Central Bank of Malta

THIRTY-SIXTH ANNUAL REPORT

AND

STATEMENT OF ACCOUNTS

2003

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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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Correspondent Banking Office

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Manager
Investments and Reserves Office

*As at 30 March 2004

THE BOARD OF DIRECTORS

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

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.

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 and Economic Affairs.

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.

Organisation Chart*

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

*As at 30 March 2004

LETTER OF TRANSMITTAL

CENTRAL BANK OF MALTA
VALLETTA

30th March 2004

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 2003, a statement of the Bank's investments and a report on the Bank's operations during that year.

Yours sincerely,

Michael C. Bonello
Governor

Contents

Governor's Statement

Malta's forthcoming accession to the European Union (EU) on 1 May 2004 is a milestone in the country's political and economic history. EU membership will present new opportunities for developing a modern economy with the capacity to generate wealth on a sustainable basis. It is known, for example, that small open economies have the potential to benefit most from regional integration and also – though this factor will come into play later - that the trade of countries sharing a common currency can be more than twice that of countries with different currencies.

These benefits, however, are by no means automatic, nor will they necessarily accrue in equal measure to all new EU Member States. A crucial factor that will determine a country's success in seizing the opportunities of the single market is the ability of its government to create a congenial policy and operating environment, and of its entrepreneurs to exploit it. These considerations suggest the need to evaluate the recent performance of the Maltese economy as a guide to the policies most likely to enhance its growth potential.

A necessary starting point is the small size of the economy, which amounts to just 0.04% of that of the EU, and its natural dependence on international trade, with imports and exports both almost as large as the GDP. These characteristics make it highly susceptible to developments in external demand. Recent trends testify to this dependence. While the average GDP growth rate in the major industrialized countries is estimated to have slowed to 1.5% between 2001 and 2003 from 2.8% in the previous three-year period, the comparable decline in Malta's GDP was much faster, from 4.6% to 0.4%. Economic activity in Malta was thus more volatile than in its main trading partners, a consequence of a heavy reliance on a few key sectors such as tourism and the electronics industry, which were adversely affected by the global slowdown.

At the same time, the fiscal balance and the external goods and services account have been characterized by persistent deficits. While the former was negatively affected by the weak economic growth, it is also clear that efforts at curbing expenditure and at achieving greater efficiency were not pursued with sufficient vigour. As for the external balance, exports did not grow fast enough to reduce the deficit to sustainable levels.

If the underlying causes of these twin deficits are not addressed decisively, they could threaten the country's past achievements. These include a per capita income level, which, at almost 70% of the EU average, is one of the highest among the new Member States, and a significant degree of price stability in recent years, with inflation at just above 1% in 2003.

The combination of slow economic growth and persistent macroeconomic imbalances suggests the need for policies aimed at improving competitiveness. And since there is growing evidence that these imbalances are due to structural as well as to cyclical factors, corrective action must focus on strengthening the economy's supply capabilities. Demand-led growth strategies would, particularly in the current situation, tend to exacerbate the fiscal and external deficits. Enhanced competitiveness would also make it easier to cope with fluctuations in external demand, thereby reducing the economy's inherent vulnerability to exogenous shocks.

Given the economy's heavy dependence on foreign trade, efforts at improving competitiveness must be accompanied by a more forceful export-oriented approach, with a particular emphasis on identifying appropriate market niches. In an increasingly competitive global environment, moreover, an important element of this approach should be the promotion of advanced skills, technology and product differentiation. This is so because Malta is not competing only for export market share, but also for foreign direct investment, which is key to achieving quality growth. This implies, for example, that increases in wages must be matched by improvements in productivity. It also means that waste and inefficiencies, in both the public and private sectors, need to be eliminated. At the same time, the resources available, be they human, physical or financial, must be put to the most effective use. Finally, in today's dynamic market place, access to market niches cannot be preserved unless the supply base develops in response to changing demands. This requires on-going, structured efforts to promote innovation and the upgrading of skills, which are a prerequisite for the attainment of higher living standards in a knowledge-driven world.

The public sector has a crucial role to play in facilitating the development of export-oriented activities by fulfilling its service functions in a more cost-effective and timely fashion. Within the context of a determined effort to reduce the fiscal deficit, moreover, a higher proportion of budgetary resources needs to be devoted to wealth-creating activities. Distortions to the price mechanism, which lead to the misallocation of resources, should be removed and productive activity encouraged. Welfare schemes should be reviewed so as to eliminate disincentives to work and introduce more flexibility in the labour market. Finally, the continued subsidization of activities and practices which are not economically self-sustaining - thereby increasing the operating costs of the productive sector and undermining its viability – must be phased out.

While necessary reforms have been undertaken in a number of areas, the growing competitive pressures being faced in export markets and the need to integrate successfully into the EU single market constitute compelling reasons for accelerating the reform process and broadening its scope.

In recognition of such realities, the EU is itself encouraging Member States to become more competitive through the single currency project and the Lisbon Strategy. Both these initiatives are indeed appropriate focal points in Malta's quest for greater competitiveness. The Bank is contributing to this objective by playing an active role in preparations for participation in Economic and Monetary Union (EMU), whose final phase is the adoption of the single currency. In the remainder of my statement I shall focus on the latter project.

The Maltese economy is well suited to participate in the common currency area. It is already closely integrated with the EU economy; it has close similarities with the euro area in the sectoral composition of GDP and in financial sector integration, as well as a high degree of business cycle synchronization; and the currency is strongly pegged to the euro. This suggests a limited vulnerability to asymmetric shocks and also that the European Central Bank's (ECB) monetary policy should not be inappropriate for domestic economic conditions. These are, therefore, relevant arguments in favour of an early adoption of the euro, an event that holds out the prospect of significant gains.

The benefits of the single currency include reductions in transactions costs, in exchange rate risks and in interest rates – all of which mean lower financing costs for traders and investors – as well as an increase in credibility. The value of these benefits for the business community should not be underestimated, given that the euro area already accounts for around a half of Malta's trade in non-primary commodities and that this proportion is likely to increase even further after membership. These advantages, moreover, more than compensate for the loss of control over monetary policy. This is limited anyway, since in a fixed exchange rate regime in which the euro is the main reference currency, interest rates must shadow those of the euro area. Similar considerations have led some analysts to conclude that the potential costs and risks associated with euro area membership are far outweighed by the benefits for small economies joining the EU.

In Malta's case the transition towards the euro should be characterized by continuity and stability. In addition to the above-mentioned evidence of the economy's readiness for EMU participation, the Maastricht inflation and long-term interest rate criteria have been met on a sustainable basis and there are no indications of major misalignment in the value of the Maltese lira. Indeed, the stability of the currency is one of the economy's main competitive strengths. The existing imbalances in the fiscal and external accounts cannot, in fact, be attributed to an incorrectly valued exchange rate, nor are they likely to be remedied through an adjustment to the external value of the lira. There is, therefore, good reason to expect that the central rate for the lira in ERM II would be close to the market rate prevailing at the time of entry. Likewise, it is probable that the lira would continue to move within a relatively narrow range, with fluctuations similar to those currently observed under the currency basket regime.

It must be stressed here that the above expectations are subject to the adoption of coherent macroeconomic policies and to the absence of economic shocks. A supportive policy framework is indeed crucial because during the transition period, which will also be characterized by the free movement of capital, the Central Bank of Malta will be obliged to focus primarily on safeguarding the external value of the Maltese lira. Thus, to an even greater extent than at present, monetary policy will have to stand ready to neutralize any pressures on the exchange rate should they develop. This means that the onus of economic adjustment must then fall on fiscal and structural policies.

The significance of this conclusion should not be underestimated because the major challenge on the way to a rapid and orderly adoption of the euro is the structural nature of the fiscal deficit. For more than a decade the deficit has exceeded the 3% of GDP reference value set by the Maastricht Treaty, while the public debt has recently risen above the 60% of GDP ceiling. Persistent fiscal deficits imply a relatively high interest rate risk premium on the Maltese lira, which, among other things, inflates government expenditure through the higher cost of debt servicing.

