7.0	7.6	7.3
Average gross annual salary (Lm)	5,001	5,054	5,068
Growth in average gross annual salary (%)	5.9	1.1	0.3

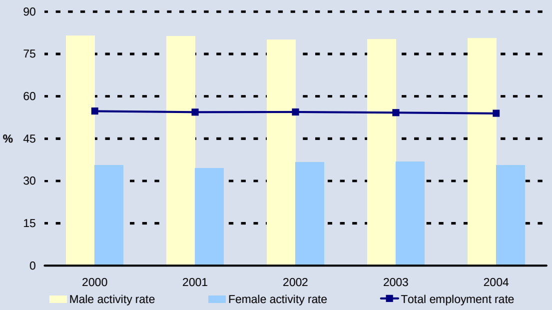
[1] Figures are based on annual averages. Figures for 2004 are based on the average for the first three quarters.
Source: NSO.

the private sector increasing as the public sector reduced its employment levels.

LFS data showed that wage growth continued to slow down. The average gross annual salary, which had risen by nearly 6% in 2002 and by 1.1% in 2003 rose by just 0.3% in 2004 to around Lm5,068.

As the labour force and the number of unemployed both shrank by around 500, the unemployment rate dropped slightly, from 7.6% to 7.3% (see Table 3.6).

Chart 3.4
ACTIVITY AND EMPLOYMENT RATES*



* The activity rate and employment rate represent the labour force and the number of employed, respectively, as a share of the working age population.
Source: NSO.

Employment remained virtually stable as higher full-time employment compensated for a small reduction among those whose main job was part-time. In 2004 private sector employment continued to rise, absorbing the impact of lower employment in the public sector.

Other key labour market indicators from the LFS were also stable. Average activity rates, which compare the labour force aged 15-64 to the population in the same age bracket, were virtually constant, at around 80% for males and 36% in the case of females (see Chart 3.4) and 58.2% overall. The overall employment rate, which shows the proportion of those aged between 15 and 64 who are employed, also remained constant at around 54%.

Whereas LFS data indicate that employment remained virtually unchanged, data compiled by the ETC show a small drop in employment during the first three quarters of 2004 (see Table 3.7).[4] ETC data also show a decline in public sector employment. Private sector

[4] This difference may be due to the fact that the two data sets are based on different methodologies. Whereas the results of the LFS are affected by sampling error, ETC statistics are administrative data compiled according to definitions set by domestic legislation on employment and social security benefits.

Table 3.7
GAINFULLY OCCUPIED BY SECTOR[1]

	2002 Jan. - Dec.	2003 Jan. - Dec.	2004 Jan. - Sept.
Gainfully occupied	**137,546**	**137,738**	**137,066**
Public sector	**47,742**	**47,093**	**46,614**
Government departments	30,340	30,238	30,109
Other	17,402	16,855	16,505
Private sector	**88,701**	**89,620**	**89,508**
Manufacturing	29,041	28,277	27,337
Wholesale & retail	15,533	15,936	16,285
Hotels & catering establishments	9,091	9,169	9,034
Transport, storage & communication	6,127	6,041	5,970
Banks & financial institutions	3,604	3,581	3,561
Other	25,305	26,616	27,321
Temporarily employed	**1,103**	**1,025**	**944**

[1] Figures are based on annual averages. Figures for 2004 are based on the average for the first three quarters.
Source: ETC.

employment went down marginally, as manufacturing industry shed jobs, whereas employment in the 'other' and wholesale and retail categories increased. The registered unemployment rate during 2004 dropped marginally to 5.6% in October from 5.7% in December 2003.

According to ETC data, the average number of persons registering as unemployed throughout the twelve months of 2004 rose to 8,254 from 7,817 recorded a year earlier (see Table 3.8). However, whereas registered unemployment was rising during the first part of the year, peaking at 8,830 in February, it then dropped to 8,104 in May and remained broadly stable thereafter (see Chart 3.5).

Around one-fourth of the average increase in registered unemployment over the year took place among unskilled persons. In terms of duration, people registering for less than a year accounted for the entire increase in registered unemployment. Conversely, the number of long-term unemployed dropped marginally. The placements to vacancies ratio rose slightly to just under 50%, which indicates that almost half of the vacancies advertised through the ETC were taken up by those registering as unemployed.

Table 3.8
REGISTERED UNEMPLOYED[1]

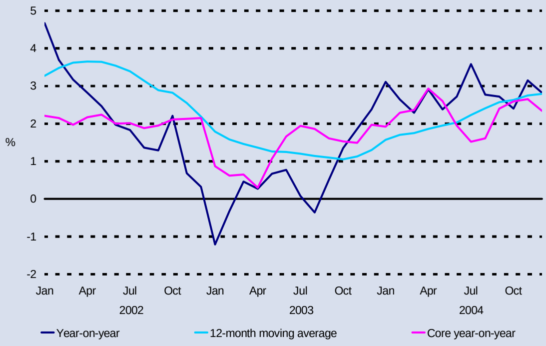
	2002	2003	2004
Skilled	5,847	6,063	6,388
Unskilled	1,734	1,753	1,866
Total	7,581	7,817	8,254
by duration			
Under 20 weeks	3,084	3,381	3,558
21 to 52 weeks	1,511	1,521	1,871
53 weeks and over	2,986	2,915	2,825
Placements to vacancies ratio (%)	45	45	49

[1] Figures are based on annual averages.
Source: ETC.

Chart 3.5
REGISTERED UNEMPLOYED

Source: ETC.

Chart 3.6
RETAIL PRICE INFLATION



Sources: Central Bank of Malta estimates; NSO.

Prices and wages

Retail prices

The upswing in inflation that began during the final quarter of 2003 continued during 2004. The official measure of inflation, based on the growth rate of the twelve-month moving average RPI, accelerated to 2.8% as at end-December 2004, up from 1.3% in the previous year (see Chart 3.6). Similarly, the year-on-year inflation rate, which offers a timelier indication of price developments, went up during most of the year, ending December at 2.8%, as against 2.4% at the end of the previous year.

The Central Bank of Malta's estimate of core inflation, which excludes components whose prices are principally driven by temporary factors, also increased. On a year-on-year basis, this measure rose to 2.3% in December, from 2% a year earlier.[5]

In 2004 the increase in headline inflation was primarily fuelled by higher indirect taxes and by the rise in international oil prices. The upward revision in the standard VAT rate from 15% to 18% in January pushed prices up across most components of the RPI, while increased excise duties and the introduction of environment-related taxes also had an impact. Inflationary pressures were dampened by the continued drop in prices of clothing and footwear and by less rapid growth in food prices.

Table 3.9
12-MONTH MOVING AVERAGE INFLATION: CONTRIBUTION TO GROWTH

	2002	2003	2004
Food	0.5	0.6	0.1
Beverages & tobacco	0.5	0.2	0.6
Clothing & footwear	-0.1	-0.5	-0.2
Housing	0.2	0.2	0.3
Water, electricity, gas & fuels	0.1	0	0
Household equipment & house maintenance cost	0	-0.1	0.2
Transport & communications	0.2	0.6	0.9
Personal care & health	0.2	0.2	0.3
Recreation & culture	0.3	0	0.1
Other goods & services	0.1	0.3	0.5
Inflation rate	**2.2**	**1.3**	**2.8**

Figures may not add up exactly due to rounding.
Source: NSO.

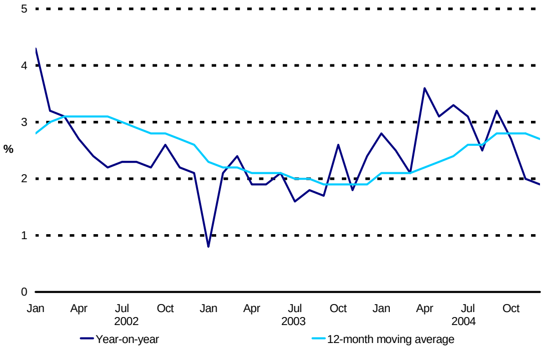
[5] The Bank's measure of core inflation was also adjusted to cater for the impact of the increase in the standard VAT rate in January 2004.

Box 1: Harmonised index of consumer prices

As from May 2004 the NSO started publishing a harmonised index of consumer prices (HICP) on a monthly basis, with the series going back to 1996. The HICP, which is compiled on the basis of regulations developed by Eurostat, the EU Commission's statistical arm, is the officially recognised index of consumer prices in the EU. Apart from allowing meaningful comparisons of price movements to be made across EU Member States, it is also used to assess whether Member States fulfil the price stability criterion for the full participation in EMU and the adoption of the euro.[6]

Although the RPI and the HICP utilise the same price collection methodologies, developments in the two indices may diverge due to differences in the coverage of the products monitored and the basket weight components. Whereas the RPI is only based on expenditure by resident private households, the HICP also takes into account expenditure by institutional households and foreigners in Malta. The latter thus allocates a significantly higher weight, close to a fifth, to the restaurants & hotels component within the basket, reflecting the significant contribution to economic activity offered by the tourism sector (see Table 1). Although both indices have an identical base month, December 2002, the RPI weights are fixed whereas the HICP is a chain index, with weights

Chart 1
HARMONISED INDEX OF CONSUMER PRICE INFLATION



Source: NSO.

updated in January each year, when newly significant goods and services may also be introduced. Moreover, the RPI is based on a local classification system with ten commodity groups, while the HICP is composed of twelve sub-indices based on an international classification system known as COICOP (Classification of Individual Consumption by Purpose).

During 2004 the 12-month moving average inflation rate based on the HICP mirrored that based on the RPI, following a similar upward trend, rising to 2.7% from 1.9% in the previous year. In contrast, the year-on-year HICP inflation rate rose from 2.4% in December 2003, reaching a peak of 3.6% in April, before dropping to 1.9% at the end of the year, mainly reflecting lower prices in restaurant and hotels (see Chart 1).

Table 1
RPI AND HICP BASKET WEIGHTS

%

	RPI	HICP
Food, beverages & tobacco	29.93	22.00
Transport & communications	23.13	16.58
Housing, water, electricity, gas & other fuels	9.82	7.26
Recreation, culture & education	8.84	11.06
Clothing & footwear	8.24	6.90
Furniture and household goods	7.65	9.30
Health	6.22	2.74
Other goods & services	6.17	24.15
of which		
Restaurants & hotels[1]	-	18.87
Total	**100.00**	**100.00**

[1] Meals consumed in restaurants are included with the "Food" component in the RPI.
Source: NSO.

[6] The price stability criterion is based on a reference value calculated as the arithmetic average of the twelve-month moving average rate of HICP inflation of the three best-performing Member States in terms of price stability plus 1.5 percentage points.

Increased fuel costs pushed up the transport & communications sub-index, which rose by 4% on average during the year and contributed just under one percentage point to the overall inflation rate (see Table 3.9). An upward revision in telephone charges and higher vehicle-related expenses also contributed.

The imposition of higher excise duties on cigarettes and alcohol raised the beverages & tobacco price index and boosted overall inflation by just over half a percentage point. Price increases in the other goods & services component added a further half percentage point to inflation, largely due to higher insurance costs.

These increases were slightly dampened by a small fall in prices of clothing & footwear. Inflationary pressures were further moderated by the removal of levies on EU food products and increased volumes of domestic agricultural supplies, whose combined impact dampened the overall growth in the food sub-index. Hence, food, which accounts for nearly a quarter of the RPI and which had contributed significantly to inflation during the previous two years, had only a small impact on inflation during 2004.

Meanwhile, core inflation rose by 0.3 percentage points to 2.3% mainly reflecting the introduction of environmental taxes. This rise was, however, smaller than that in official inflation as transport & communications and beverages & tobacco, the two main contributors to headline inflation during 2004, carry a zero weight in this measure.

Wages

Central Bank of Malta estimates, based on average weekly wage data gathered from collective agreements, suggest that wage inflation in 2004 was 1.6% for all workers and 1.4% when Government employees are excluded (see Table 3.10).[7] The Bank's estimates exclude overtime pay, production bonuses and any other allowances or income in kind, all of which also add to total labour costs, but include the cost-of-living adjustment. Moreover, they only capture wages of unionised workers covered by collective agreements, who comprise just under half of the gainfully-occupied population. They may, therefore, not be representative of developments in the non-unionised sectors of the economy.

On this basis, wage inflation was almost half that recorded during 2003 which, in turn, was roughly the same as that recorded a year earlier. Wage inflation also dropped below price inflation. The Bank's estimates also indicate that average wage increases were equally spread among different employment

Table 3.10
ESTIMATED CHANGE IN AVERAGE WAGES[1]

%

	2002	2003	2004
Unskilled	2.6	3.1	1.6
Skilled	4.3	3.0	1.4
Clerical	3.4	2.9	2.0
Administrative[2]	1.6	3.8	1.6
Average wage across categories	**3.3**	**3.1**	**1.6**
excluding civil service employees	**3.8**	**3.0**	**1.4**

[1] The Table shows Central Bank of Malta estimates based on data drawn from officially registered collective agreements. 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.

Sources: Central Bank of Malta estimates; Department of Employment & Industrial Relations; Ministry of Finance.

[7] Wage data from collective agreements for 2004 are only available for the period from January to August.

categories and ranged from 1.4% for skilled workers to 2% for clerical workers.

The slower acceleration in wages corroborates the deceleration indicated by the LFS, which captures the overall change in remuneration across the entire labour market, although wage growth as indicated by the LFS, at 0.3%, was even less rapid.

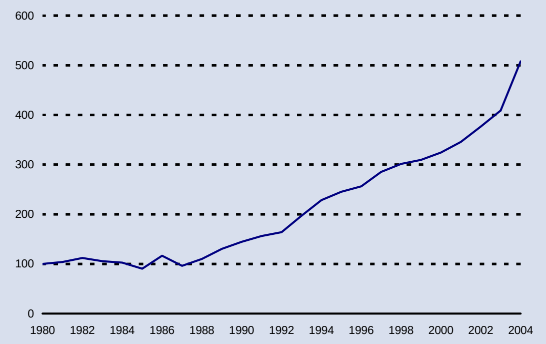
Unit labour costs, defined as the cost of labour compensation per unit of real output, increased by 1.4%. Whereas employment income per worker rose by 2% during the year, productivity (measured by real output per person in employment) increased by just 0.5%. Growth in unit labour costs moderated as compared with 2003, when they had risen by 5.9%.

Residential property prices

Developments in the property market exert an impact on household wealth and thus may influence aggregate demand, output and inflation. Given the importance of price indices related to this sector, the Central Bank of Malta upgraded the index it uses to measure price changes in residential property. The new index, which goes back to 1980, captures all advertised properties in Malta and Gozo except those for commercial purposes.[8]

According to the new index, advertised property prices continued to accelerate in 2004, rising by an estimated 24.2% on average. Thus, the general upward trend in residential property prices, in evidence since 1989, persisted (see Chart 3.7). The increase in average prices was, to an extent, inflated by developments in up-market units, as growth based on median prices was somewhat slower.[9] Prices of all property types rose during 2004, with the sharpest growth registered in the asking prices of town houses and finished flats. These increases took place against a background of low interest rates and may have reflected a shift in preferences for investment in real estate as opposed to financial assets, on account of attractive mortgage financing opportunities.

Chart 3.7
RESIDENTIAL PROPERTY PRICE INDEX
1980=100



Short-term Outlook

Assumptions for the forecast

Given the openness of the Maltese economy, a major factor influencing its performance is the state of external demand. In making assumptions about demand levels in Malta's major trading partners, the Bank made substantial reference to the European Commission's Autumn 2004 economic projections. On this basis, it is estimated that growth in external demand in 2005 will remain unchanged at the previous year's level. The Bank also assumed that inflation in Malta's major trading partners will slow down, while export prices will continue to decline, though not to the extent experienced in 2004.

On the domestic economic front, it has been assumed that the revenue and expenditure targets contained in the Government Financial Estimates for 2005 will be achieved and that the monetary policy stance will remain unchanged. The projections also take into account recent policy measures aimed at increasing production through the removal of additional vacation leave in lieu of public holidays falling on a weekend.

The Bank's forecast

The Bank's forecast for 2005 shows the Maltese economy growing at a faster pace than in 2004, but continuing to perform below its potential growth rate. The measure on public holidays mentioned above

[8] For more detailed information on the methodology used, see 'Box 2: A Reconsideration of the House Price Index' in the *Central Bank of Malta Quarterly Review* 37:4 (2004), pp. 36-38.

[9] Both the average and the median represent measures of central tendency but, as opposed to the average, the median is not influenced by outliers in the data.

Table 3.11
OUTLOOK FOR SELECTED ECONOMIC INDICATORS

%

	2003	2004	2005 [1]
GDP growth at constant market prices	(1.8)	1.5	1.7 - 2.3
Growth in GDP components at constant prices			
Private consumption expenditure	2.0	1.0	(0.6) - (0.0)
Government consumption expenditure	3.0	0.6	0.6 - 1.2
Gross fixed capital formation	34.4	5.3	6.3 - 7.0
Inventories (as % of GDP)	0.5	1.3	1.3
Exports of goods & services	(3.8)	2.5	2.8 - 3.4
Imports of goods & services	7.1	3.5	2.0 - 2.6
Unemployment rate	7.6	7.3	7.0 - 7.3
Inflation rate	1.3	2.8	1.9 - 2.3
General government deficit (as % of GDP)	10.6	5.2	4.0 - 4.4
External goods & services deficit (as % of GDP)	5.5	7.7	7.0 - 7.6

[1] Central Bank of Malta estimate.

Note: Figures in parenthesis are negative.

should boost GDP growth by around 0.4 percentage points, contributing to an overall growth rate in the range of 1.7% - 2.3%. The external sector is expected to be the main source of growth, with export volumes picking up further while the increase in import volumes slows down (see Table 3.11). A significant increase in fixed capital formation, especially by the public sector, is also expected to stimulate economic activity in 2005.

Growth in exports is expected to be underpinned by a rise in productivity as a result of higher private investment, the increase in working hours arising from the measure on public holidays, particularly in manufacturing, and strong external demand. In the case of the electronics industry, exports are seen to increase as global demand remains buoyant, though prices may remain depressed in view of the abundant international supply of electronic components. The pharmaceutical industry should also continue to expand its export volumes, while firms producing medical and precision engineering instruments are expected to maintain the positive performance of recent years. Thus, while overall export prices are projected to decline further in 2005, mainly because of developments in the electronics industry, a significant deterioration in Malta's terms of trade is not expected given that international analysts are expecting generally stable oil prices.

In the area of services, exports are expected to strengthen, although tourism earnings are projected to grow at a modest rate, as excess capacity contributes to pressures on prices and profit margins. As a result, the forecast growth in tourist arrivals and earnings in 2005 is unlikely to translate to higher employment levels in the sector.

In contrast, gross fixed capital formation is projected to accelerate in 2005, with the pick-up generated chiefly by Government capital expenditure, particularly on the new hospital. Government spending on other infrastructure projects, mainly related to the environment and roads, is also expected to rise. In this regard it is relevant to mention that a substantial part of the financing for these projects will emanate from EU structural funds. Consequently, inflows from such sources should be markedly higher than in 2004. Private sector investment, especially in manufacturing, is also expected to accelerate as domestic firms respond to growing international competition. This is most evident in the food and beverages sub-sector, where producers are gearing themselves up both to improve their competitive position in the domestic market and to venture overseas.