Against this background the Bank welcomes the Government's intention to bring the fiscal deficit down to 3% of GDP by 2006. For this purpose, the central lesson of worldwide experience with fiscal consolidation efforts, namely that reforms centred on expenditure reduction are more successful than those based on increasing taxation, will have to be taken on board. Applied to Malta, this will require far-reaching reforms in the operations of the public sector aimed at enhancing efficiency while restraining expenditure growth. Given the structural nature of the deficit, some social components of budgetary spending, such as the pension system and the provision of health and other social services, will also need to be critically reviewed. The process is, therefore, likely to imply some short-run sacrifices in terms of income and consumption. This suggests the need for a consensual approach to fiscal consolidation in an effort to reconcile what is socially desirable with what is financially affordable.

Success in this endeavour must be made a priority objective because fiscal consolidation is necessary independently from considerations relating to the adoption of the euro. There are indeed several other compelling reasons for pursuing rapid deficit-reducing policies. The foremost is that fiscal policy would thereby be recovered as a tool of economic management, crucial in a fixed exchange-rate regime in which the use of interest rates to counter cyclical fluctuations is precluded. At present only a relatively small proportion of government expenditure is associated with the promotion of long-term economic growth. The remainder largely takes the form of pensions, social benefits and other transfer payments, wages, subsidies and debt-servicing charges.

Putting Government finances on a sounder footing would also lead to a gradual reduction of the public debt, interest on which today amounts to 3.5% of GDP and is equivalent to more than two-thirds of the cost of retirement pensions. It would furthermore allow more resources to be productively used by the private sector, adding to the economy's growth potential. This would be directly conducive to narrowing the external deficit, thereby enhancing Malta's international credibility. An immediately perceptible dividend would be a lower interest rate risk premium on the lira. Not least among the positive effects of all these changes would be to encourage investment, particularly foreign direct investment.

Fiscal consolidation based on expenditure control and structural reform is clearly key to achieving the mutually reinforcing objectives of increasing the economy's competitiveness and of eventually adopting the euro. It should be equally evident that the reforms which this process entails must be credible. It is thus essential that the social partners come to perceive the reforms as necessary, effective in achieving the final goal of sustainable economic growth and employment creation, and as involving an equitable distribution of costs and benefits.

Other countries have found that this support can be obtained, and good results achieved, when governments and the social partners meet in a congenial institutional forum in a determined effort to turn around a difficult economic situation. Faced with continued weak growth prospects in increasingly competitive export markets, and the implied threat to existing employment levels and living standards, their counterparts in Malta would have to shoulder a heavy burden of responsibility if they do not take the path others have followed so successfully and fail the country at this time of need.

Bank Operations

During the past year the Bank continued to ease its monetary policy stance, cutting the central intervention rate on three occasions by a total of 75 basis points to 3%. This followed cuts in official interest rates abroad, which were prompted by weak international economic conditions. The Bank's external reserves, a key indicator of the sustainability of the exchange rate peg, expanded during the year, supporting the decisions to reduce interest rates. An easier monetary policy stance was also considered appropriate in the absence of inflationary pressures in Malta and subdued domestic economic activity.

The year also witnessed further developments relating to the Bank's statutory responsibility to ensure the stability of the financial system and to regulate and supervise domestic payment and settlement systems. In January the Bank brought into force the Directive on Cross-Border Credit Transfers, which is designed to promote more efficient international payments in line with EU legislation.

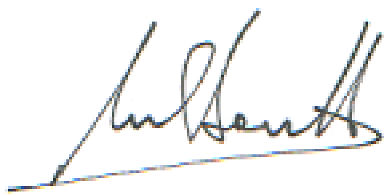
In February the Bank signed a Memorandum of Understanding with the Malta Financial Services Authority (MFSA) establishing the modalities for co-operation between the two institutions to ensure the overall safety and soundness of the financial system. Later in the year the Bank and the MFSA signed another Memorandum covering the regulation, oversight and running of payment and securities settlement systems. The Bank also co-ordinated the final phase of a comprehensive assessment of Malta's financial system conducted by an International Monetary Fund (IMF)/World Bank mission under the Financial Sector Assessment Program.

A major activity this past year involved the Bank's preparations for Malta's accession to the EU, when the Bank will become a member of the European System of Central Banks (ESCB). On accession, Malta will qualify as a 'Member State with a derogation', meaning that monetary policy will remain the Bank's responsibility, though exchange rate policy and economic policies in general will be subject to the EU's multilateral surveillance procedures.

Among other things, these preparations involved my attendance, as an observer, at meetings of the General Council of the ECB, while other Bank officials began attending meetings of the ECB's committees and working groups, also as observers. Meanwhile, preparations intensified across a wide range of the Bank's operations, including statistics, currency operations, payment systems and internal audit, to enable the Bank to meet the standards set by the ECB. Bank staff also undertook research and analysis as a basis for the formulation of recommendations on exchange rate policy in connection with Malta's eventual adoption of the euro. It is expected that when discussions with the Government have been concluded, a joint strategy document will be published.

The Bank's net operating profits amounted to Lm18.2 million in 2003 as against Lm19.8 million in 2002. The decline occurred despite the increase in the average level of external reserve holdings over the year and reflects the continued reduction in interest rates abroad.

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

Global economic conditions improved considerably in 2003, as international political tension eased following the rapid ending of the Iraq war. The United States was the main driving force behind the upturn in activity, although Japan and the emerging Asian economies also performed strongly. The euro area economy remained weak, with a number of member countries remaining in recession, but in the United Kingdom activity rebounded in the second half of the year. Thus global economic growth is estimated to have accelerated to 2.5%, from 1.9% in 2002.

Expansionary monetary and fiscal policies supported the 3.1% growth rate recorded by the US economy in 2003. With interest rates at a forty-year low, and following successive tax cuts and increased government spending on defence and security, consumption remained the main contributor to growth. Furthermore, business investment recovered in the second half of the year. Despite robust growth, the situation in the labour market remained depressed with unemployment reaching 6%, but inflationary pressures remained subdued, with the rate of inflation averaging 2.3% over the year.

The euro area continued to be characterised by sluggish economic activity, high unemployment and low inflation. The growth rate in 2003 is estimated at a meagre 0.4%, compared with 0.9% in 2002. The slowdown reflected declining investment coupled with a drop in net exports, partly as a result of the euro's appreciation. The German economy contracted by 0.1% while the French economy expanded by only 0.2%, the weakest French performance in a decade. Inflation in the area fell slowly towards the 2% benchmark of the European Central Bank (ECB), but unemployment continued to rise, reaching 8.8%. Nevertheless, despite the threat posed by the euro's strength there is confidence in an acceleration in 2004, when growth is forecast to rise to 1.8%.

Following a sluggish start, the British economy rebounded strongly in the second half of the year to achieve a 2.3% growth rate for the whole of 2003. Private and public consumption was the main driving force behind this acceleration, as investment remained relatively subdued. Compared to the previous year, unemployment and inflation remained stable at 3.1% and 1.3%, respectively.

After the previous year's contraction, the Japanese economy grew by an estimated 2.7% in 2003, a recovery supported mainly by an acceleration in business investment. Restructuring in the corporate

Table 1.1
INTERNATIONAL ECONOMIC INDICATORS
% change from previous year

	Real GDP			Consumer Prices		
	2002	2003[1]	2004[2]	2002	2003[1]	2004[2]
United States	2.2	3.1	4.6	1.6	2.3	1.5
Euro area	0.9	0.4	1.8	2.3	2.1	1.7
United Kingdom	1.7	2.3	2.8	1.3	1.3	1.6
Japan	-0.4	2.7	2.2	-1.0	-0.3	-0.2
World total	1.9	2.5	3.6	2.7	2.4	2.0

[1] Estimates
[2] Forecasts

Sources: Consensus Forecasts; Reuters.

sector, which helped boost business confidence and profitability, was the main factor behind this development. The restructuring was, however, restricted to certain areas of manufacturing, leaving other sectors still burdened by excessive debt. The expansionary fiscal policy pursued by the Japanese authorities supported demand growth, but also boosted the fiscal deficit, which is estimated to have reached 7.4% of GDP by the end of the year. During the second half of 2003, an acceleration in exports brought about by strong external demand reinforced Japanese growth, which was also spurred on by a recovery in private spending. However, deflation still persisted in Japan, with consumer prices continuing to fall and unemployment standing at 5.3% at the end of the year, which is high by Japanese standards.

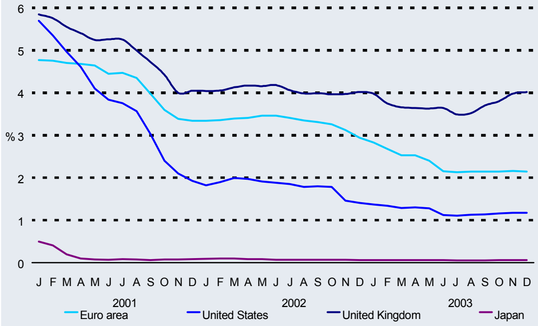
Interest rates and exchange rates

During the first six months of 2003, against a background of continued growth in productivity, the Federal Reserve kept its target for the federal funds rate unchanged at 1.25%. In late June, however, the rate was reduced by 25 basis points to 1% to support economic activity. The risk of deflation led the Federal Reserve to keep its target rate unchanged for the remaining months of 2003. As a result, short-term interest rates in the United States remained low.

Meanwhile, the ECB continued to relax its monetary policy stance, cutting the minimum bid rate on its main refinancing operations by 25 basis points in March and by a further 50 basis points in June. This brought the ECB's minimum bid rate down to 2%. However, the euro's appreciation appeared to offset most of the demand stimulus resulting from lower interest rates.

In February and in July, against a background of sluggish domestic and global growth, the Bank of England lowered its repo rate by 25 basis points. In November, as the British economy picked up and housing prices continued to rise rapidly, it reversed its policy stance, raising the repo rate by 25 points to 3.75%. In early December, the Chancellor of the Exchequer revised the Bank of England's inflation target, setting it at 2% on the basis of the harmonised index of consumer prices, as against the previous

Chart 1.1
SHORT-TERM INTEREST RATES
(monthly averages)



Source: London interbank offered rates (LIBOR).

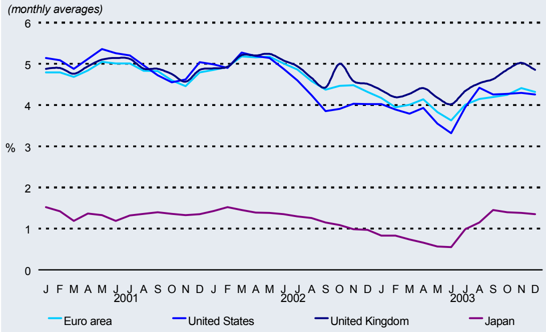
target of 2.5% as measured by the retail price index excluding mortgage payments (RPIX).

The Japanese monetary policy stance remained expansionary throughout the year, with the overnight call rate remaining at virtually zero. Indeed, the Bank of Japan eased monetary policy several times in the course of the year by increasing the target range for the outstanding balance of current accounts held at the Bank of Japan by private financial institutions.

Against a background of declining official rates, there was a general downward trend in short-term market interest rates during the first half of the year, with a stabilisation of rates in the second half (see Chart 1.1). In the United Kingdom, money market interest rates firmed from September onwards, anticipating the Bank of England's decision to raise its repo rate.

Meanwhile, in a context of very low inflation and notable productivity gains, long-term interest rates in the United States declined substantially until June (see Chart 1.2). When the economic pick-up gathered

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

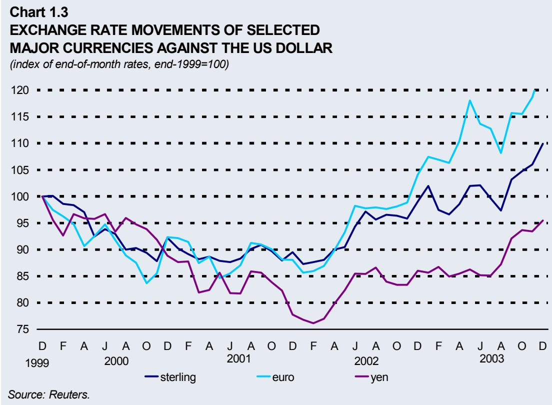


** Long-term interest rates refer to yields on ten-year government bonds.*
Source: Reuters.

momentum in the second half of the year, long-term interest rates rebounded, indicating expectations of a probable tightening of US monetary policy in 2004. Long-term rates elsewhere followed a roughly similar trend, although the expansionary monetary policy adopted by the Japanese monetary authorities kept long-term interest rates there at a very low level.

In 2003, the foreign exchange markets were characterised by the weakening of the US dollar against all other major currencies (see Chart 1.3). Over the year, the US dollar depreciated by 19.8%, 10.5% and 10% against the euro, sterling and the Japanese yen, respectively (see Table 1.2). Mounting concern over the financing of the large and growing US current account deficit was the main factor behind the decline of the US currency against the other major currencies.

During the early months of the year the US dollar lost ground against the euro and sterling on poor expectations for the economy. In late June, however, following the Federal Reserve's decision to ease monetary policy, the US dollar rebounded in relation to the European currencies (see Chart 1.3). This rebound, which extended into July and August, was based on expectations of stronger economic recovery in the US. From September onwards, following the G7 ministerial statement - which encouraged greater flexibility in exchange rates - the US dollar declined almost continuously against all other major currencies, as the Chart shows.



Against the currencies of China and other emerging Asian economies, which maintain quasi-fixed exchange rates against the dollar, the latter remained quite constant throughout the year. Hence, on a trade-weighted basis, the US dollar depreciated by only 9% in 2003.

Meanwhile, the Japanese authorities intervened repeatedly and strongly in the foreign exchange market to prevent the yen from rising significantly against the US dollar. Thus, the yen/US dollar exchange rate remained relatively stable during the first half of 2003. Subsequently, however, the yen strengthened sharply against the US dollar although, as the Chart shows,

Table 1.2
EXCHANGE RATES OF SELECTED MAJOR CURRENCIES AGAINST THE US DOLLAR - 2003

	US$/euro	US$/stg	yen/US$
Closing rate on 31.12.03	1.2570	1.7802	106.92
Closing rate on 31.12.02	1.0496	1.611	118.74
High for the year	1.2570 (31 Dec.)	1.7802 (31 Dec.)	121.29 (11 Feb.)
Low for the year	1.0368 (3 Jan.)	1.5543 (8 Apr.)	106.92 (31 Dec.)
% appreciation (+)/depreciation (-) of the currency vs the US dollar from closing rate on 31.12.02 to closing rate on 31.12.03	19.8	10.5	10.0

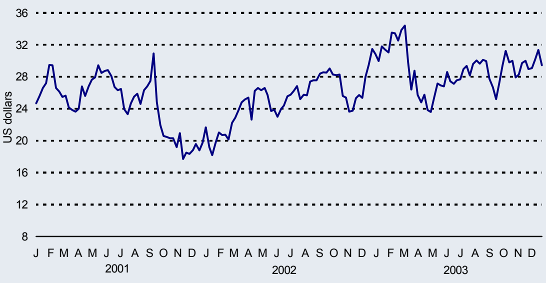
Source: Reuters.

its appreciation became less pronounced in the final months of the year.