After slowing down in 2004, private consumption is expected to decline in 2005 as disposable income is projected to rise only marginally. This is partly attributable to the continued slack in the labour market, which should result in low wage growth, even though this should be slightly stronger than in 2004. Furthermore, household disposable income is also expected to be negatively affected by the anticipated higher inflow of income tax revenue. Similarly, public consumption is expected to grow at a slower pace in line with the ongoing fiscal consolidation programme.

Reflecting the weakness of private consumption and the fiscal tightening, import growth is forecast to slow down in 2005. However, imports of industrial supplies and of capital goods are expected to register more buoyant growth. In the case of the former, this will be mainly linked to the projected pick-up in exports, while in the case of the latter, the main factor should be the significant rise in public capital expenditure. These developments should lead to a slight narrowing of the negative balance on goods and services, although the latter is still expected to remain relatively large. The shortfall on the current account will be partly financed by foreign grants from the EU and Italy, which are projected to almost double in 2005 to around 4% of GDP.

The rate of inflation should drop significantly in 2005, as the temporary effects of the hike in the VAT rate in 2004 dissipate. Nevertheless, it is still expected to remain slightly above 2%, partly because of the impact of a number of other measures introduced from the beginning of the year. These include the 17% surcharge on water and electricity consumption and the extension of eco taxes to a number of other products. Furthermore, with oil prices remaining at the high levels seen in the final quarter of 2004, domestic fuel prices are not expected to ease until later in 2005. On the other hand, weak labour market conditions and labour cost savings arising from the impact of the measure on public holidays are likely to keep underlying inflationary pressures in check.

The pick-up in economic growth in 2005 is expected to have only a marginal effect on the unemployment rate. Slight growth in employment, however, should be generated by the forecast rise in export activity and increased public sector investment. In contrast, the continued weakness in domestic consumption, together with fiscal tightening, is likely to have a dampening effect on employment growth relative to the labour force. The latter is expected to continue expanding, primarily driven by higher female participation.

In summary, the Bank is projecting an acceleration in economic growth in 2005, mainly because of the increase in the number of working days brought about by the Government measure on public holidays. However, the improved performance of the external sector should also contribute. Inflation is expected to be significantly lower than in 2004, even though it will remain slightly above 2%, and the unemployment rate will ease slightly, despite the contractionary effects on the economy of fiscal consolidation.

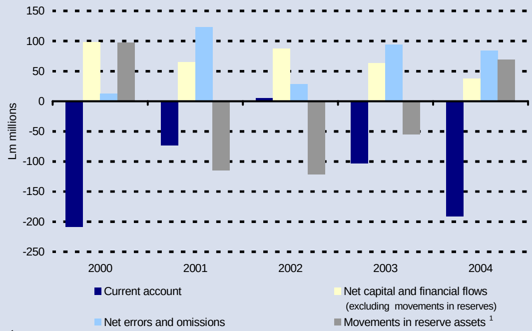
The Bank's projections hinge on the assumption that external demand will continue to grow at around the same pace as in 2004. They are therefore subject to downside risks, as growth forecasts in some of Malta's major trading partners, particularly in the euro area, could be revised downwards. On the domestic front there are downside risks too, if the pace and success of structural reforms in product and labour markets fall below expectations. However, the impact of these factors on the economy is likely to be more discernible in the medium to long term.

4. The Balance of Payments and the Maltese Lira[1]

The balance of payments

Provisional balance of payments data indicate that the current account deficit widened in 2004 compared to the previous year. This was mainly due to a combination of a larger merchandise trade gap, a decrease in the positive balance on services and a shift in the income account that swung the balance into deficit. After excluding movements in reserves, which registered a decline over the year, net inflows on the capital and financial account showed a smaller surplus. Net errors and omissions remained considerable and positive.

Chart 4.1
BALANCE OF PAYMENTS TRENDS



[1] A negative movement indicates an increase in reserve assets.
Source: NSO.

The current account

In 2004 the current account deficit widened to Lm191.3 million from Lm103.3 million (see Chart 4.1). Nearly half of this deterioration was due to a larger merchandise trade gap as imports increased and exports dropped. Developments in the income account also contributed as the surplus shifted to a deficit, while the positive balance on services

Table 4.1
EXTERNAL BALANCES[1]

Lm millions

	2003		2004	
	credit	debit	credit	debit
Current account balance		**103.3**		**191.3**
Goods and services	1,419.6	1,517.9	1,400.6	1,548.9
Goods balance		263.2		304.0
Goods	942.1	1,205.3	918.9	1,222.9
Services balance	164.9		155.7	
Services	477.5	312.6	481.7	326.0
Transport	122.4	138.6	132.0	151.2
Travel	261.5	80.9	269.1	88.0
Other services	93.7	93.1	80.6	86.7
Income (net)	15.4			17.1
Current transfers (net)		20.4		25.9
Capital and financial account balance[2]	**63.8**		**37.7**	
Capital account balance	2.4		25.3	
Financial account balance	61.4		12.5	
Direct investment	103.7		137.6	
Portfolio investment		585.8		578.8
Financial derivatives	9.0		1.1	
Other investment	534.4		452.5	
Movements in reserves[3]		**54.7**	**69.5**	
Net errors and omissions	**94.3**		**84.1**	

[1] Provisional.
[2] Excludes movements in official reserves.
[3] Excludes revaluation adjustments.
Source: NSO.

[1] This analysis is based on data available up to 9 March 2005.

Table 4.2
MERCHANDISE TRADE
(based on Customs data)

Lm millions

	2002	2003	2004[1]	% change 2003-2002	% change 2004-2003
Imports	**1,227.5**	**1,281.3**	**1,316.8**	**4.4**	**2.8**
Consumer goods	294.0	311.1	344.7	5.8	10.8
Industrial supplies	630.7	657.6	620.6	4.3	-5.6
Capital goods & others	200.0	210.7	247.1	5.3	17.3
Fuel & lubricants	102.8	101.9	104.4	-0.9	2.5
Exports	**960.7**	**928.3**	**909.2**	**-3.4**	**-2.1**
Trade balance	**-266.8**	**-353.0**	**-407.6**	**-32.3**	**-15.5**

[1] Provisional

Source: NSO.

narrowed further. The deficit on current transfers increased.

Merchandise trade

According to balance of payments data, the merchandise trade balance widened by Lm40.8 million to Lm304 million. Imports increased by Lm17.6 million while exports dropped by Lm23.2 million. Customs data for 2004 also indicate similar trends (see Table 4.2), though magnitudes differ because of differences in methodology.[2]

Customs data show that imports increased by Lm35.5 million, or 2.8%, in 2004 (see Table 4.2). Capital goods and consumer goods contributed significantly to this rise, increasing by 17.3% and 10.8%, respectively. The former were boosted in the first quarter of the year by the recording of yacht imports, which benefited from a temporary reduction in VAT. However, these transactions did not affect balance of payments data. Consumer goods also rose sharply, influenced by the removal of levies upon Malta's accession to the EU in May, which made certain imported items, particularly food and beverages, cheaper. The import bill on fuels and lubricants also increased, although the impact of higher oil prices was somewhat mitigated by the appreciation of the Maltese lira against the dollar and the cessation, during the year, of imports related to oil bunkering activity by one firm.

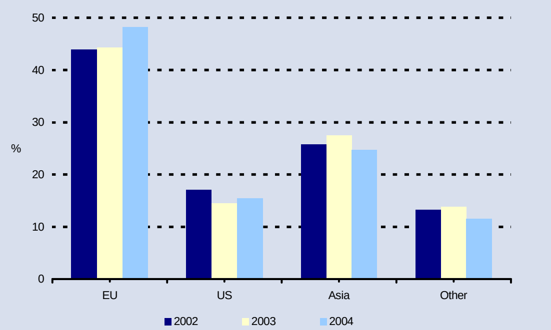
Imports of industrial supplies, particularly semi-finished goods, dropped by 5.6%. This is probably related to the reduction in manufacturing exports in value terms, which was driven by negative developments in export prices.

During the year, exports dropped by 2.1%, or Lm19.1 million, with adverse price movements having a significant impact. Exports of mineral fuels and lubricants dropped by 22.8% as a state-owned oil-bunkering firm ceased its import and re-export operations. Moreover, foreign sales of food, which had been boosted significantly by fish exports in December 2003, dropped by over a quarter to Lm25.4 million. In addition, exports of beverages & tobacco and miscellaneous manufactured goods declined, with the latter probably reflecting the closure of some firms in the textile industry. Conversely, exports of machinery and transport equipment, which also include semi-conductors, and chemical goods increased.

An analysis of merchandise trade flows on a destination basis indicates that trade links with the EU continued to strengthen in 2004. The share of exports to the EU in the total expanded from 44% to

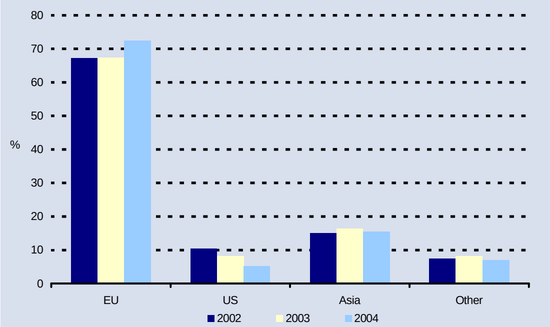
[2] Merchandise trade figures are compiled by the NSO from Customs data, which are recorded on a cost, insurance and freight basis. These data are then adjusted in the compilation of the balance of payments to cater for differences in coverage, valuation and timing. In addition, insurance and freight are allocated to the services account. As a result, the goods balance shown in Table 4.1 does not tally with the merchandise trade balance shown in Table 4.2.

Chart 4.2
DIRECTION OF TRADE - EXPORTS



Source: NSO.

Chart 4.3
DIRECTION OF TRADE - IMPORTS



Source: NSO.

48%, while the EU's share of Maltese imports increased from 67% to 72%, which probably reflected the impact of the removal of trade barriers referred to earlier. The proportion of imports from the US continued to drop, falling from 8% to 5%. The share of imports from Asia and other countries also fell. On the other hand, the share of Malta's exports to the US increased from 14% to 15% while the share of exports to Asia and other countries dropped (see Charts 4.2 and 4.3).

Services

The surplus on services narrowed by Lm9.2 million to Lm155.7 million (see Table 4.1). Lower receipts for miscellaneous business, professional and technical services accounted for most of the drop in the surplus, although higher freight payments – related to the larger import bill – and increased passenger carriage payments also contributed. On the other hand, net travel receipts rose, albeit by just 0.3% to Lm181.1 million. Gross travel receipts continued to increase, expanding by 2.9%, but they were almost matched by higher travel payments that probably reflected the sharp growth in the number of Maltese travelling abroad.

Investment income and transfers

Developments in the income component also contributed significantly towards the wider current account deficit as the balance shifted from a surplus of Lm15.4 million to a deficit of Lm17.1 million. This swing was almost completely due to larger profits recorded by foreign-owned companies operating in Malta, which increased from Lm77.4 million to Lm100.4 million. A substantial part of these profits was retained.[3] In addition, net interest receipts were lower as residents received lower income on their external assets.

Meanwhile, the deficit on current transfers widened, as private transfer payments continued to expand, with the balance on government transfers remaining largely unchanged.

The capital and financial account

The capital and financial account – excluding movements in reserves – recorded a reduced surplus in 2004. Compared to the previous year, net inflows declined by Lm26 million to Lm37.7 million in 2004.

Net inflows on the capital account increased substantially to Lm25.3 million, mostly as a result of official capital transfers from the EU and other official assistance from Italy under the Fifth Financial Protocol. In contrast, net inflows on the financial account decreased from Lm61.4 million in 2003 to Lm12.5 million. This reduction mainly reflected lower net inflows on the other investment account item, which dropped by Lm81.9 million to Lm452.5 million. This was mainly driven by a significant increase in loans granted by resident international banks to non-residents, which are recorded as outflows. A drop in inflows due to the repatriation by residents of holdings of foreign currency and deposits also contributed. Net financial inflows related to financial derivatives

[3] Retained earnings are then recorded as inflows in the direct investment component of the capital and financial account.

Table 4.3
EXCHANGE RATES OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES FOR 2004

	USD/MTL	GBP/MTL	JPY/MTL	EUR/MTL
Average for 2004	2.9061	1.5853	314.2	2.3368
Average for 2003	2.6543	1.6237	307.4	2.3470
% change	9.5	-2.4	2.2	-0.4
Closing rate on 31.12.2004	3.1392	1.6252	321.7	2.3023
Closing rate on 31.12.2003	2.9197	1.6351	312.2	2.3163
% change	7.5	-0.6	3.0	-0.6
High for the year	3.1415	1.6331	325.1	2.3598
	(28 Dec.)	(05 Jan.)	(15 Mar.)	(18 June)
Low for the year	2.7783	1.5462	296.8	2.3004
	(26 Apr.)	(18 June & 13 Apr.)	(05 Apr.)	(30 Dec.)

fell by Lm7.9 million to Lm1.1 million, while net portfolio outflows decreased marginally from Lm585.8 million to Lm578.8 million.[4] These outflows largely consist of investment by resident banks in long-term assets such as bonds and notes.

Conversely, net direct investment inflows went up by Lm33.9 million to Lm137.6 million, partly on account of higher reinvested earnings by foreign-owned companies as well as an increase in the capital base of a resident deposit money bank.

Errors and omissions, which amounted to Lm84.1 million, continued to be positive and substantial, implying an overestimation of the current account deficit or underestimated capital and financial inflows, or both. They also highlight the difficulties of capturing international transactions in an extremely open economy that has liberalised capital account transactions and has developed into an international financial centre.

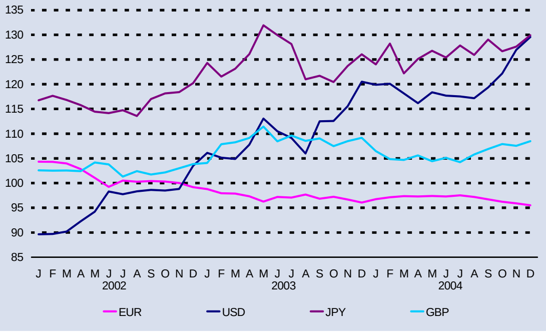
As a result of these developments, the official reserves dropped by Lm69.5 million after having increased by Lm54.7 million in the previous year.

The Maltese lira and indicators of external competitiveness

The Maltese lira

Movements of the Maltese lira in 2004 reflected international foreign exchange market developments outlined in Chapter One of this *Report*. When compared to end-December 2003, the lira depreciated by 0.6% against the euro. This limited movement of the lira against the euro reflects the large weight allocated to the euro in the Maltese lira currency basket. The lira also lost ground against sterling during the first half of the year, but regained some of

Chart 4.4
EXCHANGE RATE MOVEMENTS OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES
(index of end-of-month rates, end-1999 = 100)



[4] In the final quarter of 2003, the new category 'financial derivatives' began to be shown as a separate category of the capital and financial account. Flows related to financial derivatives were formerly included with portfolio investment. As data on financial derivatives for 2003 do not refer to the entire year, flows reported for the two years are not strictly comparable.

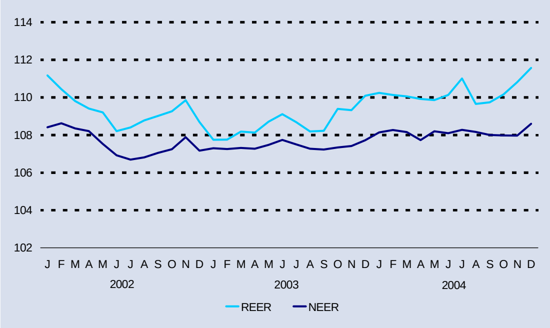
it towards the end of the year so that over the year as a whole it fell by 0.6% (see Table 4.3).

Conversely, the lira appreciated significantly against the dollar, which continued to weaken on international foreign exchange markets (see Chart 4.4). This appreciation of the lira was particularly pronounced in the final quarter of the year, when the dollar reached record lows against the euro. The lira also strengthened further against the yen, albeit at a slower pace than that recorded in 2003.

Effective exchange rates

The Nominal Effective Exchange Rate (NEER) of the Maltese lira ended the year 0.8% higher than at end-December 2003. The Real Effective Exchange Rate (REER) of the Maltese lira was stable for most of the year (see Chart 4.5). In November and December it rose substantially, ending the year 1.3% above its end-2003 level. This mainly reflected the appreciation of the Maltese lira against the US dollar. However, unfavourable price differentials also had an impact on the Index, as retail prices in Malta increased at a faster pace than they did in its trading and competitor countries.

Chart 4.5
REAL AND NOMINAL EFFECTIVE EXCHANGE RATE INDICES FOR THE MALTESE LIRA
(1995 = 100)



5. Government Finance[1]

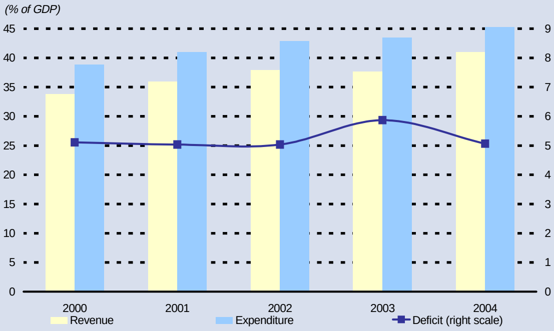
After having widened during the previous year, the deficit on the Consolidated Fund contracted in 2004 as revenue grew faster than expenditure. Measured as a proportion of GDP, the deficit fell from 5.9% in 2003 to 5.1% in 2004. The fiscal imbalance was mainly financed through the issue of long-term domestic securities and, to a lesser extent, through short-term borrowing. The Budget for 2005 projects a lower Consolidated Fund deficit of Lm76.1 million, as revenue is again estimated to grow faster than expenditure.

At the same time, the general government deficit also decreased substantially, reaching 5.2% of GDP from 10.6% a year earlier.[2] This improvement was, however, accentuated by a one-off adjustment related to the restructuring of the shipyards that took place in 2003. The general government debt rose from 72.6% of GDP in 2003 to 75.6%. According to the latest Convergence Programme, the general government deficit is expected to maintain its downward trend during the next three years, reaching 1.4% of GDP in 2007, with the debt ratio also expected to drop to 70.4% (see Box 2).

Fiscal performance in 2004

The Consolidated Fund deficit declined by Lm11.5 million in 2004, reaching Lm93.9 million (see Table 5.1).

Chart 5.1
FISCAL INDICATORS
(% of GDP)



Note: Figures refer to the Consolidated Fund.
Sources: Ministry of Finance ; NSO.

This improvement was entirely attributable to growth in revenue, which increased by 12.3%, surpassing the 9.2% rise in expenditure. As a result, the primary deficit narrowed by Lm18.2 million from its 2003 level.[3]

The increase in revenue during 2004 was generated primarily by grants from overseas, coupled with VAT receipts and a one-time payment by the new operators of the national lottery following its privatisation. Revenue growth also reflected measures that came into effect during the year regarding the taxation of income from property transfers. On the other hand, expenditure growth was mainly driven by higher spending on social security benefits, contributions to the EU Own Resources and a one-off compensatory payment to households following the increase in the VAT rate. Consequently, total revenue, which had dipped to 37.7% of GDP in 2003, recovered to 41% during 2004, while the expenditure-to-GDP ratio continued to rise, reaching 46% (see Chart 5.1).