Commodities

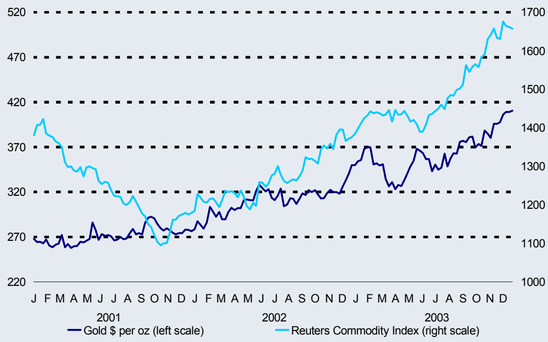
The oil price moved erratically during 2003 (see Chart 1.4). Initially, the price of Brent oil continued on its upward trend following the supply squeeze caused by output disruptions in Venezuela. Before the US-led invasion of Iraq, oil prices hit a yearly peak of \$34.9 per barrel. But prices fell abruptly once the war had started, bottoming at \$22.9 per barrel at the end of April. However, prices subsequently resumed their upward trend, mainly as a result of political uncertainty in Venezuela and Nigeria and relatively low stock levels in the United States. The decision by OPEC to reduce production ceilings at their September meeting caused a spike in prices, which soared above \$31 a barrel for the first time since the beginning of the Iraq war. On average, oil prices during 2003 were up by 0.6% from the previous year's level.

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



* Brent Blend.
Source: Reuters.

Chart 1.5
COMMODITY PRICES



Source: Reuters.

The bull trend in the gold market, which began in 2001, continued through 2003 mainly as a result of the weakness of the US dollar - which makes gold less expensive in terms of other currencies - and geopolitical tensions. On balance, over the year the price of gold rose by 19.6%, reaching \$414.80 per ounce.

Similarly, the Reuters Commodity Index[1] continued to rise, especially during the second half of the year (see Chart 1.5). The rise in commodity prices was supported by improved global economic conditions and strong investor demand, as fund managers and institutional investors sought to diversify their portfolios. Over the year, the commodity price index rose by 21.6%, 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

Monetary policy overview

The Central Bank of Malta's monetary policy strategy aims at price stability by pegging the Maltese lira to three low inflation currencies, the euro, the US dollar and the pound sterling. This arrangement dampens exchange rate fluctuations against the currencies of Malta's main trading partners, thereby limiting imported inflation. It also moderates price and wage increases as it aligns inflation expectations to those abroad. The Bank uses the central intervention rate to influence short-term interest rates in Malta and support the official reserves, which provide the necessary backing to the fixed exchange rate regime.

The Governor is responsible for taking decisions regarding monetary policy. The Monetary Policy Advisory Council, which is made up of the Board of Directors and three senior Bank officials, advises the Governor on matters related to monetary policy. In 2003 the Council met twelve times. The Bank reduced the central intervention rate by 25 basis points following the May, June and September meetings. The central intervention rate thus dropped from 3.75% to 3% at the end of December (see Chart 2.1). The decision to ease the Bank's monetary policy stance was supported by further growth in its net foreign

Chart 2.1
OFFICIAL INTEREST RATES IN MALTA AND ABROAD

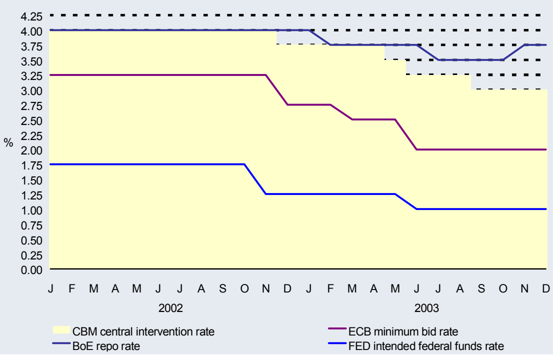
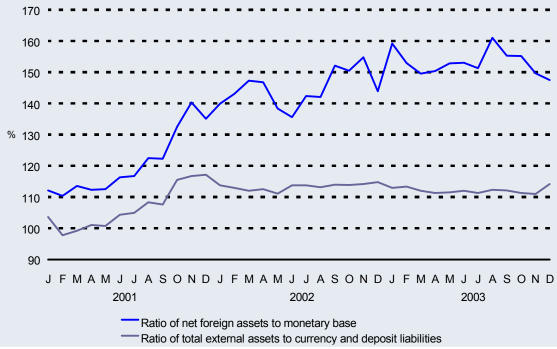


Chart 2.2
TRENDS IN THE CENTRAL BANK OF MALTA'S NET FOREIGN ASSETS



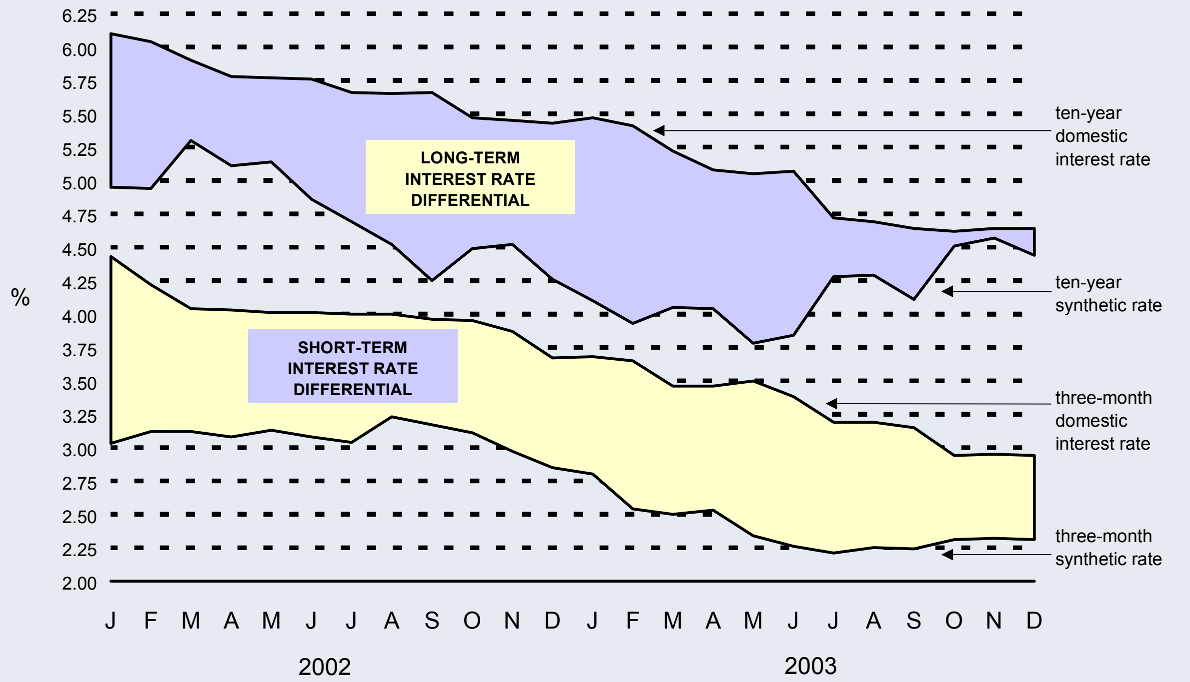
assets and reductions in official interest rates abroad. Monetary policy easing took place in the context of subdued inflation pressures and weak economic growth.

The Bank's net foreign assets continued to expand during 2003 as foreign currency inflows exceeded outflows, and stabilised at around 150% of the monetary base (see Chart 2.2). When compared to the Bank's currency and deposit liabilities the external reserves ratio remained close to 110%, as in 2002.[1]

During the year, major central banks cut official rates in response to low inflationary pressures arising from weak demand in Europe and in the United States.[2] These cuts lowered the short-term synthetic rate, which is a measure of three-month returns on foreign currency alternatives to Maltese lira assets.[3] This enabled the Bank to ease its monetary policy stance while maintaining stable the short-term differential in favour of Maltese lira assets, which stood at 63 basis points at the end of the year. Meanwhile, the difference between yields on ten-year Malta Government stocks and the long-term synthetic rate narrowed from 137 basis points to 20 basis points. Local yields dropped in view of ample liquidity conditions, whereas rates abroad started to increase during the second half of

[1] This ratio remained stable as Government deposits held with the Bank, which are not part of the monetary base, increased.
[2] See the chapter 'The International Environment' in this *Report* for more details.
[3] Short-term and long-term synthetic rates are measured on the basis of three-month Treasury bill benchmark yields and ten-year benchmark Government bond yields in the euro area, the United Kingdom and the United States, respectively. Yields are weighted by each currency's share in the Maltese lira exchange rate basket.

Chart 2.3
DOMESTIC INTEREST RATES AND SYNTHETIC RATES



Sources: Central Bank of Malta; Reuters

the year, in anticipation of possible monetary tightening (see Chart 2.3).

The monetary base[4]

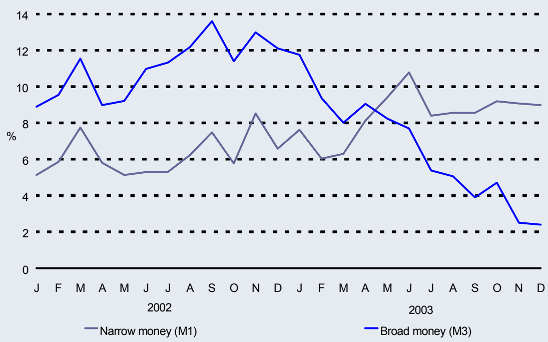
The monetary base, M0, is a measure of the Central Bank of Malta's monetary liabilities and consists of currency in issue and bank deposits with the Bank, excluding term deposits. In 2003 the monetary base expanded by Lm10.5 million, or 1.7%, compared with 8% in the previous year (see Table 2.1). Currency in issue rose by Lm24.2 million, or 5.2%, maintaining the upward trend noted in recent years. In contrast, bank deposits with the Bank contracted by Lm13.7 million, or 9%, reversing part of the previous year's increase.

Table 2.1 also displays the counterparts to the monetary base, with an increase in the Bank's assets contributing to growth in M0 and an increase in its remaining liabilities having the opposite effect. The main counterpart to growth in the monetary base was an increase in the Bank's foreign assets. This was partly due to a sale and repurchase agreement that also boosted its foreign liabilities. A sharp rise in Government deposits held at the Bank dampened growth in M0.

Monetary aggregates[5]

After having picked up in 2002, monetary growth decelerated in 2003, with broad money, M3, expanding

Chart 2.4
MONETARY AGGREGATES
(% change on previous year)



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

[5] In October 2003, the Bank 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 (Sept. 2003): 53-60.

Table 2.1
THE MONETARY BASE AND ITS SOURCES

Lm millions

	2002	2003	Chang Amount	%
Currency in issue	461.2	485.4	24.2	5.2
Bank deposits with the Central Bank of Malta[1]	151.6	137.9	-13.7	-9.0
Monetary base (M0)	**612.8**	**623.3**	**10.5**	**1.7**
Central Bank of Malta assets				
Foreign assets	880.8	935.5	54.7	6.2
Claims on Government	4.3	7.8	3.5	81.4
Fixed and other assets	50.8	49.7	-1.1	-2.2
less:				
Remaining liabilities				
Private sector deposits	1.5	2.8	1.3	86.7
Government deposits	42.9	83.2	40.3	93.9
SDR allocations	6.1	5.7	-0.4	-6.6
Foreign liabilities	7.0	25.5	18.5	264.3
Other liabilities	170.3	164.3	-6.0	-3.5
Capital and reserves	95.3	88.2	-7.1	-7.5

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

by Lm66.8 million, or 2.4% (see Table 2.2). This can be partly explained by a slowdown in economic growth and lower inflation. Lower interest rates on bank deposits also prompted portfolio shifts into alternative assets such as bonds, amid an increase in issues in the capital market. Moreover, a decline in capital inflows from abroad, which had increased substantially in 2002, contributed to the slowdown in monetary growth.

Narrow money, M1, which accounts for just over half of M3, increased by Lm123 million. In contrast with the steady decline in the annual growth rate of M3, the annual rate of growth of M1 accelerated to 9% from 6.6% in the previous year (see Chart 2.4). The pick-up in demand for M1 assets, mainly used for transaction purposes, may reflect the low opportunity cost of holding liquid instruments in an environment of low and falling interest rates.

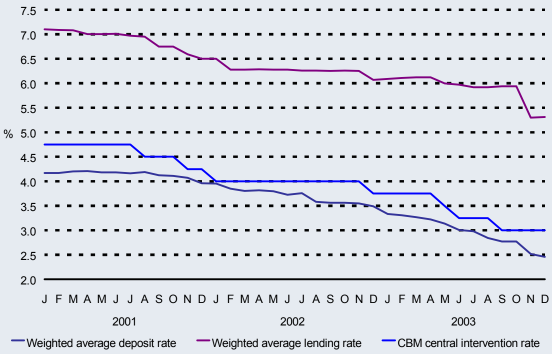
Table 2.2
MONETARY AGGREGATES

Lm millions

	2002 Amount	2002 % Change	2003 Amount	2003 % Change
NARROW MONEY (M1)	**1,367.3**	**6.6**	**1,490.3**	**9.0**
Currency in circulation	436.8	4.3	460.4	5.4
Deposits withdrawable on demand	930.5	7.7	1,029.8	10.7
INTERMEDIATE MONEY (M2)	**2,781.5**	**12.1**	**2,848.2**	**2.4**
Narrow money (M1)	1,367.3	6.6	1,490.3	9.0
Deposits redeemable at notice up to 3 months	27.9	6.1	28.8	3.2
Deposits with agreed maturity up to 2 years	1,386.2	18.3	1,329.2	-4.1
BROAD MONEY (M3)	**2,781.5**	**12.1**	**2,848.3**	**2.4**
of which FCDs[1]	309.7	17.1	320.1	3.4

[1] Foreign currency deposits, including external Maltese lira deposits.

Chart 2.5
RETAIL DEPOSIT AND LENDING RATES



Currency in circulation, which represents just under a third of M1, accelerated, rising by Lm23.6 million, or 5.4%. Deposits withdrawable on demand expanded by Lm99.3 million, or 10.7%. The bulk of this increase stemmed from higher savings deposits, which were up by Lm68.5 million to Lm756.8 million. Demand deposits also rose by Lm30.7 million to Lm273 million.

Intermediate money, M2, which consists of M1 and short-term deposits not withdrawable on demand, expanded by Lm66.7 million, or 2.4%, significantly slower than the 12.1% growth recorded in 2002.[6] Time deposits with an agreed maturity of up to two years fell by 4.1% to Lm1,329.2 million, reversing part of the 18.3% growth in the previous year. This was partly due to a contraction in foreign currency deposits. Meanwhile, savings deposits redeemable at notice up to three months remained stable at around Lm30 million.