Revenue

During 2004 revenue grew by Lm83.1 million for a total of Lm759.5 million. Almost one half of this rise came from non-tax receipts, which went up by Lm41.3 million. The remainder was attributable to both direct and indirect taxes, which increased by Lm8.3 million and Lm33.5 million, respectively.

Most of the additional non-tax revenue stemmed from grants received from the EU and Italy, the latter in terms of the Fifth Italian Financial Protocol. These funds more than offset a drop in Central Bank of Malta profits transferred to Government, as well as a decline in fees due to the non-recurrence of the Investment Registration Scheme that was in place during the last quarter of 2003.

[1] This analysis is based on information contained in the Financial Estimates 2005 and the Budget Speech 2005 and takes into account data on GDP released on 10 March 2005.

[2] General government captures all the operations of central Government, including extra-budgetary units, and local government. Data on the general government deficit and debt are taken from NSO News Release No. 50/2005 published on 18 March 2005.

[3] The primary balance excludes interest payments from expenditure, as the former are driven by the accumulated stock of debt and by movements in interest rates and are not directly under Government control. It thus gives a better indication of the fiscal policy stance.

Table 5.1
GOVERNMENT BUDGETARY OPERATIONS[1]

Lm millions

	2003	2004	2005	2004	2005
				% change	
TOTAL REVENUE	**676.4**	**759.5**	**833.8**	**12.3**	**9.8**
Direct tax [2]	330.9	339.2	354.9	2.5	4.6
Indirect tax	274.6	308.1	335.1	12.2	8.7
Grants	2.5	37.4	74.6	+	+
Other non-tax revenue	68.4	74.8	69.2	9.4	-7.5
TOTAL EXPENDITURE	**781.9**	**853.5**	**909.9**	**9.2**	**6.6**
Recurrent expenditure [2]	677.9	743.9	772.8	9.7	3.9
Capital expenditure	104.0	109.6	137.1	5.4	25.1
BALANCE ON CONSOLIDATED FUND	**-105.4**	**-93.9**	**-76.1**	-	-
Interest payments	63.0	69.7	77.7	10.6	11.4
Primary balance [3]	-42.4	-24.2	1.6	-	-
GENERAL GOVERNMENT BALANCE[4]	**-189.8**	**-96.7**	**-**	**-**	**-**

+ indicates a value exceeding + / - 100%

[1] Data for 2004 and 2005 are revised estimates and estimates, respectively, as shown in the *Financial Estimates 2005* and the *Budget Speech 2005* published in November 2004.

[2] Excluding the state contribution to the social security account.

[3] Total revenue less total expenditure excluding interest payments.

[4] General government balances are taken from NSO News Release No. 50/2005 published on 18 March 2005.

Sources: Ministry of Finance; NSO.

The increase in indirect tax revenue was mainly driven by higher inflows from VAT and from licences, taxes and fines. The former grew by Lm16.6 million, or 13.4%, reflecting the increase in the standard rate from 15% to 18% in January, a widening of the tax base in May and the introduction of a temporary scheme entailing a reduced rate on the importation of yachts. The latter yielded Lm3.2 million. On the other hand, licences, taxes and fines increased by Lm13.1 million, most of which was attributable to the one-time payment received on the privatisation of national lottery operations. Duty on documents on transfers of immovable property also produced more revenue, following changes to taxation on the sale and transfer of property. Meanwhile, revenue from Customs and Excise was Lm3.8 million higher than the level recorded in 2003 due mainly to an increase in excise duties on cigarettes. In contrast, receipts from levies on imported goods fell due to the removal of levies on EU products following accession.

Direct tax revenue was up by Lm8.3 million. Income tax contributed more than half of this rise, increasing by Lm4.7 million and driven mainly by higher intakes from capital gains taxes, as income earned from the transfer and sale of property, including inherited estate, became subject to a stricter tax regime. However, higher income from employment also contributed and, coupled with an improving labour market, also led to a rise in social security contributions.

Expenditure

Total expenditure for 2004 increased by Lm71.6 million. Recurrent spending expanded by Lm66 million, or 9.7%, and accounted for almost the entire rise. Capital outlays rose by Lm5.6 million.

The expansion in recurrent outlays mainly reflected higher spending on programmes and initiatives, which rose by Lm42.8 million, or 14.4%. The main contributory factors were higher spending on social security benefits - mostly retirement pensions - and a one-off compensation to households following the increase in the standard VAT rate. Moreover, for the first time, the Government contributed to EU own resources following EU membership in May. Payments in this regard amounted to around 2% of total expenditure. At the same time, outlays on medicines and medical supplies were the main factor driving up spending on operations and maintenance, which rose by almost Lm8 million.

The Government's wage bill increased by Lm5.7 million, driven mainly by the cost of living adjustment and annual salary increments. Higher wages offset the decline in spending due to the reclassification of the Drainage Directorate outside the Government's departmental structure. This reclassification, coupled with higher transfers to Industrial Projects and Services Ltd (IPSL) and the Malta College of Arts, Science and Technology (MCAST), drove up contributions to Government entities by Lm2.8 million, offsetting a drop in transfers to the shipyards. Interest payments rose by Lm6.7 million, reflecting increased levels of outstanding debt.

Capital expenditure continued to expand, albeit less rapidly than in the previous two years, adding Lm5.6 million to Lm109.6 million. Higher outlays were mostly related to the purchase of embassy premises abroad and the acquisition of new equipment for the Armed Forces and for the Ministry of Agriculture and Fisheries. However, the effect of these factors was dampened by lower spending on education, roads, public transport and subsidies to the shipyards. Capital spending on health, which accounted for around one-fourth of the total, remained broadly unchanged over the previous year.

Government debt and financing operations

Gross Government debt went up by Lm94.7 million during 2004, broadly in line with the Consolidated Fund deficit, ending the year at Lm1,354.2 million, or 73% of GDP (see Chart 5.2).[4] This rise was mainly attributable to a Lm100 million increase in Malta

Table 5.2
GOVERNMENT DEBT AND FINANCING OPERATIONS

Lm millions

	2003	2004
CONSOLIDATED FUND BALANCE	**-105.4**	**-93.9**
Contributions to sinking funds (foreign)[1]	-5.9	-7.4
Contributions to sinking funds (local)[1]	-6.4	-6.4
Sinking funds of converted loans	2.1	9.0
Proceeds from sale of assets	0	0
Borrowing requirement	115.6	98.7
Changes in		
Gross Government debt [2]	**183.2**	**94.7**
Malta Government stocks	100.4	100.0
Treasury bills	13.5	13.1
Local loans	41.8	-14.4
Foreign loans	27.5	-4.0

[1] Negative figures indicate an application of funds.

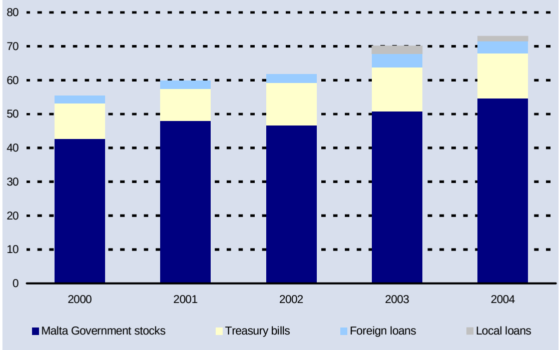
[2] The change in gross Government debt is not necessarily equal to the public sector borrowing requirement due to changes in Government deposits and differences in definitions used.

Sources: Central Bank of Malta; Ministry of Finance.

[4] Data on Government debt refer to central Government excluding Extra-Budgetary Units.

Government stocks (MGS), following three issues that took place during the year (see Table 5.2). The Government also resorted to short-term borrowing, with Treasury bills in issue rising by Lm13.1 million. On the other hand, both local and foreign loans declined. The former decreased by Lm14.4 million, as around one-third of the debt previously owed by the shipyards and assumed by Government in 2003 was repaid. Similarly, the outstanding volume of foreign loans also decreased as repayments were only marginally offset by negative revaluation effects. Indeed, the low share of foreign loans, amounting to around 5% of the total, suggests that risks arising from exchange rate fluctuations are limited.

Chart 5.2
GROSS GOVERNMENT DEBT
(% of GDP)



Consequently, at the end of 2004, MGS outstanding amounted to Lm1,012.8 million, or 74.8% of Government debt, while Treasury Bills equalled Lm245.4 million, or 18.1%. Local and foreign loans, which stood at Lm27.4 million and Lm68.6 million, respectively, accounted for the remainder.

Box 2: Convergence Programme 2004-2007

As a Member State of the European Union, Malta is required to submit Convergence Programmes in line with Council Regulation (EC) No. 1466/97, which focuses on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies. This Regulation states that all Member States that have not adopted the euro have to submit Convergence Programmes to the Council and the Commission at regular intervals. Consequently, in May 2004 Malta presented its first Convergence Programme covering the period 2004-2007. The Programme includes an analysis of the economy and the medium-term outlook, a detailed explanation of the Government's medium-term budgetary objectives and the underlying policies and reforms.

Responding to the Convergence Programme, the Council decided on 5 July 2004 that, with the general government deficit and gross government debt standing at 9.7% and 70.4% of GDP respectively, in 2003 Malta was in an excessive deficit position. As a result, the Maltese authorities were requested to correct this position by 2006 at the latest, through the implementation of structural measures aimed at curbing expenditure and reducing growth in the debt ratio.

In line with the same Council Regulation, Member States that have not adopted the euro are requested to submit an update of the Convergence Programme in the latter part of the year. Accordingly, Malta submitted an updated version of the Convergence Programme containing the latest fiscal position, in December. Subsequently, on 22 December the Commission reported that the Maltese Government appeared to be taking the necessary action to achieve the 2005 deficit target and indicated that no further steps were necessary under the excessive deficit procedure. In February 2005, the ECOFIN Council endorsed the Commission's recommendation.

According to the updated Convergence Programme, the Government expects the general government deficit-to-GDP ratio to decline gradually from 5.2% in 2004 to 3.7% in 2005 (see Table 1). Two-thirds of this drop will be achieved through higher taxation, while one-off measures, such as the sale of Government property, are expected to contribute to the remaining third. By 2007, the deficit-to-GDP ratio should reach 1.4%.

On the other hand, the general government debt-to-GDP ratio is expected to decline from 73.2% in 2004 to 72% in 2005. The debt ratio should continue to fall over the Programme period due to privatisation proceeds, higher economic growth and a gradual improvement in the primary balance, reaching 70.4% by 2007.

Table 1
MEDIUM-TERM FISCAL DEVELOPMENTS

as % of GDP

	2003	2004	2005*	2006*	2007*
General government balance	-9.6	-5.2	-3.7	-2.3	-1.4
General government primary balance	-5.8	-1.4	0.3	1.6	2.4
General government debt	70.4	73.2	72.0	70.5	70.4

* Forecasts

Source: 'Malta: Update of Convergence Programme 2004 - 2007', Ministry of Finance.

6. Financial Stability Analysis

The Central Bank of Malta's underlying objective in promoting financial stability is the timely identification of vulnerabilities and the assessment of risks to the financial system that could result in systemic disturbances.

During 2004 the pick-up in the Maltese economy and the continued low interest rate environment reduced the interest debt burden for both the household and the corporate sectors, as competition for loan origination intensified. The overall assessment of the local banking system still appears favourable, with stress tests showing that credit institutions are adequately capitalised to withstand plausible economic shocks. Banks experienced higher profitability, reflecting increased efficiency arising from cost-containment and a decline in doubtful assets. Lending increased, mainly driven by the demand for mortgage loans by households, while credit risk from the corporate sector declined. However, there were still some downside risks arising mainly from uncertain international economic developments, particularly with regard to exchange rate movements, inflationary expectations and external deficits. Domestically, although the interest debt burden was alleviated by low interest rates, household debt levels relative to income rose sharply, while property prices continued to rise.

Regulatory developments

During the year, various regulations and laws related to banking were introduced both locally and internationally. Further Directives and Regulations were adopted by the EU in connection with the Financial Services Action Plan (FSAP). The two most important developments were the recasting of the European Union Codified Banking Directive and the Capital Adequacy Directive implementing Basel II. The adoption and implementation of International Accounting Standards (IASs) with a carved-out version of IAS 39 was endorsed by the European Commission in November. In the domestic sphere, the MFSA amended various Directives governing the banking, insurance and investment services sectors in order to harmonise the local regulatory regime with the EU *Acquis*. The EU Regulations on the single passport and freedom to provide financial services were adopted in May 2004.

The financial sector

The banking sector

Credit institutions in Malta continued to maintain a level of capital well above the statutory minimum requirement and were generally more robust than in previous years as enhanced risk management reduced credit, market and operational risks substantially.

The capital adequacy ratio (CAR) of the domestic credit institutions stood at 19.1% at the end of 2004, compared with 17.8% in 2003, although their core capital adequacy ratio (CCAR) fell marginally to 15.5% (see Chart 6.1). The total banking system's CAR continued on its upward trend, reaching 21.4% by the end of the year, reflecting a rise in the banks' own funds (see Table 6.1). The CCAR for the banking system as a whole also ended the year slightly higher at 18.2%. Stress testing in respect of exceptional, but plausible events showed that even in adverse scenarios, credit institutions in Malta would be left with adequate capital, reflecting their robustness.

Chart 6.1
CAPITAL ADEQUACY

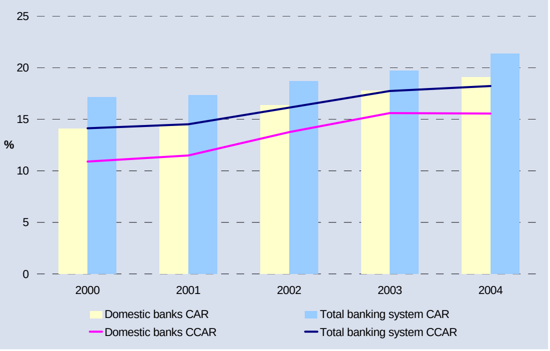


Table 6.1
FINANCIAL SOUNDNESS INDICATORS

	2003	% 2004
Regulatory capital to risk-weighted assets (CAR)	19.7	21.4
Regulatory Tier 1 capital to risk-weighted assets (CCAR)	17.7	18.2
Non-performing loans net of provisions to capital	38.4	30.6
Non-performing loans to total gross loans	8.1	6.6
Return on assets (ROA)	1.0	1.3
Return on equity (ROE)	10.2	13.9
Interest margin to gross income	70.9	45.7
Non-interest expenses to gross income	57.8	46.9
Liquid assets to total assets	24.6	24.3
Liquid assets to short-term liabilities	56.3	45.5

The banking sector's profitability has traditionally been influenced by the net interest income earned from its core operations. The low interest rate environment of recent years, however, has induced banks to diversify their sources of income in order to maintain profit margins. As a result, income generated from non-interest activities, such as foreign exchange dealing, securities trading, fee income and other services was an important contributor to the banks' profits.

The banks' operating costs fell by 6.7% during the year, reflecting lower non-interest expenses resulting particularly from write-backs and lower provisions. As a result, their cost-to-assets ratio decreased by 30 basis points to 1.2% (see Chart 6.2).

The increase in bank profitability was reflected both in the return-on-equity ratio (ROE) and in the return-on-assets ratio (ROA), with the ROE and the ROA for the banking sector as a whole rising to 13.9% and 1.3%, respectively, as at end-December 2004, from 10.2% and 1% at the end of the previous year (see Table 6.1).

The banks' total assets increased by 15.3%, reflecting a sharp increase both in holdings of foreign investment securities and in loan portfolios. The latter, which constitute the largest asset component of the banks' balance sheet, increased by Lm257.3 million (7.4%) to Lm3.7 billion during 2004, largely reflecting lending to the household sector.[1] In addition, asset quality within the banking sector continued to improve, reflecting a further decline in non-performing loans (see Chart 6.3). This notwithstanding, the overall level of non-performing loans remains high and, coupled with the lack of diversification in the banks' loan portfolio, remains a source of concern.

Over the last three years, credit institutions introduced

Chart 6.2
PROFITABILITY

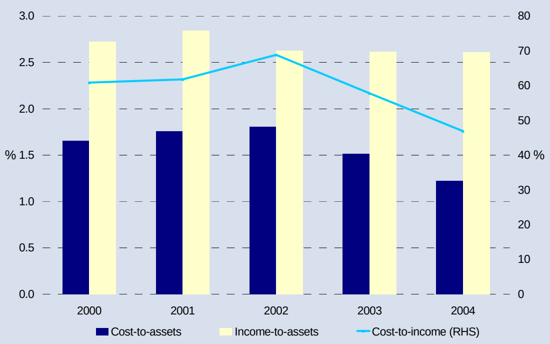
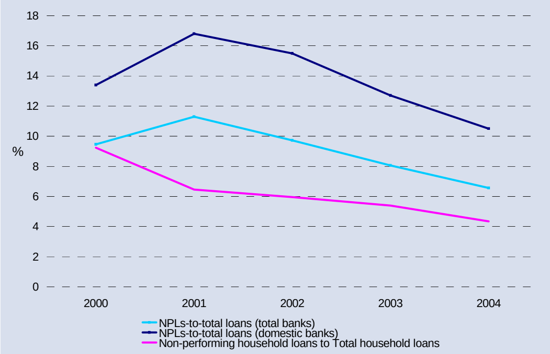
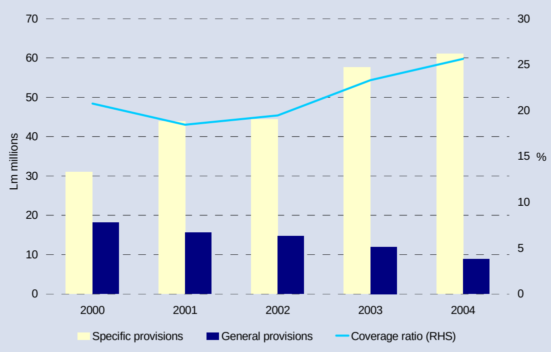


Chart 6.3
NON-PERFORMING LOANS



[1] These data exclude interbank loans.

Chart 6.4
PROVISIONS



more efficient credit risk management systems that reversed the rising trend of non-performing loans noted in the previous years. However, overall loan loss provisions remained unchanged during 2004, with an increase by one major bank offsetting a reduction by another. Thus, the coverage ratio improved during the year, rising to 25.6% from 23.3% at end 2003 (see Chart 6.4).

Over 60% of the banks' loan portfolio is collateralised, with immovable property accounting for half the value of the collateral held by banks. This high concentration of real estate in the value of collateral amplifies the degree of credit risk to which the banks are exposed, particularly on account of the difficulties that are likely to be encountered in liquidating this type of collateral.

The non-bank financial sector

The net worth and profitability of the insurance sector continued to improve in 2004, underpinned by rising business volume. In fact, both general and life insurance premia increased significantly during the year.

The bullish stock market, coupled with the economic growth experienced by some of the major industrialised countries, drove the international as well as the domestic SICAVs market higher. Issuance of corporate securities on the domestic capital market stagnated somewhat during 2004, reflecting companies' preference for more traditional sources of finance. The small turnover and correspondingly low liquidity in the stock market remain a concern. The price-earnings ratio of non-bank equity moved erratically, but that of the banking sector recorded a moderate increase, reflecting investors' confidence in the banks.