In 2003 banks continued to reduce their deposit rates, following the cuts in the central intervention rate. Thus the weighted average interest rate on Maltese lira deposits fell by 103 basis points, from 3.49% to 2.46% (see Chart 2.5). Interest rates on time deposits experienced the largest decline. Although official interest rates remained unchanged after September,

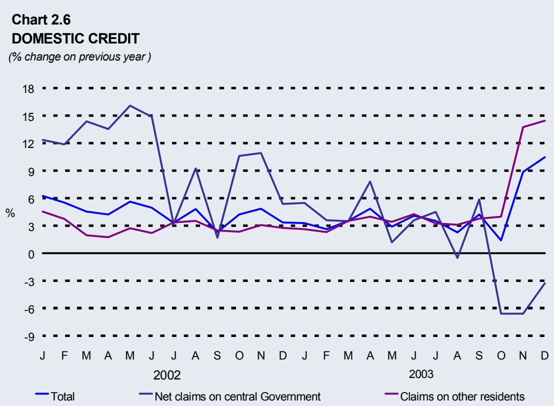
Table 2.3
BROAD MONEY AND ITS COUNTERPARTS

Lm millions

	2002	2003
Broad money (M3)	**2,781.5**	**2,848.3**
Domestic credit	**2,401.5**	**2,652.5**
Net claims on central Government	539.5	521.8
Claims on other residents	1,862.0	2,130.8
Net foreign assets	**1,301.3**	**1,413.7**
Central Bank of Malta	881.6	919.0
Banks	419.7	494.7
less:		
Other counterparts of M3[1]	**921.3**	**1,217.9**
Changes as percentage of broad money in the previous year	%	%
Broad money (M3)	**12.1**	**2.4**
Domestic credit	**3.1**	**9.0**
Net claims on central Government	1.1	-0.6
Claims on other residents	2.0	9.7
Net foreign assets	**8.5**	**4.0**
Central Bank of Malta	4.6	1.3
Banks	3.9	2.7
less:		
Other counterparts of M3[1]	**-0.5**	**10.7**

[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.

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



the weighted average rate on deposits continued to decrease, as lower rates were applied on new deposits.

Counterparts to monetary growth

The slowdown in monetary growth during 2003 was mainly attributable to less rapid growth in the net foreign assets of the banking system, which had expanded vigorously in the previous year. A significant jump in domestic credit was matched by a similar increase in the other counterparts of M3, resulting in a neutral impact on broad money (see Table 2.3).

In contrast with the deceleration noted in recent years, domestic credit expanded at a faster pace in 2003. However, the Lm251 million, or 10.5%, increase was mainly attributable to an extraordinary rise in claims on other residents, as a foreign-owned bank broadened its equity base through an injection of foreign capital and subsequently re-invested the funds in a subsidiary company. On the other hand, the annual growth rate of net claims on central Government continued to decelerate (see Chart 2.6).

Largely as a result of the exceptional rise referred to earlier, claims on other residents expanded by Lm268.8 million, or 14.4%, during 2003. Otherwise, growth in claims on other residents, which had been on a gradual downward trend since 1999, only rose slightly. In 2003, inflation fell faster than nominal lending rates, which resulted in higher real lending rates and these may have dampened underlying credit expansion. Furthermore, firms may have been reluctant to borrow in view of the general uncertainty in the domestic and foreign economic environment.

At the end of 2003 loans and advances (including bills discounted) accounted for around 88% of bank claims on other residents, the rest mainly consisting of bank holdings of corporate debt and equity. Growth in the banks' total loans and advances picked up from 2.6% to 5.5% in 2003, as a result of increased credit to the private sector (see Table 2.4).

Private sector credit expanded by Lm114.5 million, or 7.4%, after growing by 1.4% in 2002. Personal credit

Table 2.4
CLAIMS ON OTHER RESIDENTS[1]

Lm millions

	2002		2003	
	Amount	Annual Growth (%)	Amount	Annual Growth (%)
Claims on the non-bank private sector	1,610.3	1.7	1,899.6	18.0
of which loans and advances	1,551.8	1.4	1,666.3	7.4
Claims on public non-financial companies	251.1	9.7	230.6	-8.2
of which loans and advances	224.0	12.4	206.8	-7.7
Claims on other general Government	0.6	0.0	0.6	-0.6
of which loans and advances	0.6	0.0	0.6	-0.6
TOTAL CLAIMS	**1,862.0**	**2.8**	**2,130.8**	**14.4**
of which loans and advances	**1,776.4**	**2.6**	**1,873.7**	**5.5**

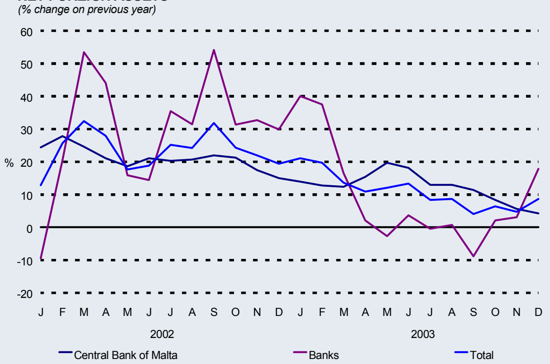
[1] Claims on other residents consist mainly of loans and advances (including bills discounted) and holdings of securities, including equities, issued by the non-bank private sector and public non-financial companies. Interbank claims are excluded.

and lending to the construction industry experienced strong growth, reflecting buoyant activity in the housing market. In contrast, loans and advances to the tourism industry contracted, while lending to other sectors remained weak. Meanwhile, loans and advances to public non-financial companies contracted by Lm17.2 million, or 7.7%, mainly as a result of a drop in outstanding loans to the energy and water industry, and the transport, storage and communications sector.

Net claims on central Government contracted by Lm17.7 million, or 3.3%, during the year under review as an increase in Government deposits held with the Bank outweighed a rise in banks' claims on Government. Proceeds from bond issues and a loan from the Council of Europe boosted Government deposits.[7] At the same time, bank claims on Government expanded, despite a reduction in holdings of Malta Government stocks, as banks added to their portfolio of Treasury bills.

The net foreign assets of the banking system continued to expand during 2003, though at a slower pace than in the previous year, rising by 8.6% to Lm1,413.7 million. The deceleration was observed in the holdings of both the Bank and the rest of the banking system (see Chart 2.7). This mirrored the deterioration in the current account of the balance of payments and a deceleration in capital inflows. Narrower differentials between domestic and foreign interest rates, together with a strong recovery in equity markets abroad, may explain the decline in portfolio inflows. Lower inflows associated with the repatriation of residents' foreign holdings may have also contributed.

Chart 2.7
NET FOREIGN ASSETS
(% change on previous year)



The net foreign assets of the Bank accounted for around two-thirds of the combined holdings of the entire banking system at the end of 2003. The Bank's net portfolio expanded by Lm37.4 million, or 4.3%, over the year, after rising by 15% in the previous year. Most of the increase in the Bank's net foreign assets reflected purchases of foreign exchange from the rest of the banking system, although the proceeds from the Council of Europe loan referred to earlier also contributed significantly.

The net foreign assets of the rest of the banking system expanded by Lm75 million, or 17.9%. A new bank began operating during the year, boosting the net foreign assets of the banking system considerably. Another important factor contributing to the rise in the banks' holdings was the sale of an equity investment by a public corporation to a non-resident firm in August. On the other hand, regular sales of foreign currency to the Bank, as well as the repayment of a foreign loan by a public non-financial company in April, restrained growth in the banks' net foreign assets.

The other counterparts of M3 gained Lm296.6 million, or 32.2%, dampening monetary growth. A large part of this rise was due to the increase in bank capital referred to earlier.

The money market

Activity in the interbank market continued to decline in 2003, with the value of interbank loans falling from Lm98.1 million to Lm96.2 million. This mainly reflected the relatively modest market-based funding requirements of banks in view of their high level of liquidity. Trading continued to be dominated by a few participants. The maturity structure of interbank loans ranged from one to thirty days, with loans of up to fourteen days being the most popular. The interest

[7] For further details see the chapter 'Government Finance' in this *Report*.

rate on one-week loans fell in line with official rates, ending the year at 2.96%, 80 basis points lower than in 2002.[8]

The Treasury continued to resort regularly to the money market to finance its short-term borrowing requirements, issuing a total of Lm732.1 million worth of Treasury bills, up from Lm720.3 million in the previous year.[9] Three-month bills accounted for almost three-quarters of total issues, with the rest having a maturity between six and twelve months. Banks participated more heavily than in 2002, subscribing to over four-fifths of the total amount issued, with other investors purchasing the remainder. Yields in the primary market moved in tandem with the central intervention rate, with the yield on the three-month bill shedding 73 basis points to 2.94% over the year.