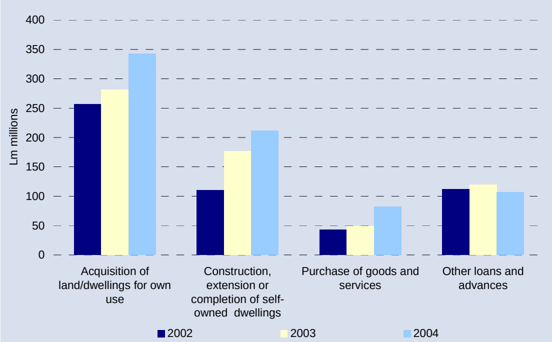
The non-financial sector

The household sector

Household debt increased by 18.7% in 2004, as low interest rates may have induced households to carry increased debt under a perception of a constant debt-servicing burden. Since most borrowing carries a variable rate of interest, any eventual high increases in interest rates may put the household sector under financial pressure, a fact that may be of concern to credit institutions on account of their exposure to the sector.

Borrowing by households for the purchase and construction of houses increased by 21% to Lm554 million during 2004 (see Chart 6.5). At the same time, the demand for dwellings continued to drive house prices higher, as explained in Chapter Three of this *Report*. The correlation between rising house prices and the growth of household debt shows that a rapid fall in prices might affect the ability of households to repay loans in the event of forced sale or lower income. This could have further consequences for the banks, especially as some institutions might have eased credit standards through higher loan-to-value ratios and extended repayment periods. While there are indications of increased risk in household portfolios, as shown by the deterioration in the household loans-to-GDP and the loans-to-income ratios, it is still difficult to envisage a scenario in which a fall in house prices

Chart 6.5
HOUSEHOLD BORROWING
(all banks)



alone could trigger difficulties for the local financial system.[2] Furthermore, the default rate by the household sector has traditionally been very low.

The corporate sector

Lending to the corporate sector picked up slightly during 2004 while deposits fell marginally from Lm418 million in 2003 to Lm414 million in 2004.[3] Credit risk appears to have waned somewhat during the year with the number of creditors' forced insolvencies declining considerably. Furthermore, although the gross indebtness of the corporate sector measured in terms of bank debt increased by 6.8% during 2004, large credit exposures by the major domestic banks vis-à-vis the sector increased only marginally.

Risk outlook

Financial stability analysis focuses on downside risks to the base economic scenario rather than on the most likely outcome, so as to highlight potential threats to the stability of the system. While the current financial environment appears to be benign, expectations for 2005 appear to be more cautious than in 2004 due to the continuing uncertainty regarding the prospects for economic growth. Although the risks appear to be limited, there are some areas that warrant attention. The continued rapid build-up of debt by the household sector is flagged as a potential source of concern in the event of a rapid and substantial decline in house prices and a reversal of the current low interest rate scenario. A potential rise in interest rates is also a source of concern in respect of credit institutions' fixed interest portfolios. On the other hand, the Maltese banking system is well capitalised, as demonstrated by the high CAR. In fact, univariate stress testing on total own funds in relation to various risks confirms that the system has a strong capital base that would enable it to absorb plausible economic and financial shocks.

[2] National Accounts data show that the household loans-to-GDP ratio increased by 5.7 percentage points in 2004 while the loans-to-disposable income ratio increased by 4.9 percentage points as at September 2004.

[3] Corporate data refers to resident companies with exposure to banks operating domestically.

Part II

BANK POLICIES, OPERATIONS AND ACTIVITIES

1. The Conduct of Monetary Policy

The primary objective of the Central Bank of Malta's monetary policy is price stability, which is widely acknowledged to be a key condition for securing economic growth in the long term. The Bank seeks to achieve this by pegging the exchange rate of the Maltese lira to three low-inflation currencies - the euro, the pound sterling and the US dollar. Within this framework, the Bank's Monetary Policy Advisory Council meets monthly to set the central intervention rate at a level that is considered adequate to support the fixed exchange rate. The Bank ensures that market interest rates remain around this level by conducting regular open market operations to influence liquidity conditions in the banking system. In this manner the Bank seeks to influence domestic market interest rates, particularly at the very short end of the spectrum.

Before a decision is taken on the stance of monetary policy, the Bank's Monetary Policy Advisory Council analyses both domestic and international economic and financial developments at its monthly meetings. A final decision is taken by the Governor, who is the Chairman of the Council.

Throughout 2004, the Bank left its central intervention rate unchanged at 3%, considering that, at this level, official interest rates offered appropriate support to the exchange rate peg (see Chart 1.1). An unchanged monetary policy stance was also considered appropriate in the absence of strong inflationary pressures and in the context of weak domestic economic activity.

Chart 1.1
OFFICIAL INTEREST RATES IN MALTA AND ABROAD

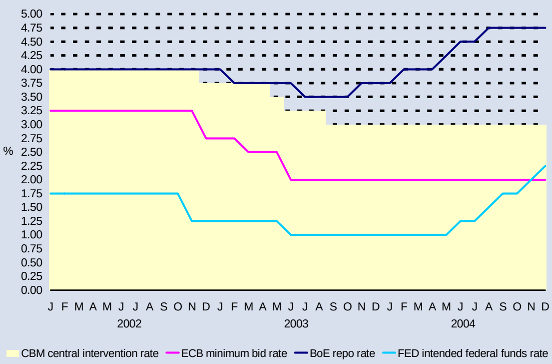
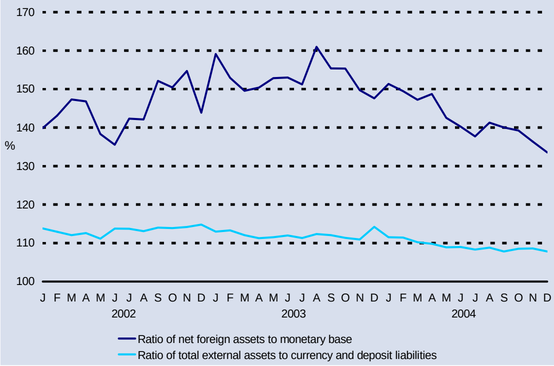


Chart 1.2
TRENDS IN THE CENTRAL BANK OF MALTA'S NET FOREIGN ASSETS

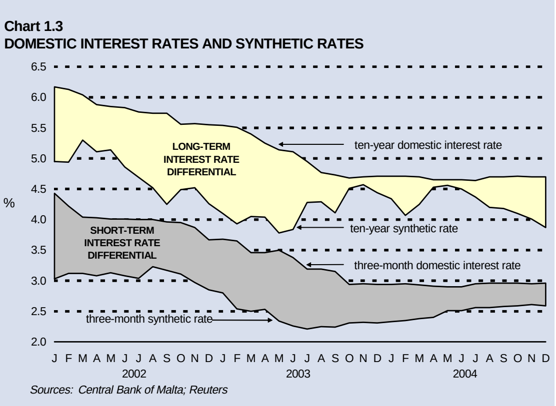


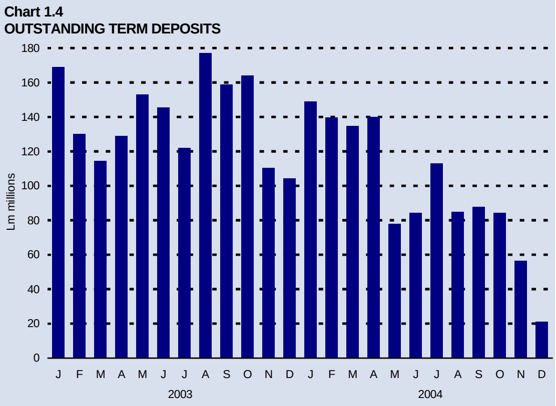
The Bank's external reserves were generally stable during the first three quarters of the year, though they declined in the final quarter as a result of seasonal factors and structural factors including higher oil prices and the adjustment of consumption patterns following trade liberalisation. Although the Bank's net foreign assets declined as a proportion of the monetary base, the statutory ratio between the external reserves and the Bank's currency and deposit liabilities remained broadly unchanged at close to 110% (see Chart 1.2).

During the first half of the year, the short-term premium on the Maltese lira narrowed as money market rates abroad rose, dropping to 39 basis points in May (see Chart 1.3). However, it fluctuated slightly around that level thereafter, ending the year at 37 basis points. In contrast, the ten-year premium on the lira widened to just over 80 basis points by end-December.

External reserves management

In order to maintain confidence in the Maltese lira, the Central Bank of Malta Act obliges the Bank to keep an amount of external reserves equivalent to not less than 60% of its currency and deposit liabilities. In managing these reserves, the Bank's policy is to protect their value, ensure adequate liquidity and generate income. Accordingly, the Bank's portfolio is designed to limit exchange rate and credit risks. As a result, the reserves are mainly composed of deposits with first class foreign banks





and investment grade securities issued by non-residents.[1] The parameters for the management of the external reserves are set by the Investments Policy Committee, which is chaired by the Governor and includes the Deputy Governor and other senior Bank officials.

The Bank computes and publishes daily spot and forward exchange rates for the Maltese lira against major currencies, which are also published on Reuters. On 1 November 2004 the Bank started quoting the official exchange rate with respect to the euro in terms of units of domestic currency per one euro. Trades with financial institutions in the spot market for euro, the pound sterling and the US dollar take place on a daily basis. Forward foreign exchange trades, where rates are computed on the basis of the spot rates and interest rate differentials vis-à-vis major currencies, are also conducted.

In 2004 the Bank shifted from being a net buyer to a net seller in the spot foreign exchange market. Foreign currency sales totalled Lm68.6 million and exceeded the value of purchases, which amounted to Lm56.3 million. The Bank also entered into forward contracts worth Lm36.6 million, most of which were closed before year-end. In addition the Bank opened Lm98.2 million worth of swap contracts, of which under a half were still open at the end of December.

During the year, transactions in the foreign exchange market – excluding interbank deals and deals between the Bank and credit and financial institutions – rose to Lm2.9 billion, from Lm2.4 billion in 2003. Activity in the interbank foreign exchange market also rose, reaching Lm17.3 million, from Lm13.6 million a year before.

Open market operations

The Bank engages in open market operations so that the level of liquidity in the banking system remains compatible with its monetary policy stance. As a result, throughout the year the Bank absorbed excess liquidity from the banks through fourteen-day term deposit auctions. A total of Lm2.7 billion was absorbed through such auctions, compared to Lm3.5 billion the year before. In view of the excess liquidity which continued to characterise the domestic banking system, the interest rate bids for such deposits remained unchanged at the existing floor of 2.95%, that is, 5 basis points below the central intervention rate prevailing throughout the year. However, since overall bank liquidity decreased significantly towards the end of the year, the banks reduced the balances held in term deposits with the Central Bank to Lm21 million by end-December, compared with Lm104 million at the end of the previous year (see Chart 1.4). For the third consecutive year, no reverse repo auctions were held during 2004.

Other standing facilities

To help credit institutions fine-tune their short-term liquidity management the Bank provides additional borrowing and deposit facilities. In particular, the Bank offers a marginal lending facility, which is an overnight loan facility secured by a pledge of collateral. As from 2004, new eligibility criteria were applied to this

[1] See the ‘Financial Statements’ section in this *Report* for more details.

facility, while the interest rate charged on such loans was revised upwards from 55 to 150 basis points above the central intervention rate.[2] In the course of the year, just under Lm6 million were injected into the banking system in this manner. On the other hand, to offload excess liquidity, banks placed around Lm87 million in the overnight deposit facility provided by the Bank, somewhat less than the Lm106.4 million placed in this facility in 2003. As with the marginal lending facility, the rate of remuneration on overnight deposits was revised upwards to 150 basis points below the central intervention rate, thus ensuring a symmetric treatment when the Bank is absorbing and injecting liquidity.

Reserve requirements

Credit institutions are obliged to maintain reserve deposits with the Bank, thereby ensuring greater leverage by the Bank on the money creation process in the country. In 2004 the reserve requirement ratio was left unchanged at 4% of the institutions' specified liabilities. However, to allow banks more flexibility in the way they manage their liquidity, balances in these accounts may vary, as long as the minimum requirement is met on average during the maintenance period, which runs from the fifteenth day of each month to the fourteenth day of the following month.

On 15 January 2004 the Bank announced changes to the method of determining the remuneration rate applied to reserve requirements. This was linked to the central intervention rate, at a discount of 25 basis points. Prior to this change the rate was fixed at 2.7%. At the same time, the remuneration rate on reserve deposits held by credit institutions operating in foreign currency was linked, also at a discount of 25 basis points, to the policy rate of their base currency. The Bank also amended CBM Directive No 1 with effect from 1 October 2004 providing for the possibility of credit institutions being exempted from the reserve deposit requirement under certain conditions.

Exchange controls

As from 19 April 2004, ahead of Malta's accession to the EU on 1 May, all remaining restrictions on external transactions were lifted. Some restrictions remain in effect in relation to property purchases in terms of a special derogation negotiated with the EU.[3] Restrictions also remain on contracts with life insurance companies not resident in either the EU or any other EEA country, namely Iceland, Liechtenstein and Norway. In addition, transactions in securities registered in Malta but not listed on the Malta Stock Exchange have to be cleared by the Registrar of Companies of the MFSA. This procedure, however, is not applicable in the case of international companies as defined in Article 2 of the Income Tax Act, or to companies owning a vessel registered under the Merchant Shipping Act, and where the resident participation does not exceed 20% of the equity.

The Bank continued to collect information on external transactions, since it retains responsibility for the administrative functions under the External

Table 1.1

SUPPLEMENTARY DATA ON EXTERNAL TRANSACTIONS

Lm millions

	2003	2004
Cash gifts	9.7	7.4
Portfolio investment in foreign currency	49.5	58.3
Borrowing by resident companies from overseas lenders	94.4	27.4
Borrowing by resident persons from overseas lenders	0.8	2.4
Lending by residents to overseas borrowers	3.2	8.6

[2] See "Box 1: Changes in the Monetary Policy Operational Framework used by the Central Bank of Malta", *Central Bank of Malta Quarterly Review* 37:2 (2004), pp. 20-21 for more details.

[3] Citizens of EU Member States who have not resided continuously in Malta for a minimum of five years require a permit to acquire immovable property as a secondary residence. Individuals who are not citizens of an EU Member State may not acquire any immovable property in Malta without a permit.

Transactions Act and the compilation of the related statistical information. This is used, to a large extent, to supplement data collected by the Bank and the NSO on the balance of payments. Such data are shown in Table 1.1.

As from 1 January 2005, regulations on the reporting of cash movements came into effect (through Legal Notice 531 of 2004). These oblige any person who enters or leaves the country carrying cash or monetary instruments amounting to Lm5,000 or more to declare such sum to the Comptroller of Customs. The purpose of this new reporting procedure is to harmonise border controls throughout the EU on cash movements to help combat money laundering and the financing of terrorist and/or other criminal activities.

Money and capital markets

The conduct of monetary policy depends on well-functioning money and capital markets. To this end, the Bank acts as market maker in Government securities and ensures their liquidity in the secondary market by being ready to trade in such securities on the initiative of the market. In line with the Central Bank of Malta Act, the Bank refrains from purchasing Government debt instruments in the primary market and does not provide any other form of financing to Government. The Bank, however, continues to collect and analyse data on Government debt and advises the Government on new debt issues.

The Bank publishes daily bid prices for Government stocks to indicate the price at which it has traded or is prepared to trade. Redemption yields, representing the annualisation of yields to maturity based on the methodology adopted by the International Securities Market Association (ISMA), are also quoted. This ensures that bonds paying interest annually and those paying semi-annual interest can be better compared.

In the secondary Treasury bill market, the Bank regularly quoted selling and buying rates for both retail and wholesale amounts on the basis of weighted average yields arising from weekly Treasury bill auctions. During the year, the Bank held further meetings with the Treasury and the MSE with the objective of implementing the dematerialisation of Treasury bill certificates in 2005. Meanwhile, the Financial Markets Committee, with members from the Bank and other credit institutions, met eleven times during 2004, providing a forum for the regular exchange of views and information on market-related issues. Discussions focused on the Bank's monetary policy operational framework, the payment system, the European Master Agreement (EMA), foreign exchange spreads, and preliminary issues relating to the workings of the ERM II system.

2. Financial Stability

In terms of the Central Bank of Malta Act, the Bank is responsible for ensuring the stability and soundness of the financial system. To carry out these responsibilities effectively, the Bank monitors the domestic financial system to identify any weaknesses in its structure. The Bank is also responsible for regulating domestic payment and settlement systems and ensuring their smooth operation. The Bank also contributes to the updating of domestic financial standards in line with international developments.

The Bank monitors the soundness of the financial system by drawing on data from prudential returns submitted by credit and financial institutions. This analysis, coupled with further analyses of the corporate sector in terms of leverage, profitability and liquidity, complements the monitoring of credit risk within the banking system. An assessment of the non-financial sector and market infrastructure is also conducted. In addition, stress-testing is carried out to evaluate the potential effects of specified changes in risk factors on the soundness of the banking system. Stress-testing is applied both to the credit portfolio of credit institutions and to the market risks arising from the institutions' foreign currency, interest rate, liquidity and equity price exposure. Relevant issues arising from the Bank's assessment are then discussed with the MFSA through the Standing Committee established under the Memorandum of Understanding (MoU) signed between the Bank and the MFSA in 2002.

During the year, the Bank initiated a study on the use of models for the early identification of probable defaults in the corporate sector. A quarterly survey on bank lending was also initiated to address issues relating to credit standards for loan approval as well as other factors affecting the demand for credit. The Bank is currently studying the implications for financial stability arising from the implementation of the new international framework on capital measurement and capital standards, commonly known as Basle II. This new framework has a greater focus on risk measurement and control. It encourages banks to become more sophisticated in their analysis of risk and to improve operational process controls by aligning regulatory requirements with internal risk measurement methodologies.

In the course of the year, the Bank continued to participate actively in the ESCB's Banking Supervision Committee (BSC) and its working groups, especially the Working Group on Macro-Prudential Analysis (WGMA) and the Working Group on Banking Development (WGBD). The Bank also conducted surveys of the banking system on behalf of the BSC. Furthermore, the Bank continued its work on crisis management and discussions were held with credit institutions to review their contingency plans in this regard.

On account of the Bank's joint participation with the MFSA in the EU Level 3 Committee of European Banking Supervisors (CEBS), the Bank became a member of CEBS Secretariat Ltd. The latter was established to administer the meetings of the Committee through enhanced co-operation and networking among the relevant EU regulators.

Upon Malta's accession to the EU, the Governor and the Chairman of the MFSA, together with their counterparts from the other new EU Member States, signed two MoUs, one on co-operation in crisis management, and the other on co-operation and the exchange of information in the operation of payment systems within the ESCB. At the same time, a number of EU laws and regulations having a bearing on financial stability were introduced. Among these were the regulations on European Single Passport Rights and the Freedom to Provide Services, which give credit institutions and insurance companies in any EU Member State the right to open branches or provide services in other member countries, and the Financial Conglomerates

Directive, which ensures the soundness and effective supervision of financial conglomerates across borders.

The Bank is also involved in a long-term exercise initiated by the IMF, the Co-ordinated Compilation Exercise (CCE). This follows the finalisation of the Fund's *Compilation Guide on Financial Soundness Indicators*. The main aim of the CCE is to develop countries' ability to compile Financial Soundness Indicators, which form the basis of the IMF's Financial Sector Assessment Programme.

3. Banking and Currency Operations

As banker to the Government and to the rest of the domestic banking system, the Central Bank of Malta provides a range of banking services to the public sector and to credit and financial institutions in Malta. In addition, as issuer of the domestic currency, the Bank ensures that the supply of notes and coins is sufficient to meet the needs of the public, that the currency in circulation is fit for use and that any counterfeits are quickly detected.

Banker to the public sector

The Bank maintains accounts for the Treasury, other Government departments and a number of public corporations. It also provides them with various foreign exchange services.

During the year, the number of cheques drawn on the Bank and presented for settlement by the rest of the banking system continued to fall, from 1.6 million in 2003 to 1.4 million, although their value remained largely unchanged at Lm342.5 million. As most of these cheques are issued by the Government, the decline mainly reflected the increased use of the direct credit system. The Bank also offers an encashment facility for cheques drawn on it by the Government.

The number of payments made by direct credit rose from 1 million in 2003 to 1.3 million in 2004, while their value increased from Lm287.9 million to Lm293.9 million. Payments made in respect of social security benefits registered the largest increase in value, while Government salaries, which account for over half of direct credit entries, also continued to rise. Over the past two years the number of direct credit payments has almost doubled, as salaries, social security benefits, interest on Government stocks and pension payments have increasingly been credited directly to the recipients' accounts.

The foreign exchange services provided by the Bank include the use of documentary letters of credit, inward and outward bills for collection, transfers, guarantees, and the sale and purchase of foreign exchange and travellers' cheques. The bulk of cross-border foreign exchange transactions are carried out by SWIFT transfers. In 2004 the value of foreign exchange receipts processed by the Bank on behalf of the Government and public corporations fell to Lm67 million, from Lm92.8 million in the previous year. On the other hand, foreign exchange payments rose to Lm112.8 million, from Lm90.6 million in 2003.

The Bank continued to effect payments in connection with external debt servicing by the Government. Capital payments amounted to Lm3.8 million compared with Lm4.6 million in 2003, whereas interest payments rose from Lm1.8 million in 2003 to Lm3.5 million in 2004. An additional Lm6.9 million was transferred to sinking funds earmarked for foreign debt servicing, up from Lm5.9 million in the previous year.

The Bank also manages the Foreign Pension Subsidy Scheme on behalf of the Government. The amount paid under the scheme fell to Lm10,215 in 2004 from Lm15,572 in 2003.

The Bank is also responsible for the administration and maintenance of accounts in connection with banking arrangements between Malta and Libya. Under these arrangements, the central banks of the two countries settle outstanding balances arising from bilateral trade transactions on a quarterly basis.

Banker to the banking system

As banker to the rest of the banking system the Bank provides the domestic credit institutions with deposit facilities.[1] These institutions maintain balances at the Bank to comply with statutory reserve requirements, to settle interbank transactions and to carry out daily operations in the domestic financial markets. The Bank

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

also maintains settlement accounts for the Malta Stock Exchange, enabling brokers to settle trades in listed securities.

The Bank acts as investment manager for the Depositor Compensation Scheme and the Investor Compensation Scheme[2], both of which entered into force in January 2003. Apart from this function, the Bank is also responsible for providing financial, accounting and other support services to the schemes.

The Bank also acts as custodian of assets under the Insurance Business Act of 1998, whereby certain specified assets backing funds guaranteed by insurance companies are held in the name of the Bank for the account of such companies.

Payment and securities settlement systems

The Bank plays a central role in the management of the local payment and settlement system. It is responsible for the operation of the Malta Real-Time Interbank Settlement System (MaRIS) and the associated settlement and payment finality. In this regard, the Bank has full responsibility and control over the day-to-day business operations of the settlement accounts. The system processed 48,066 interbank payments with a total value of Lm12.9 billion during 2004. Compared with 2003 this represented an increase of 29% in volume but a drop of 11% in value, reflecting growth in low value transactions such as those related to internet banking.

On 1 January the International Bank Account Number (IBAN) was introduced, after preparations for its introduction were finalised in 2003. The IBAN is a set standard for bank account numbers that uniquely identifies a customer's bank account held at a bank anywhere in the world.

Following consultations with credit institutions the Bank formulated its payment systems oversight policy document, which outlines the principles and provides the guidelines on the basis of which the Bank will conduct payment systems oversight. The Bank also discussed proposals for a new securities settlement system that would start operating on a delivery versus payment basis.

The Bank is responsible for the management of the Malta Clearing House, through which most cheques issued in Malta are settled. Whereas the number of cheques cleared fell slightly, from 6.7 million in 2003 to 6.6 million in 2004, their value rose by Lm0.1 billion to Lm2.7 billion. The daily average number and value of cheques processed during the year amounted to 26,395 and Lm10.7 million, respectively.

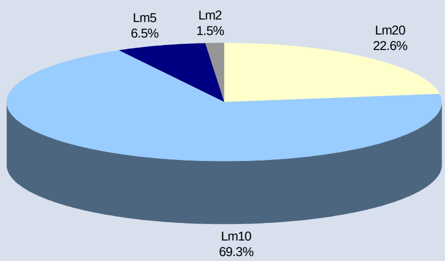
Currency operations

Circulation of banknotes and coins

The stock of currency notes and coins issued and outstanding at the end of 2004 stood at Lm506.4 million, up by 4.3% from the end-2003 level (see Table 3.1). As in 2003, the share of notes and coins in broad money continued to edge higher, rising to 17.4% from 17%, after having declined steadily during the previous twenty years. It appears that over the past two years the demand for cash has been sustained by the relatively low level of interest rates, which reduces the opportunity cost of holding non-interest bearing assets.

Movements in the amount of currency in issue continued to follow the usual seasonal pattern. Currency in issue fell by Lm8.4 million in January, as credit institutions disposed of excess holdings

Chart 3.1
COMPOSITION OF CURRENCY NOTES ISSUED AND OUTSTANDING AS AT END-2004



[2] The Depositor Compensation Scheme was set up to compensate depositors in the event of a bank failure. The Investor Compensation Scheme protects clients of licensed investment services providers that go out of business.

Table 3.1

CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE BANK IN 2004

Lm thousands

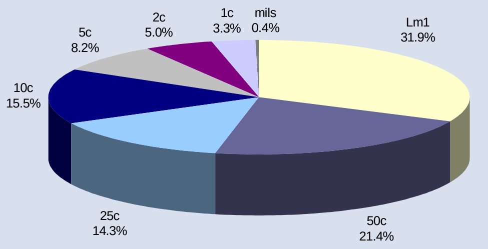
	Notes and coins			Issued and
	Issued	Paid-in	Net issue	outstanding[1]
January	20,260	28,621	-8,361	477,012
February	25,039	21,453	3,586	480,198
March	30,066	24,658	5,408	486,006
April	29,901	24,677	5,224	491,231
May	30,753	28,366	2,387	493,618
June	35,800	27,076	8,724	502,342
July	29,091	29,625	-534	501,807
August	27,796	25,727	2,069	503,877
September	25,795	25,885	-90	503,787
October	27,591	27,609	-18	503,769
November	26,090	29,222	-3,132	500,637
December	33,834	28,066	5,768	506,405
2004	**342,016**	**320,985**	**21,031**	**506,405**
2003	246,973	222,848	24,125	485,373

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

accumulated during the festive season. Currency holdings were then rebuilt in the following five months, with June registering the largest increase of the year. Currency in issue remained high during the summer, which coincides with the peak tourist season. It then fell in November, but recovered in December, fuelled by the normal pick-up in the demand for cash during the festive period.

At the end of December the value of notes in issue stood at Lm487.2 million, an increase of Lm20.1 million, or 4.3%, from the previous year's level. The Lm10 note accounted for 69.3% of the total value of notes in issue at the end of the year, up from 68.4% a year earlier (see Chart 3.1). By contrast, while the amount of Lm20 notes in circulation increased, their share in the total declined further, by 0.9 percentage points to 22.6%. The share of the remaining denominations was stable.

Chart 3.2
COMPOSITION OF COINS ISSUED AND OUTSTANDING AS AT END-2004



The value of the outstanding stock of coins rose by Lm1 million, or 5.3%, to Lm19.2 million during the year under review. While this mainly reflected increased demand for higher-value coins, there was a general rise in demand for all denominations. The shares of the various denominations in the total thus remained broadly unchanged, with the Lm1 coin still recording the highest share by value, followed by the 50c coin (see Chart 3.2).

On 17 June, the 25c and 50c coins of the 1st series were withdrawn from circulation and ceased to be exchangeable at the Bank. No new note or coin issues were made during the year.

Commemorative coins

On 27 April the Bank issued a gold coin to commemorate Malta's accession to the European Union on 1 May 2004. The coin was designed by Marc Spiteri, the winner of the national competition launched by the Bank for the selection of the theme. Noel Galea Bason modelled the emblem of Malta. The emblem and the year of issue are shown on the obverse of the coin, while the reverse shows the Maltese and European Union flags merged within the circle of twelve stars that symbolises the European Union. The fusion of the flags is a figurative representation of Malta's accession to the European Union. This gold proof coin, which is legal tender in Malta for the value of Lm25, was struck at the Royal Mint in the UK. It weighs 3.994g, with a finesse of 916.7 and a diameter of 19.3mm.

On 20 October the Bank issued the fourth commemorative coin in the Distinguished Maltese Personalities Series. The coin commemorates the painter Giuseppe Calì, who lived between 1846 and 1930. The emblem of Malta and the year of issue appear on the obverse of the coin, while the reverse shows a likeness of Giuseppe Calì. The coin was designed by the Maltese artist Noel Galea Bason. The silver proof coin, which is legal tender in Malta for the value of Lm5, was struck at the Royal Mint. It weighs 28.28g, with a finesse of 0.925 and a diameter of 38.61mm.

Anti-counterfeit measures

The Bank continued to examine cases of counterfeit currency throughout 2004, analysing local and foreign banknotes suspected to be counterfeit. In this matter, the Bank worked closely with the ECB during the year and, following the entry into force of amendments to the Central Bank of Malta Act in May, it undertook the function of a National Counterfeit Centre with the duty of co-ordinating counterfeit deterrence in Malta. The Bank was also designated a National Analysis Centre and Coin National Analysis Centre, thus assuming sole responsibility for the analysis of counterfeit currency notes and coins in Malta.

In November the Bank and the Police Corps signed a Memorandum of Understanding establishing a framework for co-operation between the two parties. This provides for the regular exchange of information between the two organisations and the compilation of a national database on counterfeit currency.

4. Internal Management

Administration

The Board of Directors

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

At the beginning of January 2005, the Board of Directors was composed of Michael C. Bonello, Governor and Chairman, David A. Pullicino, Deputy Governor, and Joseph V. Gatt, Philomena Meli and Charles J. Falzon as non-executive Directors. Charles J. Falzon was appointed as Director for a period of five years with effect from 7 February 2004. Bernadette Muscat served as Secretary to the Board. Over the year, the Board held eleven meetings.

Management

The Executive Management Committee is the body responsible for advising the Governors on matters related to the Bank's internal management and administration. The Committee is composed of the Governor (as Chairman), the Deputy Governor, and the five Directors responsible for the five divisions of the Bank. The Committee held 49 meetings during the year.

During 2004 further changes were made to the Bank's structure and internal organisation. The designation of the Deputy General Manager grade was changed to that of Director of Division. This was done to better reflect the function of the role, which is more closely related to directing policy within each division. The Directors continued to be responsible for their existing divisions, with the Senior Managers being responsible for the management of individual departments or particular functions within each division. The names of a number of offices and departments were also changed to reflect more clearly the tasks and operations they performed. Thus, the Economics Division was renamed the Economics and External Relations Division; the Balance of Payments Office was renamed the External Transactions Data Office; the Correspondent Banking Office was renamed the Middle Office; the former Middle Office was renamed the Foreign Exchange Market Analysis Office; and the Open Market Operations Office was renamed the Monetary Operations Office. Furthermore, within the structure of the Information Systems Department, an office was established with overall responsibility for software development.

With Malta's accession to the EU on 1 May 2004, the Central Bank of Malta became part of the ESCB. The ESCB is made up of the ECB together with the national central banks of all the EU Member States.

The status of the Bank's officials sitting on the various ESCB committees, working groups and task forces was upgraded from that of observer to that of full member. By the end of 2004 officials from the Bank sat on 47 such committees, working groups and task forces. As part of its new commitments, the Central Bank of Malta also began hosting ESCB meetings. Thus, in September the Bank hosted two ESCB working group meetings, one held by the Counterfeit Working Group and the other by the Working Group on Developments in Banking.

Over the year, the ESCB Briefing Committee continued to co-ordinate ESCB-related work. The Committee, which is chaired by the Governor and includes observers who represent the Bank on the twelve committees of the ESCB, meets approximately once every two weeks. A senior executive was assigned the responsibility for preparing a report on practical issues relating to Malta's eventual adoption of the euro.

Governors' official activities in Malta

During the year the Governor was invited to address various events organised by constituted bodies and professional organisations on economic and financial issues. He also gave a number of interviews to the local press.

The Governor continued to participate in meetings of the Malta Council for Economic and Social Development (MCESD), where in May he also gave a presentation on competitiveness and growth. The Governor is also a member of the Board of Governors of the MFSA.

Governor's official activities overseas

The Governor continued to attend meetings of the General Council of the ECB, which were held on four occasions during the year. For the June meeting, the first following accession, the Governor was accompanied by the Deputy Governor.

In April the Governor accompanied the Minister of Finance to an informal ECOFIN meeting, which was held in Dublin, while in June he took part in a symposium organised by the Bank of England and the Annual General Meeting of the BIS. In September the Governor accompanied the Parliamentary Secretary at the Ministry of Finance to the informal ECOFIN meeting held in The Hague and to the Annual Meetings of the IMF and World Bank held in Washington DC.

In January the Governor took part in the first Eurosystem Seminar organised jointly by the ECB and the Banca d'Italia which was held in Naples, where he chaired a panel discussion on Exchange Rate Regimes and Policies in the Mediterranean Countries. In February he also participated as a panellist in a conference on the challenges for central banks in an enlarged EMU organised jointly by the European Community Studies Association, the Research Institute for European Affairs and the Oesterreichische Nationalbank in Vienna. In March the Governor attended a high level seminar on the accession process organised jointly by the ECB and the Banque de France, and in November he delivered a presentation on the Maltese economy at a seminar organised by the Embassy of Malta in The Hague.

The Governor also gave various interviews to the foreign press.

Economic analysis and research

As part of the monetary policy process, Bank staff carry out an on-going analysis of economic and financial developments in Malta and abroad. The Bank publishes its analysis in its *Quarterly Review* and *Annual Report*. During 2004, among other issues, Bank staff studied some of the implications of the adoption of the European System of Accounts for the compilation of Malta's national accounts. The Bank also prepared reports and forecasts on the Maltese economy at the request of the ECB and the EU Commission.

During the year under review, the Bank began to provide forecasts of the main macroeconomic variables for the Maltese economy by means of a new econometric model that uses quarterly data. In the second half of the year, the forecasts for National Accounts data were adjusted to comply with ESA 95 standards. The Bank also prepared independent forecasts of key fiscal variables for Malta as part of the work carried out in this area by the ESCB.

Meanwhile, research projects focused on the estimation of the equilibrium exchange rate for Malta and on the strategy for Malta's participation in EMU and the eventual adoption of the euro.

Statistics

To fulfil its obligations at both the national and the international level, the Bank continued to compile, disseminate and publish a wide variety of economic and financial statistics. To this end, it continued to co-operate closely with other local agencies involved in the collection of statistics, particularly the NSO and the MFSA. The Technical Committee on Financial Statistics, which includes representatives from the MFSA, the NSO, the Malta Bankers Association, the Malta Stock Exchange and the credit and financial institutions, continued to meet regularly during the year to co-ordinate the transition to new reporting systems.

The Bank regularly provided the IMF with data for use in its surveillance of its members' economic policies and continued to meet the requirements set by the Fund's General Data Dissemination System (GDDS).

The Bank continued to provide economic and financial statistics to the ECB and to Eurostat, the

EU's statistical agency. Furthermore, Bank officials regularly participated in EU and ESCB statistics committees and working groups.

The Bank also contributed updated statistical information on bond markets and the balance of payments to the ECB's publications.

In line with its new obligations arising out of EU membership and Malta's eventual participation in the euro area, the Bank continued the process of harmonising its monetary statistics with EU and ECB regulations and guidelines. Accordingly, the Bank started discussions with the reporting agents on the submission of flow statistics for the monetary aggregates and their counterparts, which is expected to begin to take place early in 2005.

In the course of the year, the Bank also continued to introduce new information management systems so as to improve the efficiency, security and quality of data exchanges within the ESCB.

For the purposes of compiling monthly balance of payments (BOP) statistics and the quarterly international investment position (IIP) in line with ECB Guideline ECB/2004/15, the Bank, in conjunction with the NSO, launched a new direct reporting data collection system. Work on the international reserves template, drawn up in line with this Guideline, was finalised, while the development of the IT infrastructure for the BOP/IIP system is expected to be implemented early in 2005. A new set of report forms was designed for surveying collective investment schemes and firms that provide investment services.

The Bank, in conjunction with the NSO and the Ministry of Finance, continued to participate in the *ad hoc* Action Group on Government Finance Statistics (GFS) which was set up to improve standards in the compilation of Government deficit and debt levels for the Excessive Deficit Procedure notification that is submitted to Eurostat twice yearly.

The Bank continued to submit statistics on the external debt of the Government and non-financial public sector corporations to the World Bank and to international credit rating agencies.

Human resources

At the end of 2004 the Bank's full-time staff complement stood at 300, with a further sixteen employees engaged on a part-time basis. During the year, the Bank recruited a Trainee Economics Officer and two General and Financial Auditors. Three employees resigned from the Bank while five other staff members opted for voluntary severance. One employee in the non-clerical category retired on medical grounds.

As in previous years the Bank offered temporary employment to a number of university students during the summer months. The Employee Assistance Programme launched with the help of Caritas Malta in 1999 was again renewed during 2004.

Human resource audit

The organisational and human resource audit begun in 2003 was continued in 2004. A Human Resource Fitting Process, designed to assess whether current staff members could fit the job profiles required by new structures and to identify possible vacancies, was concluded in April. This was followed by the drawing up of new job descriptions and the subsequent issue of internal calls for applications to fill resulting vacancies in the Bank's various Divisions.

Training and development

As in previous years, the Bank provided training opportunities to its staff both through in-house programmes and through external courses organised by local and foreign institutions (see Table 4.1).

In 2004 the Bank maintained its arrangement with the Faculty of Economics, Management and Accountancy of the University of Malta concerning the one-year transition course designed to upgrade the skills of suitably qualified employees to enable them to join a post-graduate course leading to qualification at Masters level in Economics. One employee successfully completed this programme during the year.

As indicated in the Table, a large number of staff attended seminars and courses organised by local institutions. The topics covered included IT-related

Table 4.1

STAFF TRAINING

Type of Training	No. of courses	No. of participants
Overseas courses	37	41
In-house courses	10	330
Local external courses	55	184

matters, management, accounting and auditing, risk management, economic and financial matters, records management, legal matters, industrial relations, health and safety, human resource management, currency and security issues, the EU and economic developments.

Courses organised by foreign institutions covered various areas, including financial, economic and fiscal policy issues; information technology security and audit; risk management; counterfeit monitoring systems; financial reporting; government debt management; statistics; business continuity planning and strategy; and the functioning of the ESCB.