Turnover in the secondary market for Treasury bills amounted to Lm142.8 million, up from Lm123.6 million in 2002, reflecting strong demand by banks. On the other hand, the value of transactions involving the Bank fell from Lm53 million to Lm39.3 million, with the Bank's purchases exceeding sales at Lm33.6 million and Lm5.7 million, respectively.

The capital market

Net issues of long-term debt securities increased to Lm121.1 million in 2003, from Lm47.5 million in the previous year. As Table 2.5 indicates, there was a substantial rise in Government issues whereas net corporate issues declined. The increase in Government long-term borrowing followed the deterioration in its fiscal position, while the reduction in private sector issues may be attributable to the slowdown in economic activity. Overall, demand for debt securities was strong in 2003 as falling bank deposit rates induced portfolio shifts towards bonds.

Government resorted to the capital market for financing in February, July and November, issuing five different stocks with a combined value of Lm148.8 million. Since Lm48.9 million worth of stocks matured during the course of the year, net issues of Government stocks in the primary market amounted to Lm99.9 million, whereas the Government had made no net issues in the market in 2002. Terms to maturity ranged between

Table 2.5
ISSUES OF LONG-TERM DEBT SECURITIES[1]

Lm millions

	2001	2002	2003
Government			
Total issues [2]	153.8	66.5	148.8
Redemptions	53.8	66.5	48.9
Net issues	100.0	0.0	99.9
Corporate			
Total issues	4.5	50.5	24.7
Redemptions	30.0	3.0	3.5
Net issues	-25.5	47.5	21.2
Total net issues	**74.5**	**47.5**	**121.1**

[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 Lm125,000 in 2001, Lm176,200 in 2002 and Lm66,700 in 2003.

Sources: Central Bank of Malta; The Treasury

[8] As no interbank deals in this maturity took place in December 2002, the official fixing rate was used instead.

[9] The Treasury also bought back Lm6 million of the total amount issued during the year.

Table 2.6

SECONDARY MARKET TRADING IN GOVERNMENT STOCKS

Lm millions

	2001	2002	2003
Central Bank of Malta purchases	10.3	0.2	5.4
Central Bank of Malta sales	8.8	0.9	0
Other deals[1]	114.4	43.7	42.9
Total	**133.5**	**44.8**	**48.3**

[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; Malta Stock Exchange

seven and twenty years, whereas coupon rates offered ranged from 4.8% to 5.9%. Households purchased just under half of the total amount issued while collective investment schemes and insurance companies accounted for most of the rest. In contrast, banks took up less than 10%. As a result, the non-bank sector overtook the banking sector as the largest holder of long-term Government securities.

Net corporate bond issues amounted to Lm21.2 million, down from Lm47.5 million in the previous year. Four firms, two of which operate in the tourism industry, issued bonds with terms to maturity of between five and ten years and coupon rates ranging from 5.75% to 6.8%. Response from investors was strong and all issuing companies exercised their over-allotment option and increased bond offerings. These bonds were subsequently listed on the Malta Stock Exchange (MSE).

Following a steep decline in 2002, turnover in the secondary market for Government bonds recovered slightly to Lm48.3 million. The Bank's involvement in the secondary market was minimal, so that most deals were between other investors (see Table 2.6). Trading was not widely spread across securities, with investors preferring the longer end of the market. Thus, bonds having a term to maturity of ten years or more accounted for over half of the total volume. As regards the secondary market for corporate bonds, turnover remained largely unchanged at Lm10.2 million, despite the increase in the number of listed bonds referred to earlier. Turnover was spread quite evenly across a broad range of securities.

Yields on Government bonds traded in the secondary market continued to decline, as developments in the money market were slowly transmitted to the capital market. Strong demand drove Government bond prices higher, lowering yields. The benchmark rate for the 10-year bond declined by 77 basis points to 4.66%. Yields stabilised in the latter months of the year, suggesting that market participants were not envisaging further cuts in domestic interest rates

Chart 2.8
GOVERNMENT BOND YIELDS
(end of month)

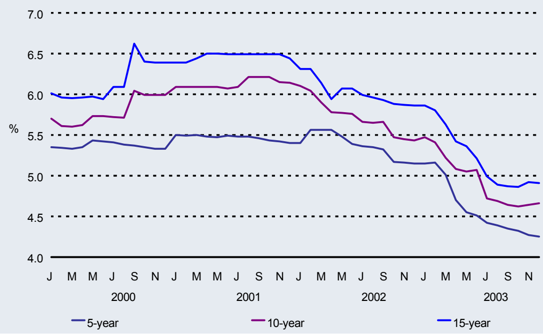


Chart 2.9
MALTA STOCK EXCHANGE SHARE INDEX
(end of month)

Source: Malta Stock Exchange

(see Chart 2.8). Yields on corporate bonds traded in the secondary market ended the year generally lower.

Turnover in the equity market fell to Lm15.2 million, from Lm20.5 million in the previous year, with trading mainly concentrated in the largest three equities listed on the Exchange. The MSE share index started to recover towards the end of last year in contrast with the drops recorded in recent years (see Chart 2.9). This increased by 13.6% to 2,125.8 in 2003. Gains were not evenly spread, however, and some equity prices fell.

3. Output, Prices and Employment

The Maltese economy continued to grow at below its potential rate in 2003. This can be primarily attributed to the weak performance of Malta's main trading partners, particularly the euro area economies. These expanded more slowly during 2003, reducing the possibilities of turnover growth for Malta's export-oriented industries, which also faced increasing competition from emerging market economies. This led many enterprises to speed up their restructuring, resulting in redundancies in both manufacturing and tourism. As a result, disposable income grew only modestly, and private consumption expanded at a slower pace than in 2002. The growth rate would probably have been even lower had aggregate demand not been sustained by fiscal expansion during the first half of the year.

Domestic demand appeared to slow down significantly during the second half of the year, which saw a sharp turnaround in the fiscal stance and a further rise in unemployment. By the end of the year, the number of persons on the unemployment register had risen by 8.8% over its year-ago level, reaching 8,175 even though the Employment and Training Corporation (ETC) reported a higher number of job vacancies than in 2002. This suggests a growing mismatch between the skills required by industry and those available in the labour market, which in turn may explain why wage inflation remained relatively unchanged in 2003 despite the rising number of job seekers. The resulting rise in unit labour costs was the main reason why core inflation remained close to 2%, in spite of a significant drop in the twelve-month moving average rate of inflation.

Aggregate demand[1]

Central Bank of Malta estimates indicate that real GDP grew by 0.7% in 2003, down from 1.7% a year earlier (see Table 3.2). During the first half of the year, domestic demand expanded sharply, partly driven by a sharp widening of the fiscal deficit, but in the second half private and public consumption was estimated to have slowed down significantly. Activity was then sustained by gross fixed capital formation and a slight improvement in exports.

Table 3.1
GDP AT CONSTANT 1995 PRICES BY CATEGORY OF EXPENDITURE

Lm millions

	1999	2000	2001	2002	January-September 2002	January-September 2003
Private consumption expenditure	829.0	890.1	905.1	928.1	697.5	704.6
Government consumption expenditure	240.6	253.6	261.2	267.5	201.4	217.3
Gross fixed capital formation	320.9	377.2	335.2	290.5	208.2	255.7
Inventory changes	8.6	29.9	-34.9	-57.7	-46.7	-58.6
Domestic absorption	**1,399.1**	**1,550.8**	**1,466.6**	**1,428.4**	**1,060.4**	**1,119.0**
Exports of goods & services	1,230.7	1,299.4	1,236.3	1,273.6	950.1	935.2
Imports of goods & services	1,285.6	1,419.7	1,289.1	1,263.8	938.5	978.8
Balance of trade in goods and services	**-54.9**	**-120.3**	**-52.8**	**9.8**	**11.6**	**-43.6**
GROSS DOMESTIC PRODUCT	**1,344.2**	**1,430.5**	**1,413.8**	**1,438.1**	**1,072.1**	**1,075.5**

Source: National Statistics Office

[1] 2003 GDP data are Central Bank of Malta estimates, largely based on trends shown by official data during the first nine months of the year. Inventory changes are assumed to have remained relatively stable as a percentage of GDP at about their 2002 level, thus not affecting economic growth significantly.