Themes covered by the Bank's in-house training courses included management and supervisory development, information technology, induction courses, health and safety and other specific job-related programmes.

Early in the year, the Bank launched a new Performance Management System (PMS). A half-day seminar was organised during which staff discussed the benefits and functions of the system, while a Coaching and Feedback Skills Workshop for office managers was also held.

Academic and professional courses

During the year under review, the Board of Directors approved a development scheme to encourage staff to pursue post-graduate courses at leading foreign universities in areas of interest to the Bank. The scheme consists of a scholarship to support one employee per year. In 2004, an economist from the Bank's Economic Analysis Office was selected under the terms of the scheme to read for a Masters degree in Economics at the University College, London.

An increasing number of employees availed themselves of the Bank's self-development study scheme, and by the end of the year fifty employees were benefiting from the scheme. During 2004, fifteen new study loans were approved under this scheme.

During the year seven staff members successfully completed post-graduate studies. Another four employees graduated in Financial Services and Computer Studies with foreign educational institutions. Six other employees completed their studies in other related diploma or certificate courses held locally and organised on behalf of foreign universities.

During the year, several employees were pursuing various qualifications related to the Bank's core functions. By the end of the year, fifty employees were following an approved course of study on a part-time basis. Twenty employees were following post-graduate courses, twenty-six were following first degree programmes, while another four were following a diploma course. The Bank also sponsored two information technology students under a Traineeship Scheme administered jointly with the Swatar Training Centre.

Table 4.2

ACADEMIC AND PROFESSIONAL COURSES

Type of programme	No. of employees who successfully completed programmes during 2004	No. of employees pursuing programmes
Postgraduate courses	7	19
Honours first degree courses	4	26
Post-graduate diploma	0	1
Diploma courses	3	4
Transition course to MA Economics	1	0

Gender equality and discrimination

The Bank continued to give due importance to gender equality. In the latter part of 2004, the Bank set up a working group on the promotion of equality to deal with such issues.

In respect of employment levels, female staff members constituted 36.7% of the Bank's full-time staff complement at the end of the year. Female staff members make up 16.9% of the executive grade. These proportions were relatively unchanged compared to 2003.

More than 45% of staff members currently involved in self-development programmes on a part-time basis are female. Moreover, during 2004 participation by females in the Bank's training programmes was as follows: 28.3% in internal courses, 35.7% in local external courses, and 26.3% in courses overseas.

Health and safety

During the year, the Bank, with the help of an external expert, carried out a health and safety risk assessment to ensure compliance with the Occupational Health and Safety Act.

Premises

During the year under review the Bank's Boardroom was refurbished and its communication systems infrastructure upgraded.

Information technology

The Bank's core accounting system, Flexcube, was upgraded and modified during the second half of the year. The Bank also introduced a new time and attendance module, which was linked to the personnel system. This replaced the manual recording of attendance with data from electronic palm readers. In addition, the SWIFT communication platform was upgraded to SWIFTNet.

The Bank also installed all the necessary equipment to link to the ESCB's network, known as CoreNet. By the end of the year CebaMail, Counterfeit Monitoring and the Teleconferencing systems were running on this network.

Risk management and audit

During 2004 the Bank reviewed its internal policies and procedures to ensure that operational procedures and controls are kept updated to reflect changes in business processes.

The Bank pursued its efforts in evaluating several high-risk business processes, identifying and assessing specific risks and the corresponding controls. The results derived for various offices now form part of the Bank's Risk Matrix. In terms of the Bank's Business Continuity Plan, several tests were undertaken to ensure that critical business processes remained operative under adverse conditions. The Bank formulated and approved an Information Security Standard, setting out an information security framework, which will be based on ISO 17799.

The Bank's Audit Committee met seven times during 2004. The Committee discussed the effectiveness of internal controls and risk management through the assurance reports and opinions formed by the Bank's internal auditors. The Committee also discussed the Bank's financial statements and its role in strengthening the objectivity and credibility of financial reporting with the Bank's external auditors.

In June 2004 the Internal Audit Charter was amended mainly to reflect the new obligations on the Bank's internal audit functions relating to the ESCB and to fully adopt the International Standards for the Professional Practice of Internal Auditing and the Code of Ethics of the Institute of Internal Auditors (IIA). A new Audit Manual was also developed.

During the year, in its assurance role, the Bank's Audit Office conducted several risk based audits to provide the necessary assurances to the Bank's senior management, the Audit Committee and the Board of Directors, in terms of the adequacy of risk management and the overall control framework. The Bank's Audit Office also initiated audits on behalf of the Internal Auditors Committee (IAC) of the ESCB.

Legal issues

Amendments to the Central Bank of Malta Act (Cap.

204) came into force on 1 May 2004. These were mainly concerned with the establishment of the Currency Surveillance Unit and the implementation of a Council Regulation that lays down measures necessary for the protection of the euro currency against counterfeiting. To provide for an increase in maximum penalties, Legal Notice 75 of 2003 on penalties for offences and infringements was also amended.

The Bank amended CBM Directive No 1 so as to enable it, under certain conditions, to grant exemptions to credit institutions from the requirement of maintaining reserve deposits on a non-discriminatory basis. On 19 November 2004, in order to safeguard the Bank's independence, the Public Contracts Regulations 2003 were amended so as to exclude the Bank from the scope of such Regulations.

A Working Group composed of officials from the Bank and the MFSA proposed amendments to the Financial Collateral Arrangements Regulations 2004. As a result, the scope of these Regulations was extended to cover providers of collateral licensed in any jurisdiction.

Information and public relations

The Bank continued to communicate information and to maintain relations with the public and local and international institutions, both through its publications and through its website. At the same time, the Bank continued to build up its capacity to translate ECB documents into Maltese through the appointment of external freelance translators and through the development of a financial terminology database.

Publications

During the year the Bank continued to inform the public on various issues relating to its functions and operations through regular press releases. The Bank also continued to publish its *Quarterly Review* which, in addition to *the Annual Report*, gives a detailed analysis of economic and financial developments in Malta and abroad. The Bank also published a weekly money market report and a monthly release of monetary statistics.

The Library

The Bank's library is an important source of information in the fields of economics, banking and finance. Primarily it serves the needs of the Bank's own staff, but it also meets requests for information by other public and private sector bodies and the general public, particularly students involved in research work on economic and financial matters.

In the course of the year, new books, periodicals and specialised publications related to the Bank's functions and operations were added to the Bank's collection. The Bank's library also continued to receive and store publications issued by international organisations, such as the IMF, the World Bank Group and the EBRD.

Cultural and educational activities

As in previous years, the Bank organised a number of cultural and philanthropic activities. It also organised regular educational visits for secondary and post-secondary school students who were briefed on the role and functions of the Bank and given the opportunity to view the Bank's numismatic exhibition at its premises.

5. Relations with International Institutions

In 2004 the Central Bank of Malta continued to develop its relations with international and regional financial institutions, such as the IMF, the World Bank Group, the EBRD and the ECB. Following Malta's accession to the EU on 1 May, the Bank's relationship with the ECB and the other national central banks participating in the ESCB was strengthened further. Thus, the status of the Bank's representatives on the ESCB's decision-making bodies and committees changed from that of observer to that of full member when these meet in ESCB composition, and the Governor began to attend meetings of the General Council of the ECB as a full member.

Following EU membership, the Bank monitored EU legislative developments affecting the financial sector. It co-operated with the Ministry of Finance and the MFSA to ensure the effective implementation of such legislation. It also started to notify the ECB and other EU institutions of measures implementing new EU Directives and Regulations within the remit of the Bank, as required of all EU Member States.

Meanwhile, the Governor continued to fulfil the role of Governor for Malta at the IMF, assisted by the Deputy Governor who was Alternate Governor. The Governor is also Alternate Governor for Malta at the EBRD.

The Bank continued to follow closely the initiatives endorsed by the Bank for International Settlements (BIS) in the field of financial stability. In addition, during 2004 the Bank monitored discussions on proposals for the introduction of new standards in the field of corporate governance and international financial reporting and accounting standards, particularly those relating to International Accounting Standard 39 (IAS 39) dealing with the valuation of financial instruments.

The Bank also continued to collaborate with the Ministry of Finance on matters related to Malta's membership of the International Bank for Reconstruction and Development (IBRD) and the Multilateral Investment Guarantee Agency (MIGA), both affiliates of the World Bank Group.

International Monetary Fund

As the institution representing Malta at the IMF, the Bank, in consultation with the Minister of Finance, voted on a number of resolutions proposed by the Executive Board of the Fund in the course of the year.

The Bank also co-operated with the Fund in matters related to the latter's operational budget, although it was not requested to effect any payments in this regard during 2004. As a result, the Fund's holdings of Maltese currency and Malta's reserve position in the Fund remained unchanged from the levels reported at the end of 2003, at SDR61.7 million (around Lm30.5 million) and SDR40.3 million (around Lm19.9 million), respectively.

On the other hand, the Bank effected a number of transactions through the Fund's SDR Department during the year. These resulted in net receipts of SDR0.9 million. As a result, Malta's total SDR holdings reached SDR30.8 million by the end of the year, from SDR29.8 million at the end of 2003.

In May an IMF Interim Article IV Mission visited Malta to discuss the latest economic developments and Malta's intent with respect to participation in the EU's Exchange Rate Mechanism (ERM II) and the eventual adoption of the euro. This Mission was a follow-up to the Article IV Consultation Mission that visited Malta in 2003. In November the Deputy Managing Director of the IMF, Mr Agustín Carstens, visited Malta to gain a deeper understanding of the structure and orientation of the Maltese economy. Discussions were held with the Prime Minister and Minister of Finance, the Governor and other Bank officials. Mr Carstens was accompanied by Mr Pier-Carlo Padoan, the Executive Director for Italy who also represents Malta on the Fund's Executive Board.

As in previous years the Bank continued to submit data regularly to the Fund in line with the requirements of the General Data Dissemination System (GDDS). Meanwhile, the Bank continued with its preparations for eventual participation in the Special Data Dissemination Standard (SDDS). In December, Bank officials participated in a conference on the methodology used by the IMF and the ECB for compiling financial stability indicators. This was part of on-going efforts by the IMF and the ECB to bridge the gap between the methodologies used by the two institutions in the compilation of such indicators.

World Bank Group

The Bank continued to monitor relevant developments at the World Bank and its affiliates. As in past years it co-operated with the Ministry of Finance on a number of resolutions proposed by the Executive Board of the IBRD and MIGA on which the Ministry was requested to vote.

The Bank also contributed to a *World Bank Questionnaire on Access to Financial Services*, through which the IBRD sought to assess the state of development of financial sectors in member countries.

European Bank for Reconstruction and Development

During 2004 the Bank continued to collaborate with the Ministry of Finance on issues related to Malta's membership of the EBRD. The Bank advised the Ministry on a number of resolutions proposed by the Board of Directors of the EBRD that required the approval of member countries. The Bank also worked with the Ministry in reviewing selected projects proposed by the EBRD.

In February Mr Michael Neumayr, the Executive Director for Austria who also represents Malta on the EBRD's Executive Board, paid a courtesy visit to Malta. He met the Minister of Finance and officials of the Bank, the Ministry of Finance and Malta Enterprise. Mr Neumayr and an expert from the EBRD also participated in an information seminar held in Malta in June to promote the EBRD's Trade Facilitation Programme. The seminar was jointly organised by the EBRD and Malta Enterprise.

In April the Bank effected the eighth annual payment of Malta's contribution to the general capital increase of the EBRD on behalf of the Government. This general capital increase was approved at the Annual Meeting of the Board of Governors in 1996.

European Union

The Bank continued to monitor legislative developments of relevance to the financial sector within the EU. These covered, in particular, the statistical field and measures to combat the financing of terrorism and money laundering. The Bank also closely followed initiatives under the EU's Financial Services Action Plan (FSAP).

Following membership in May, senior officials from the Bank and the Ministry of Finance attended as members meetings of the Economic and Financial Committee (EFC) and its sub-committees. In 2004 the Governor of the Bank also attended one meeting of the ECOFIN Council of Ministers.

In 2004 the Bank collaborated with the Ministry of Finance in the preparation of Malta's Convergence Programme, which was presented to the European Commission in May. An update of the Programme was then submitted in December.

Meanwhile, the Bank continued to monitor on-going assessment procedures initiated by the European Commission and the ECOFIN Council with respect to excessive deficits and the Convergence and Stability Programmes submitted by Member States, particularly those pertaining to Malta. The Bank also monitored the outcome of the assessments by the European Commission and the ECB of the state of preparedness of the new Member States for the adoption of the euro.

As in past years, Bank staff continued to attend seminars and conferences organised by the European Commission. These included seminars on the compilation of economic and financial statistics, communication aspects of the changeover to the euro, cash-handling procedures and the detection of counterfeit currency. With respect to the latter, the Bank started to attend meetings of the Counterfeit Coin Experts Group (CCEG) of the European Anti-Fraud Office of the Commission (OLAF).

European System of Central Banks

Upon EU accession, the Central Bank of Malta became a member of the ESCB, which is composed of the ECB and the national central banks (NCBs) of the 25 EU Member States. As a participant in the System's capital, the Central Bank of Malta paid EUR252,023.87 to the ECB, that is, 7% of its share in the subscribed capital of the ECB.

As with other EU forums, the status of the Governor on the General Council and of the Bank's experts on the ESCB committees and task forces was upgraded from observer to member with immediate effect. Through their regular attendance at these meetings, the Bank's experts contributed to the preparation of various reports that were discussed by the Governing and General Councils of the ECB.

During the year the Bank also signed an Agreement amending the ERM II Agreement of 1 September 1998. This lays down the operating procedures for an exchange rate mechanism in stage three of EMU.

During the year, an expert from the ECB visited the Bank to advise on the legal framework applicable to monetary operations and reserve management. The Bank also benefited from technical assistance from the Banca d' Italia on the preparation of fiscal forecasts in line with ESCB requirements.

Progress was made with the further adaptation of the organisational structure and practices of the Bank with a view to facilitating the integration of its systems with those of the ESCB. In particular, further upgrades were made to the infrastructure and procedures governing payments and securities settlement, the statistical reporting system and the Bank's telecommunications facilities. Tests were also conducted to assess the Bank's capacity to respect ESCB standards in the field of foreign exchange intervention, data transmission, the execution of payment orders and teleconferencing.

In the course of the year, the Governor and other officials of the Bank delivered a series of presentations to the media and to representatives of Government and the financial sector on the functioning of ERM II and other aspects of EMU. The Bank also advised the Government on matters related to Malta's eventual adoption of the euro and contributed to the drafting of a document setting out Malta's strategy in this regard. During the year, the Bank appointed a Euro Project Co-ordinator to represent it on national and international euro-related committees and to liaise with the constituted bodies, the general public and other interested parties on practical aspects related to the adoption of the euro. In mid-year, senior Bank officials were involved in discussions with representatives of the European Commission and the ECB on Malta's preparedness for future entry into ERM II and the euro area.

Other

Over the course of the year, the Bank continued to strengthen its relationship with non-EU central banks and specialised institutions that carry out activities relevant to the financial sector. As in past years, it participated in events sponsored by international commercial organisations, including some of the largest international financial intermediaries and specialised institutions that service the industry. In October, the Bank hosted a workshop on Central Bank Governance for officials from Bank Indonesia.

The Bank also participated in a number of seminars and conferences on the prevention and detection of money laundering and the financing of terrorism. These were organised by the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (PC-R-EV) and the Committee of Experts on the Revision of the Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime (PC-RM).

ECONOMIC & FINANCIAL POLICY CALENDAR 2004

This calendar lists relevant policy measures in the monetary, fiscal and exchange rate fields that came into effect during the year

15 January: ***Monetary policy operational framework***

The Bank effects changes in its monetary policy operational framework. The overnight deposit rate is set at 150 basis points below the central intervention rate (CIR), while the marginal lending rate is set at 150 basis points above the CIR. The remuneration rate on reserve deposits held with the Bank is linked to the CIR at a discount of 25 basis points, while that on reserve deposits held by credit institutions operating in foreign currency is linked at a discount of 25 basis points to the policy rate of the particular foreign currency.

17 January: ***Repeal of gold control regulations***

The Gold (Control) Regulations 1996 are repealed through LN 38 in terms of the Supplies and Services Act (Cap. 117). These regulations empowered the Commissioner of Inland Revenue to approve and monitor the importation into Malta of gold bullion by licensed dealers or artificers and required dealers to keep records relating to the use of imported gold.

20 February: ***Regulations on European passport rights for credit institutions***

Regulations bringing into effect a notification procedure which credit institutions must follow in order to establish a branch or provide services in another EU Member State, are issued through LN 88 in terms of the Banking Act (Cap. 371).

19 April: ***Removal of restrictions and obligations on external transactions***

All restrictions and obligations published through LN 427 of 2003 are removed by the Minister of Finance through LN 382 of 2004 in terms of the External Transactions Act (Cap. 233). Some exceptions are to remain in force with respect to transactions with residents of third countries, that is, non-EEA countries (EEA countries include all Member States of the EU and Iceland, Liechtenstein and Norway), related to contracts with non-resident life insurance companies and the issue, acquisition, sale and redemption of securities not listed on the Malta Stock Exchange and registered in Malta.

30 April: ***Regulations on the winding up procedure for credit institutions***

Regulations on the procedure to be followed when a credit institution with branches in other Member States is wound up, are issued through LN 228 in terms of the Banking Act (Cap. 371). In such cases, the winding-up process is subject to a single bankruptcy proceeding initiated in the Member State where the credit institution has its registered office (home state) and is governed by a single bankruptcy law, that of the home state.

1 May: ***Central Bank of Malta joins the ESCB***

Upon Malta's accession to the EU, the Central Bank of Malta becomes a member of the ESCB. The ESCB is made up of the ECB and the national central banks of all EU Member States. The central banks of Member States outside the euro area are required to pay a minimal percentage of their subscribed capital as a contribution to the operational costs of the ECB. Upon attaining membership of the ESCB, the Central Bank of Malta paid EUR252,023.87, which amounts to 7% of its share in the subscribed capital of the ECB. The shares of national central banks in the ECB's capital are compiled on the basis of the shares of the respective Member States in the total population and the gross domestic product of the EU, with weightings adjusted every five years. The share of the Central Bank of Malta is 0.064%.

1 May: ***Malta joins the European Investment Bank (EIB)***

Upon accession to the EU, Malta, represented by the Minister of Finance, becomes a member of the Board of Governors of the EIB. The EIB is the main financing institution of the EU. All 25 Member States contribute to the EIB's subscribed capital, which amounts to EUR163.6 billion. Malta's capital subscription in the EIB will amount to EUR69,804,000, representing 0.043% of the EIB's capital. In terms of Article (5) of the EIB statute, Malta's paid up contribution to the capital of the EIB will be EUR3,692,450, to be paid in eight instalments.

21 May: ***Malta's Convergence Programme 2004-2007***

The Government of Malta submits its first Convergence Programme to the EU, covering the period 2004-2007. This programme, compiled by the Ministry of Finance, sets out Malta's fiscal policy objectives within a macroeconomic policy framework. It aims to reduce the fiscal deficit to below 3% by 2006, and the general government debt-to-GDP ratio to 70.4% by 2007.

11 June: ***Regulations on administrative penalties***

These regulations, issued through LN 330 in terms of the Central Bank of Malta Act (Cap. 204), list amendments to the administrative penalties which may be imposed by the Central Bank of Malta without recourse to a court hearing.

5 July: ***ECOFIN Decision on Malta's Convergence Programme 2004-2007***

The EU Council issues an Opinion and Decision on Malta's Convergence Programme. It observes that the macro-economic scenario underlying the Programme appears to reflect plausible growth assumptions. However the Council notes that this scenario is subject to a certain degree of uncertainty given a possible over-estimation of the nominal ESA 95 GDP and the exposure to external shocks of the Maltese economy. In concluding its Opinion, the Council decides that on the basis of Recommendations from the European Commission, an excessive fiscal deficit exists in Malta (under Article 104(6) of the Treaty). It therefore makes Recommendations to Malta (under Article 104(7)) with a view to bringing this situation to an end.

20 July: ***Regulations on the admission of securities to the official stock exchange listing***

These regulations, issued through LN 364 in terms of the Financial Markets Act (Cap. 345), implement the relevant provisions of Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001, on the admission of securities to the official stock exchange listing and on information to be published on those securities.

24 August: ***Amendment of financial collateral arrangements***

The Financial Collateral Agreements Regulations 2004 issued through LN 177, which implemented the provisions of Directive 2002/47/EC on financial collateral agreements, are amended through LN388 in terms of the Set-off and Netting on Insolvency Act (Cap. 459).

1 September: ***Amendment of banking and financial institutions' Directives***

The MFSA, as the Competent Authority in terms of Article 4(2) of the Banking Act 1994 and Article 13(2) of the Financial Institutions Act 1994, amends Directives BD/01, BD/02, BD/04, BD/05, BD/07, BD/09, BD/10 and FID/01.

5 October: ***Privatisation of Malta Freeport***

The Government signs an agreement with the CMA-CGM Group, granting it a thirty-year concession to operate and develop the Malta Freeport. As a result of the agreement the Government sells all its shares in Malta Freeport

Terminals Ltd and leases the port facilities while granting a license for the operation of the port. For the duration of the lease the Government will remain the owner of the site of the port facilities.

9 November: ***Regulations on the reporting of cash movements***

Regulations are issued obliging any person entering or leaving Malta and carrying a sum equivalent to Lm5,000 or more to declare that sum to the Comptroller of Customs. A record of declarations made under these regulations will be maintained by the Central Bank of Malta. These regulations came into effect on 1 January 2005, through LN 463 in terms of the External Transactions Act (Cap. 233).

23 November: ***Trust (Amendments) Act (Act XIII of 2004)***

Parliament enacts the Trusts (Amendment) Act 2004 (Act XIII of 2004). Among other things, the Act deletes, amends and substitutes a number of Articles of the principal Trusts Act (Cap. 331). These amendments, which make it possible for Maltese residents to set up a trust under Maltese law, seek to eliminate the risk of harmful tax practices and will gradually eliminate nominee companies, as requested by the OECD and the Financial Action Task Force (FATF). Parts II, III, VI, VIII, XVII and XIX of this Act came into force on 1 January 2005.

24 November: ***Measures introduced in the Budget 2005***

The Minister of Finance presents the Budget Estimates for the year 2005 to Parliament. Major measures announced include:

Cost of living increase

- A weekly wage increase of Lm1.75 to compensate for the cost of living increase during the year to September 2004.

Indirect taxation and increases in administered prices

- A fuel surcharge on water and electricity bills, varying from 9 to 15.6%, depending on actual consumption, to come into effect on 1 January 2005.
- Increases in excise duties of 5c on cigarettes, with immediate effect.
- A 3% excise duty on all mobile telephony services, with immediate effect.
- The introduction of excise duty and value added tax on kerosene, with immediate effect. Persons entitled to non-contributory social benefits and contributory unemployment benefits are to be compensated by a one-off payment of Lm12.
- An increase of Lm10 in the passenger departure tax, to come into effect on 1 August 2005.
- An increase of 5 cents in bus fares, to come into effect on 1 January 2005.

Labour market

- Public holidays falling on weekends will no longer be added to the annual leave entitlement.
- Women returning to work after an absence of five years will benefit from a one-year tax holiday.
- Unemployed persons will be required to attend training courses offered by the ETC.

Environmental measures

- The list of items subject to an eco-contribution is increased, while a one-off refund of 15.25% on the CIF value (not exceeding Lm50) will be given for each solar energy product acquired by a household and on each purchase of an electric car.

Social welfare

- Families with four or more children will have their children's allowance increased.
- Parents of children with disabilities attending private schools will benefit from tax cuts.

Incentives to industry

- Setting-up of venture capital fund.
- The introduction of fiscal benefits: for research and development carried out by local entrepreneurs in industry in Malta; for companies which employ less than eleven full-time employees (SMEs); and, for the audio-visual industry/setting-up of international conferences in Malta.

24 November: *White Paper on pension reform*

The Government sets out its proposals on the sustainability and adequacy of Malta's pension system in a White Paper, basing the case for pension reform on the conclusions of various reports carried out since 1997 and setting out the critical issues that collectively underpin the foreseeable future difficulties in the current system. The Paper suggests a system based on a three-pillar approach, and also proposes the gradual lifting of the retirement age to 65 years for both men and women.

26 November: *Regulations on investment services*

The Recognised Investment Exchange (Transparency) Regulations 2004 concerning the implementation of the relevant provisions of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, are issued through LN 491 in terms of the Finance Markets Act (Cap. 345).

7 December: *Update of Malta's Convergence Programme 2004-2007*

The Government submits to the EU Commission an update of Malta's Convergence Programme covering the period 2004-2007. The Update is prepared in accordance with the Council Regulation (EC) No 1466/97 and conforms to the revised Opinion of the EU Council on the content and format of Stability and Convergence Programmes. The Update takes into account the impact of the 2005 Budget and revises projections for economic growth.

7 December: *New financial institution licensed*

The MFSA issues a license, in terms of the Financial Institutions Act 1994 (Cap. 376), to CommFinance Ltd to undertake the business of a financial institution in Malta. CommFinance Ltd is a wholly-owned subsidiary of the Commonwealth Bank of Australia.

14 December: *European Commission Communication on Malta's fiscal deficit*

The European Commission submits a Communication to the Council in which it states that Malta, the Czech Republic, Cyprus, Poland and Slovakia are on track to correct their fiscal deficits. The Commission notes that the Government has taken effective action to achieve the 2005 target in response to the Council's Recommendations.

24 December: *Regulations on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate*

Regulations implementing the provisions of Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, are issued through LN 521 in terms of the Malta Financial Services Authority Act (Cap. 330).

Part III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2004

Directors' report

The Directors present their report and the audited financial statements of the Bank for the year ended 31 December 2004.

Principal activities and review of operations

The Bank's Mission and Objectives are set out on page 3 of the Annual Report. The Governor's Statement and the Bank's Policies, Operations and Activities, included in the Annual Report on pages 11 to 14 and pages 55 to 74 respectively, give a detailed account of the Bank's activities and operations during 2004.

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 2004, 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 (Cap. 204).

Financial results

The Bank's financial statements for the year ended 31 December 2004 are set out on pages A-6 to A-30 and disclose an operating profit of Lm14.9 million (2003: Lm18.2 million). The amount payable to Government is Lm14 million (2003: Lm18.2 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 Joseph V. Gatt
Ms Philomena Meli
Mr Charles J. Falzon (appointed on 7 February 2004)

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

Auditors

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

By order of the Board

M. C. Bonello	D. A. Pullicino
Governor	Deputy Governor

Castille Place
Valletta
Malta

28 February 2005

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 (Cap. 204). 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 2004, 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 (Cap. 204).

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.

The financial statements of the Central Bank of Malta for the year ended 31 December 2004 are included in the Annual Report 2004, which is published in hard-copy printed form and on the Bank's website. The Directors are responsible for the maintenance and integrity of the Annual Report on the website in view of their responsibility for the controls over, and the security of, the website. Access to information published on the Bank's website is available in other countries and jurisdictions, where legislation governing the preparation and dissemination of financial statements may differ from requirements or practice in Malta.

Report of the auditors

To the Board of Directors of the Central Bank of Malta

We have audited the financial statements set out on pages A-6 to A-30. As described in the statement of Directors' responsibilities on page A-4, 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 2004 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 A-10, and have been properly prepared in accordance with the Central Bank of Malta Act (Cap. 204).

Ernst & Young

Malta

28 February 2005

PricewaterhouseCoopers

Malta

28 February 2005

Profit and loss account

	Notes	**2004** **Lm'000**	2003 Lm'000
Profit for the financial year	3	**14,901**	18,233
Transfer to reserves for risks and contingencies	23	**(900)**	-
Payable to the Government of Malta in terms of Section 24(4) of the Central Bank of Malta Act (Cap. 204)		**14,001**	18,233

Balance sheet

	Notes	**2004 Lm'000**	2003 Lm'000
Assets			
Cash and balances with banks	4	**5,470**	12,839
Gold balances		**496**	497
Placements with banks	5	**391,789**	665,168
Available-for-sale investment securities	6	**426,777**	220,540
Claims on the International Monetary Fund	7	**35,136**	35,686
Participating interest in the European Central Bank	8	**107**	-
Other foreign currency assets		**779**	818
Total external assets		**860,554**	935,548
Available-for-sale local assets:			
Treasury bills	9	**8,209**	437
Domestic debt securities	10	**13,129**	7,335
Derivative financial instruments	11	**567**	2,133
Other assets	12	**34,240**	35,258
Tangible fixed assets	13	**8,931**	4,693
Prepayments and accrued income		**10,513**	7,612
Total assets		**936,143**	993,016
Liabilities and equity			
Liabilities			
Notes and coins in circulation	14	**506,405**	485,373
Deposits by:			
Central banks	15	**15**	-
Banks	16	**166,303**	242,162
Government	17	**115,661**	83,198
Others	18	**11,147**	8,455
Profits payable to Government		**14,001**	18,233
Foreign liabilities	19	**-**	25,496
Derivative financial instruments	11	**1,298**	4,048
Other liabilities	20	**32,632**	33,762
Accruals and deferred income		**2,665**	4,064
		850,127	904,791
Capital and reserves			
Capital	21	**5,000**	5,000
General reserve fund	22	**23,000**	23,000
Special reserve fund	22	**13,000**	13,000
Reserves for risks and contingencies	23	**43,950**	43,050
Fair value reserve	24	**1,066**	4,175
		86,016	88,225
Total liabilities and equity		**936,143**	993,016

The financial statements on pages A-6 to A-30 were approved for issue by the Board of Directors on 28 February 2005 and were signed on its behalf by:

M. C. Bonello	D. A. Pullicino	G. Huber	R. Filletti
Governor	Deputy Governor	Director 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 2003	5,000	23,000	13,000	43,050	11,291	-	95,341
Arising in the financial period:							
- net losses from changes in fair value of available-for-sale assets	-	-	-	-	(3,374)	-	(3,374)
Transfers:							
- net gains transferred to net profit on disposal of available-for-sale assets	-	-	-	-	(3,742)	-	(3,742)
Net losses not recognised in the profit and loss account	-	-	-	-	(7,116)	-	(7,116)
Profit for the financial year	-	-	-	-	-	18,233	18,233
Total recognised (losses)/gains	-	-	-	-	(7,116)	18,233	11,117
Transfer to profits payable to Government	-	-	-	-	-	(18,233)	(18,233)
Balance at 31 December 2003	5,000	23,000	13,000	43,050	4,175	-	88,225
Balance at 1 January 2004	5,000	23,000	13,000	43,050	4,175	-	88,225
Arising in the financial period:							
- net losses from changes in fair value of available-for-sale assets	-	-	-	-	(1,074)	-	(1,074)
Transfers:							
- net gains transferred to net profit on disposal of available-for-sale assets	-	-	-	-	(2,035)	-	(2,035)
Net losses not recognised in the profit and loss account	-	-	-	-	(3,109)	-	(3,109)
Profit for the financial year	-	-	-	-	-	14,901	14,901
Total recognised (losses)/gains	-	-	-	-	(3,109)	14,901	11,792
Transfer to reserves for risks and contingencies	-	-	-	900	-	(900)	-
Transfer to profits payable to Government	-	-	-	-	-	(14,001)	(14,001)
Balance at 31 December 2004	**5,000**	**23,000**	**13,000**	**43,950**	**1,066**	**-**	**86,016**

Cash flow statement

	Notes	**2004 Lm'000**	2003 Lm'000
Cash flows from operating activities			
Profit for the financial year		**14,901**	18,233
(Increase)/decrease in prepayments and accrued income		**(2,901)**	334
Decrease in accruals and deferred income		**(1,399)**	(914)
Depreciation of tangible fixed assets	13	**342**	321
Amortisation of premiums and discounts on investments		**2,373**	(397)
Profit on sale of investments		**(1,869)**	(3,880)
Profit on sale of tangible fixed assets		**-**	(46)
Cash flows from operating profits before changes in operating assets and liabilities		**11,447**	13,651
Net changes in operating assets and liabilities:			
Placements with banks		**203,844**	4,211
Other foreign exchange assets		**590**	1,828
Treasury bills		**(7,929)**	(138)
Malta Government securities		**(5,852)**	(5,166)
Derivative financial instruments		**(1,184)**	1,921
Other assets		**1,018**	2,056
Deposits		**7,279**	(24,230)
Other liabilities		**(1,130)**	(2,127)
Net cash from/(used in) operating activities		**208,083**	(7,994)
Cash flows from investing activities			
Purchase of securities		**(617,238)**	(313,626)
Proceeds from sale and maturity of securities		**407,369**	323,170
Acquisition of participating interest in the European Central Bank	8	**(107)**	-
Purchase of tangible fixed assets	13	**(4,580)**	(123)
Proceeds from sale of tangible fixed assets		**-**	91
Net cash (used in)/from investing activities		**(214,556)**	9,512
Cash flows from financing activities			
Net movement in currency in issue		**21,032**	24,126
Payment to the Government under Section 24(4) of the Central Bank of Malta Act (Cap. 204)		**(18,233)**	(24,782)
Net cash from/(used in) financing activities		**2,799**	(656)
Movement in cash and cash equivalents		**(3,674)**	862
Cash and cash equivalents at 1 January		**206,723**	205,861
Cash and cash equivalents at 31 December	25	**203,049**	206,723

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 considered by the Bank as appropriate to a central bank and applicable in terms of the Central Bank of Malta Act (Cap. 204), as amplified below and in the accounting policies described subsequently.

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.

(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. Internally transacted deals such as transfers of investments between portfolios are accounted for on the same basis as third party transactions. While this is not strictly in accordance with the requirements of IAS 39, the Bank considers this policy as more suited to its circumstances, considering also the high level of control exercised to ensure that such deals are properly initiated and recorded, and effected strictly on an arm's length 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, currency swaps and cross-currency interest rate 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 and valuation techniques, including discounted cash flow models, as appropriate. Discounting techniques reflecting the fact that the respective exchange or settlement will not occur until a future date, are used 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

During the current financial year, the Bank changed its accounting policy in respect of measurement of gold balances. In prior financial years, gold balances were included at current market value based on the Maltese lira average of the London fixings for the month of December. In the opinion of the Directors, current market value is more fairly reflected by the Maltese lira equivalent of the London fixings as at the balance sheet date and the Bank's accounting policy was changed accordingly. This change in accounting policy did not have material effects on the Bank's results for the current and preceding financial years and its financial position as at the balance sheet dates.

(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 SDR2.02143 to Lm1 as quoted by the Fund at the close of business on 31 December 2004. The International Monetary Fund Maltese lira holdings are revalued against the SDR at the representative rate for the Maltese lira quoted by the Fund at 31 December 2004. Adjustments on revaluations of the International Monetary Fund holdings are reflected in the corresponding asset - Currency Subscription.

(f) Participating interest in the European Central Bank

Considering the nature of the instrument, the substance of the arrangements in place and the reliability with which its fair value can be measured, the Bank's participating interest in the European Central Bank is carried in the Bank's balance sheet at its original amount in foreign currency, translated at the exchange rate ruling at the date of acquisition.

(g) 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.

(h) 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.

1. Accounting policies - continued

(h) Other financial instruments *- continued*

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.

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.

(i) 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.

(j) 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.

(k) Tangible fixed assets

All tangible fixed assets are stated at historical cost less accumulated depreciation. Land is not depreciated as it is deemed to have an indefinite life. 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:

Freehold buildings	2%
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.

(l) 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

(m) 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.

(n) 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 107.63% (2003: 114.20%). In accordance with Section 19(1) of the Central Bank of Malta Act (Cap. 204), the minimum ratio in this respect is 60%.

3. Profit for the financial year

The profit for the financial year is stated after charging:

	2004	2003
	Lm'000	Lm'000
Fees and salaries:		
Directors' remuneration	**56**	50
Staff costs	**2,921**	2,921
Depreciation of tangible fixed assets	**342**	321
Auditors' remuneration	**19**	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

	2004	2003
	Lm'000	Lm'000
Cash in hand	**348**	257
Balances with banks - repayable on call and at short notice	**5,122**	12,582
	5,470	12,839

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

	2004	2003
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**38,832**	88,467
- Three months or less but over one month	**93,711**	216,636
- One month or less	**259,246**	360,065
	391,789	665,168

6. Available-for-sale investment securities

	2004	2003
	Lm'000	Lm'000
By remaining maturity		
- Over five years	**25,753**	58,834
- Five years or less but over one year	**202,554**	130,670
- One year or less but over three months	**136,624**	27,507
- Three months or less	**61,846**	3,529
	426,777	220,540

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 2004, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of USD20 million or Lm6 million approximately (2003: USD20 million or Lm7 million approximately). No amounts were borrowed under these facilities at the balance sheet dates. Also, as at 31 December 2004, investment securities with a fair value of Lm23,000 (2003: Lm244,000) were lent out under a securities lending programme with a counterparty. At 31 December 2003 investment securities with a fair value of Lm18,682,000 were subject to sale and repurchase agreements.

7. Claims on the International Monetary Fund

	2004	2003
	Lm'000	Lm'000
Reserve Tranche Position	**19,916**	20,495
Special Drawing Rights	**15,220**	15,191
	35,136	35,686

Malta's membership subscription to the International Monetary Fund amounts to SDR102,000,000 (2003: SDR102,000,000).

7. Claims on the International Monetary Fund - continued

The Bank's position with the International Monetary Fund at 31 December 2004 is reflected in the balance sheet as follows:

(a) Reserve Tranche Position included above is equivalent to SDR40,259,007. 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 SDR30,765,673. 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 18), 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 Lm30,543,226 and represents the balance of the quota paid in Maltese liri. A corresponding liability included with "Other liabilities" (see Note 20) exists in the form of IMF current accounts of Lm30,543,226 or SDR61,740,993.

8. Participating interest in the European Central Bank

On 1 May 2004 Malta joined the European Union and consequently the Bank became a member of the European System of Central Banks (ESCB). In accordance with Article 28 of the Statute of the ESCB and the European Central Bank (ECB), the Bank became the subscriber of the capital of the ECB. This balance represents the Bank's participating interest in the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the ESCB Statute and which must be adjusted every five years. The share of Malta in the ECB's capital is 0.0647% and was calculated in accordance with Article 29 of the Statute of the ESCB, on the basis of population and GDP data provided by the European Commission. As Malta does not participate in the euro area, the transitional provisions of Article 48 of the Statute apply. Consequently, the Bank was required to pay-up a minimal contribution of 7% of its allocated share capital in the ECB upon entry to the ESCB on 1 May 2004 amounting to EUR252,024. Appendix 1 to these financial statements on pages A-31 to A-33 includes detailed disclosures of participating interests held by euro area and non-euro area national central banks (NCBs).

9. Treasury bills

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

	2004	2003
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**314**	2
- Three months or less but over one month	**5,973**	204
- One month or less	**1,922**	231
	8,209	437

10. Domestic debt securities

	2004 **Lm'000**	2003 Lm'000
Malta Government Stocks listed on the Malta Stock Exchange	**13,129**	7,335

Amounts include:

	2004 **Lm'000**	2003 Lm'000
By remaining maturity		
- Over five years	**11,540**	5,777
- Five years or less but over one year	**1,335**	1,013
- One year or less	**254**	545
	13,129	7,335

11. Derivative financial instruments

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

	Assets	
	2004 **Lm'000**	2003 Lm'000
Foreign exchange and other derivatives held for trading:		
Foreign exchange contracts maturing within six months from the balance sheet date		
- forward purchase of EUR3 million (2003: EUR3.4 million) against Lm	**27**	13
- forward purchase of EUR34.2 million (2003: EUR52.4 million) against USD	**174**	1,536
- forward purchase of GBP4.1 million against USD	**-**	172
Foreign exchange contract expiring in 2010		
- forward sale of EUR24.1 million (2003: EUR31.8 million) against Lm	**287**	412
Other derivative contracts maturing in 2009		
- cross-currency interest rate swaps with principal amounts of Lm15 million (vide Note below)	**79**	-
	567	2,133

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

11. Derivative financial instruments - continued

	Liabilities	
	2004	2003
	Lm'000	Lm'000
Foreign exchange and other derivatives held for trading:		
Foreign exchange contracts maturing within six months from the balance sheet date		
- forward purchase of USD67 million (2003: USD120 million) against Lm	**1,124**	3,935
- forward purchase of GBP3.5 million against USD	**16**	-
- forward sale of Lm3 million against GBP	**-**	9
- forward sale of JPY1,270 million (2003: JPY1,250 million) against USD	**1**	104
Other derivative contract maturing in 2009		
- cross-currency interest rate swap with a principal amount of Lm5 million (vide Note below)	**157**	-
	1,298	4,048

During the current financial year, the Bank has entered into a cross-currency interest rate swap arrangement with an international financial institution whereby the Bank has undertaken to purchase upon inception and sell forward, the principal amount of Lm10 million against EUR, at the same exchange rate. The Bank will pay fixed interest amounts on the Lm principal amount annually and will receive variable interest amounts at quarterly intervals, based on reset floating interest rates linked to 3 month EURIBOR, computed by reference to the EUR principal amount. For the purposes of managing its exposures from this arrangement, the Bank entered into similar swap agreements, offsetting the contract mentioned above, with two local financial institutions. Under each agreement the Bank has undertaken to sell upon inception and buy forward Lm5 million against EUR at the same exchange rate for each respective contract. During the term of these contracts, the Bank will receive fixed interest amounts on the Lm principal amount on an annual basis and will pay variable interest amounts at quarterly intervals based on 3 month EURIBOR determined by reference to the EUR principal amount.

12. Other assets

	2004	2003
	Lm'000	Lm'000
International Monetary Fund Currency Subscription	**30,543**	31,431
Others	**3,697**	3,827
	34,240	35,258

13. Tangible fixed assets

	Freehold property Lm'000	Leasehold property Lm'000	Others Lm'000	Total Lm'000
Year ended 31 December 2004				
Opening net book amount	-	4,237	456	4,693
Additions	4,268	1	311	4,580
Depreciation charge for the year	-	(46)	(296)	(342)
Transfer of property improvements:				
- cost	1,319	(1,319)	-	-
- accumulated depreciation	(71)	71	-	-
Closing net book amount	**5,516**	**2,944**	**471**	**8,931**
At 31 December 2004				
Cost	5,587	3,182	2,632	11,401
Accumulated depreciation	(71)	(238)	(2,161)	(2,470)
Net book amount	5,516	2,944	471	8,931
At 31 December 2003				
Cost	-	4,500	2,321	6,821
Accumulated depreciation	-	(263)	(1,865)	(2,128)
Net book amount	-	4,237	456	4,693

During the current financial year, the Bank acquired from Government the freehold title to its main premises at Castille Place for a consideration of Lm4.3 million. These premises, which were previously held on a temporary lease from Government, had been extensively altered in prior years to adapt them to the Bank's requirements. The carrying amount of these improvements has been transferred from the leasehold property category to freehold property in the table disclosed above subsequent to the property acquisition.

14. Notes and coins in circulation

	2004 Lm'000	2003 Lm'000
Notes	**487,165**	467,098
Coins	**19,240**	18,275
	506,405	485,373

15. Central bank deposits

Deposits by central banks are denominated in Maltese liri and are repayable on demand.

16. Bank deposits

	2004 **Lm'000**	2003 Lm'000
Reserve deposits held in terms of Section 37 of the Central Bank of Malta Act (Cap. 204)	**145,303**	137,862
Liabilities arising from monetary policy instruments	**21,000**	104,300
	166,303	242,162

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

Amounts include:

	2004 **Lm'000**	2003 Lm'000
By currency		
MTL	**166,301**	230,073
EUR	**2**	10,600
USD	**-**	1,489
	166,303	242,162

17. Government deposits

Amounts include:

	2004 **Lm'000**	2003 Lm'000
Current accounts by currency		
MTL	**50,429**	27,275
EUR	**12,323**	3,058
USD	**1,822**	1,454
GBP	**348**	402
Others	**110**	72
Sinking fund accounts by currency		
MTL	**35,100**	38,695
EUR	**13,732**	9,871
USD	**1,699**	2,270
Others	**98**	101
	115,661	83,198

Government deposits are repayable on demand.

18. Other deposits

	2004	2003
	Lm'000	Lm'000
Deposits by public sector corporations and similar entities:		
- Repayable on demand	**4,025**	2,336
International Monetary Fund SDR allocation	**5,584**	5,746
Others:		
- Repayable on demand	**1,538**	373
	11,147	8,455

Amounts include:

	2004	2003
	Lm'000	Lm'000
By currency		
MTL	**1,490**	1,472
EUR	**3,411**	382
SDR	**5,584**	5,746
Others	**662**	855
	11,147	8,455

19. Foreign liabilities

	2004	2003
	Lm'000	Lm'000
Amounts payable under banking arrangements:		
- Repayable within three months	**-**	6,587
Amounts payable to counterparties under sale and repurchase agreements in respect of investment securities:		
- Repayable within three months	**-**	18,909
	-	25,496

20. Other liabilities

	2004	2003
	Lm'000	Lm'000
International Monetary Fund non-interest bearing notes	**-**	14,614
International Monetary Fund current accounts	**30,543**	16,817
Others	**2,089**	2,331
	32,632	33,762

21. Capital

The capital authorised by Section 18(1) of the Central Bank of Malta Act (Cap. 204) is fully paid up and held by the Government of Malta.

22. Reserve funds

Reserves are maintained in terms of Section 18(2) and (3) of the Central Bank of Malta Act (Cap. 204). 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 (Cap. 204), 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.

23. Reserves for risks and contingencies

Reserves for risks and contingencies are maintained in terms of Section 24 of the Central Bank of Malta Act (Cap. 204) to cover the broad range of risks to which the Bank is exposed. The major risks in this regard arise from: 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.

24. 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
At 1 January 2003	11,238	53
Net (losses)/gains from changes in fair value	(3,431)	57
Net (gains)/losses transferred to net profit on disposal	(3,745)	3
At 31 December 2003	4,062	113
Net losses from changes in fair value	(1,017)	(57)
Net gains transferred to net profit on disposal	(2,030)	(5)
At 31 December 2004	**1,015**	**51**

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

25. Cash and cash equivalents

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

	2004	2003
	Lm'000	Lm'000
Cash and balances with banks (Note 4)	**5,470**	12,839
Treasury bills maturing within three months (Note 9)	**-**	234
Placements with banks maturing within three months (Note 5)	**339,818**	409,353
Deposits maturing within three months (Notes 15, 16, 17 and 18)	**(142,239)**	(190,207)
Foreign liabilities maturing within three months (Note 19)	**-**	(25,496)
	203,049	206,723

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

26. 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 23 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.

26. 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:

	2004	2003
	%	%
EUR	**73.76**	73.43
GBP	**18.99**	18.87
USD	**7.18**	7.60
Others	**0.07**	0.10
	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 or realisable nature 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.

26. 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.

27. Contingent liabilities and commitments

	2004	2003
	Lm'000	Lm'000
Contingent liabilities		
Guarantees and letters of credit	**20,436**	4,637
Commitments		
Repayment of foreign loans received by the Bank on behalf of the Government under Financial Conventions	**10,333**	12,600
Total	**30,769**	17,237

By remaining maturity:

Guarantees and letters of credit

	2004	2003
	Lm'000	Lm'000
- Five years or less but over one year	**3,949**	561
- One year or less but over three months	**10,027**	1,303
- Three months or less	**6,460**	2,773
	20,436	4,637

27. 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

	2004	2003
	Lm'000	Lm'000
- Over five years	**2,354**	3,367
- Five years or less but over one year	**5,973**	7,174
- One year or less but over three months	**1,870**	1,917
- Three months or less	**136**	142
	10,333	12,600

28. 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.

29. General

(a) Demonetised currency notes and coins

Demonetised currency notes

In accordance with Section 42 of the Central Bank of Malta Act (Cap. 204), after the expiration of one year following the end of the period established in the notice 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 Bank.

29. General - continued

(a) Demonetised currency notes and coins *- continued*

During 2004, demonetised currency notes presented for redemption amounted to Lm170,541 (2003: Lm585,644). At 31 December 2004, the value of unpresented demonetised currency notes amounted to Lm2,703,335 (2003: Lm2,873,876) analysed as follows:

	2004	2003
	Lm'000	Lm'000
Ten year period expires in:		
- 2008	**940**	957
- 2010	**1,763**	1,917
	2,703	2,874

Demonetised coins

In accordance with Section 43 of the Central Bank of Malta Act (Cap. 204), after the expiration of six months following the end of the period established in the notice of demonetisation, any unpresented demonetised coins shall cease to be included in the Bank's currency liabilities. The value of such coins, after deducting therefrom the value of any coins which are subsequently redeemed, are apportioned to the profit and loss account of the Bank over the remaining period until the expiration of two years from the end of the period above mentioned. After the expiry of two years from the notice of demonetisation, demonetised coins not yet presented are no longer redeemed by the Bank.

The two year period in respect of the 50c 1st series and 25c 1st series coins expired on 17 June 2004. Coins presented for redemption during the current financial year until this date amounted to Lm8,984 (2003: Lm5,820).

(b) Average number of employees

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

	2004	2003
	Number	Number
Governors and Directors	**7**	7
Heads and Executives	**70**	69
Supervisory and clerical staff	**197**	195
Non-clerical staff	**40**	45
	314	316

29. General - continued

(c) Assets held in custody

At 31 December 2004, assets held in custody by the Bank in terms of the Insurance Business Act amounted to Lm24,159,000 (2003: Lm24,120,000).

(d) Management of funds belonging to the Investor and Depositor Compensation Schemes

During the previous financial year, the Bank had been appointed as investment manager in respect of funds belonging to the Investor and Depositor Compensation Schemes. The Bank manages these funds on a discretionary basis but in accordance with the investment parameters set by the Management Committees of the respective Schemes. The amount of funds belonging to the Schemes, managed by the Bank, is adjusted by the amount of investments so effected. Accordingly as at 31 December 2004, the Investor and Depositor Compensation Schemes had interest-bearing deposits of Lm669 (2003: Lm45,739) and Lm1,499 (2003: Lm397,684) respectively, with the Bank.

30. 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 (Cap. 204).

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.

30. 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	136	83	77	52	348
Balances with banks repayable on call and at short notice by exposure country					
France	71	-	-	-	71
Germany	89	-	-	-	89
Italy	74	-	-	-	74
United Kingdom	24	65	102	16	207
United States of America	-	-	4,102	-	4,102
Other countries	62	8	7	136	213
International financial institutions	239	112	1	14	366
	559	185	4,212	166	5,122
Gold balances by exposure country					
United Kingdom	-	-	-	434	434
Others	-	-	-	62	62
	-	-	-	496	496
Placements with banks by exposure country					
Australia	-	6,153	-	-	6,153
Belgium	57,335	-	-	-	57,335
Canada	16,071	-	-	-	16,071
Denmark	4,344	3,077	-	-	7,421
France	36,920	9,230	-	-	46,150
Germany	10,859	-	-	-	10,859
Ireland	19,546	-	-	-	19,546
Italy	23,890	-	-	-	23,890
Netherlands	54,294	-	-	-	54,294
Sweden	26,061	-	-	-	26,061
Switzerland	6,515	-	-	-	6,515
United Kingdom	27,799	63,930	-	-	91,729
International financial institutions	10,859	1,845	13,061	-	25,765
	294,493	84,235	13,061	-	391,789
Available-for-sale investment securities by issuer category					
Government	55,935	4,495	6,279	-	66,709
Monetary financial institutions	218,281	50,651	9,317	-	278,249
Other financial institutions	40,743	9,994	2,467	-	53,204
Non-financial institutions	2,667	-	-	-	2,667
Supranationals	14,206	3,174	8,568	-	25,948
	331,832	68,314	26,631	-	426,777
Claims on the International Monetary Fund	-	-	-	35,136	35,136
Participating interest in the European Central Bank	107	-	-	-	107
Other foreign currency assets	-	-	-	779	779
Total external assets	**627,127**	**152,817**	**43,981**	**36,629**	**860,554**

Supplementary information to the financial statements: Appendix 1

ESCB members' percentage share held in the ECB's capital

	Until 31 December 2003 %	From 1 January to 30 April 2004 %	From 1 May 2004 %
Nationale Bank van België / Banque Nationale de Belgique	2.8658	2.8297	2.5502
Deutsche Bundesbank	24.4935	23.4040	21.1364
Bank of Greece	2.0564	2.1614	1.8974
Banco de España	8.8935	8.7801	7.7758
Banque de France	16.8337	16.5175	14.8712
Central Bank and Financial Services Authority of Ireland	0.8496	1.0254	0.9219
Banca d'Italia	14.8950	14.5726	13.0516
Banque centrale du Luxembourg	0.1492	0.1708	0.1568
De Nederlandsche Bank	4.2780	4.4323	3.9955
Oesterreichische Nationalbank	2.3594	2.3019	2.0800
Banco de Portugal	1.9232	2.0129	1.7653
Suomen Pankki-Finlands Bank	1.3970	1.4298	1.2887
Subtotal euro area NCBs	**80.9943**	**79.6384**	**71.4908**
Česká národní banka	-	-	1.4584
Danmarks Nationalbank	1.6709	1.7216	1.5663
Eesti Pank	-	-	0.1784
Central Bank of Cyprus	-	-	0.1300
Latvijas Banka	-	-	0.2978
Lietuvos bankas	-	-	0.4425
Magyar Nemzeti Bank	-	-	1.3884
Central Bank of Malta	-	-	0.0647
Narodowy Bank Polski	-	-	5.1380
Banka Slovenije	-	-	0.3345
Národná banka Slovenska	-	-	0.7147
Sveriges Riksbank	2.6537	2.6636	2.4133
Bank of England	14.6811	15.9764	14.3822
Subtotal non-euro area NCBs	**19.0057**	**20.3616**	**28.5092**
Total euro area and non-euro area NCBs	**100.0000**	**100.0000**	**100.0000**

Appendix 1 - continued

ESCB members' subscribed and paid-up capital

	Subscribed capital until 31 December 2003 EUR'000	Paid-up capital until 31 December 2003 EUR'000
Nationale Bank van België / Banque Nationale de Belgique	143,290	143,290
Deutsche Bundesbank	1,224,675	1,224,675
Bank of Greece	102,820	102,820
Banco de España	444,675	444,675
Banque de France	841,685	841,685
Central Bank and Financial Services Authority of Ireland	42,480	42,480
Banca d'Italia	744,750	744,750
Banque centrale du Luxembourg	7,460	7,460
De Nederlandsche Bank	213,900	213,900
Oesterreichische Nationalbank	117,970	117,970
Banco de Portugal	96,160	96,160
Suomen Pankki-Finlands Bank	69,850	69,850
Subtotal euro area NCBs	**4,049,715**	**4,049,715**
Česká národní banka	-	-
Danmarks Nationalbank	83,545	4,177
Eesti Pank	-	-
Central Bank of Cyprus	-	-
Latvijas Banka	-	-
Lietuvos bankas	-	-
Magyar Nemzeti Bank	-	-
Central Bank of Malta	-	-
Narodowy Bank Polski	-	-
Banka Slovenije	-	-
Národná banka Slovenska	-	-
Sveriges Riksbank	132,685	6,634
Bank of England	734,055	36,703
Subtotal non-euro area NCBs	**950,285**	**47,514**
Total euro area and non-euro area NCBs	**5,000,000**	**4,097,229**

Appendix 1 - continued

ESCB members' subscribed and paid-up capital – continued

	Subscribed capital from 1 January to 30 April 2004 EUR'000	Paid-up capital from 1 January to 30 April 2004 EUR'000	Subscribed capital from 1 May 2004 EUR'000	Paid-up capital from 1 May 2004 EUR'000
Nationale Bank van België/ Banque Nationale de Belgique	141,485	141,485	141,910	141,910
Deutsche Bundesbank	1,170,200	1,170,200	1,176,171	1,176,171
Bank of Greece	108,070	108,070	105,584	105,584
Banco de España	439,005	439,005	432,698	432,698
Banque de France	825,875	825,875	827,533	827,533
Central Bank and Financial Services Authority of Ireland	51,270	51,270	51,301	51,301
Banca d'Italia	728,630	728,630	726,278	726,278
Banque centrale du Luxembourg	8,540	8,540	8,725	8,725
De Nederlandsche Bank	221,615	221,615	222,336	222,336
Oesterreichische Nationalbank	115,095	115,095	115,745	115,745
Banco de Portugal	100,645	100,645	98,233	98,233
Suomen Pankki-Finlands Bank	71,490	71,490	71,712	71,712
Subtotal euro area NCBs	**3,981,920**	**3,981,920**	**3,978,226**	**3,978,226**
Česká národní banka	-	-	81,155	5,681
Danmarks Nationalbank	86,080	4,304	87,159	6,101
Eesti Pank	-	-	9,927	695
Central Bank of Cyprus	-	-	7,234	506
Latvijas Banka	-	-	16,572	1,160
Lietuvos bankas	-	-	24,624	1,724
Magyar Nemzeti Bank	-	-	77,260	5,408
Central Bank of Malta	-	-	3,600	252
Narodowy Bank Polski	-	-	285,913	20,014
Banka Slovenije	-	-	18,614	1,303
Národná banka Slovenska	-	-	39,771	2,784
Sveriges Riksbank	133,180	6,659	134,292	9,400
Bank of England	798,820	39,941	800,322	56,023
Subtotal non-euro area NCBs	**1,018,080**	**50,904**	**1,586,443**	**111,051**
Total euro area and non-euro area NCBs	**5,000,000**	**4,032,824**	**5,564,669**	**4,089,277**