Table 3.2
YEAR-ON-YEAR % CHANGES IN GDP AT CONSTANT 1995 PRICES

%

	1999	2000	2001	2002	2003 Central Bank of Malta estimates
Private consumption expenditure	6.1	7.4	1.7	2.5	1.3
Government consumption expenditure	-0.6	5.4	3.0	2.4	6.4
Gross fixed capital formation	4.0	17.5	-11.1	-13.3	16.2
Domestic Absorption	**5.8**	**10.8**	**-5.4**	**-2.6**	**5.0**
Exports of goods & services	8.2	5.6	-4.9	3.0	-1.1
Imports of goods & services	10.1	10.4	-9.2	-2.0	3.7
GROSS DOMESTIC PRODUCT	**4.1**	**6.4**	**-1.2**	**1.7**	**0.7**

Sources: Central Bank of Malta estimates; National Statistics Office.

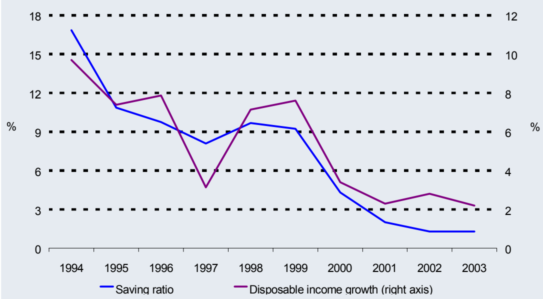
As in 2002, inflation continued to decline, with the overall GDP deflator going up by 1% compared with the 1.1% rise recorded in the previous year. This deceleration mainly reflected the continued easing in consumer price inflation, but a deterioration in Malta's terms of trade, caused by a sharper drop in export prices than in import prices, also contributed.

Consumption expenditure

Private consumption expenditure is estimated to have grown by 1.3% in real terms in 2003. The increase was mainly concentrated in the first quarter, possibly fuelled by a substantial rise in Government expenditure and a significant increase in employment income in manufacturing and public administration. Private consumption then slowed down as the influence of these factors grew progressively less important. While overall consumption growth decelerated when compared with 2002, there were significant differences in its composition compared with the previous year. In particular, expenditure by Maltese tourists abroad grew substantially, in contrast with the decline observed a year earlier. On the other hand, domestic sales by local manufacturing firms fell, halting the upward trend that had characterised previous years. Imports of consumer goods rose at virtually the same pace as in 2002, even though the amount of consumer imports intended for re-export shrank, indicating a rise in domestic demand for imported consumer goods. Consumption of telecommunications, whose share of overall household expenditure continued to increase, also remained on an upward path, although its rate of growth slowed down considerably as the market for some services, particularly telephony, appeared to have reached saturation stage.

In 2003 private consumption growth mirrored the increase in disposable income. As a result, the household saving ratio, which had fallen for four consecutive years, stabilised at 1.3% (see Chart 3.1). Disposable income is estimated to have grown by 2.2% in nominal terms in 2003, down from 2.8% in the preceding year. Property income, the second most important component of household earnings, contracted over the year on account of low interest rates. Conversely, employment income grew by a slightly higher margin than in 2002. This acceleration was concentrated in the first half of the year, after which the increase in the number of the unemployed

Chart 3.1
HOUSEHOLD SAVING RATIO* AND DISPOSABLE INCOME



* Household saving as a % of disposable income

Sources: National Statistics Office; Central Bank of Malta estimates; Ministry of Finance & Economic Affairs.

dampened the overall rise in the wage bill. Disposable income growth in 2003 was also dampened by a marginal increase in the share of direct taxes out of gross household income, which in turn reflected the progressive structure of income tax.

Higher Government consumption expenditure contributed significantly to the overall expansion in the volume of economic activity during 2003 (see Table 3.2). For a large part of the year, Government current expenditure was expanding at a very rapid pace. From the third quarter onwards, however, Government spending slowed and as a result the overall annual growth in Government consumption fell to 6.4%.

Gross fixed capital formation

After having declined substantially for two consecutive years, gross fixed capital formation rose in 2003. To a large extent, this increase reflected the fact that in 2002 gross fixed capital formation was significantly depressed by the sale of aircraft by the national airline, entailing a disinvestment equivalent to some 2.5% of GDP. There also was a slight underlying rise in investment during 2003, reflected in an increase in imports of capital goods. Gross fixed capital formation in the manufacturing industry grew marginally, on the back of investment outlays made by enterprises in the food and beverages and the toys and games sectors which offset slight cutbacks in investment by other sub-sectors of manufacturing. Construction activity remained buoyant, although this was entirely attributable to higher expenditure on public sector projects. These were mainly related to the new hospital, although higher outlays on the infrastructure also contributed.

External demand and supply

Malta's external deficit on goods and services is estimated to have widened in 2003. This development primarily reflected the previous year's sale of aircraft, which depressed the level of re-exports of goods for 2003 relative to the previous year. In turn, the fact that the national airline then leased its fleet led to higher service payments abroad in 2003. Both visible and invisible exports increased on a year-on-year basis, mainly reflecting a recovery in exports of electronics and transport equipment and in gross tourism earnings – which rose despite a drop in tourist arrivals. Profit margins were, however, depressed by a further drop in selling prices, while tourism activity slowed down somewhat during the second half of the year. Meanwhile, re-exports fell after having risen significantly during 2002, even taking into account the sale of aircraft.

Imports of goods and services expanded in real terms (see Table 3.2). An increase in investment in machinery contributed to higher imports of capital goods, while imports of consumer goods rose at a faster pace than overall private consumption, possibly in response to further cuts in import levies. Imports of industrial goods also grew in 2003, although, as mentioned previously, the terms of trade - the ratio of export to import prices - are estimated to have worsened.

The labour market[2]

Labour market activity contracted during the twelve months to September 2003. Data compiled by the ETC and the Labour Force Surveys (LFSs) carried out by the National Statistics Office (NSO) show a decline

Table 3.3

LABOUR MARKET: MAIN INDICATORS

number of persons

	September	
	2002	2003
Labour supply	145,241	144,922
Males	103,854	103,233
Females	41,387	41,689
Registered unemployed	7,520	7,942
Males	6,074	6,265
Females	1,446	1,677
Unemployment rate (%)	5.2	5.5
Gainfully occupied	137,721	136,980

Source: Employment and Training Corporation

[2] At the time of writing, data on the labour supply and the gainfully occupied population were only available for the period up to September 2003.

in the gainfully occupied population, an increase in the number of unemployed persons and a rise in the unemployment rate. LFS results, however, suggest that the changes were larger than indicated by ETC data. This may be due to the fact that the two sets of data are based on entirely different concepts and procedures. ETC statistics, shown in Tables 3.3 and 3.4, are administrative data compiled according to definitions set by local legislation on employment and social security benefits. On the other hand, the LFSs are surveys based on definitions set by the International Labour Organisation and Eurostat, the European Union's statistical agency. This makes LFS data comparable with the labour market statistics of other countries. The LFSs also include information on part-time employment, which is not captured in the ETC data.

The decrease in the gainfully occupied population was mainly due to job losses in private direct production, with manufacturing firms in the footwear and clothing sub-sector reducing their complement sharply during the twelve months to September 2003 (see Table 3.4). This was the result of restructuring programmes in export-oriented firms, which accentuated the effects of the global economic slowdown on the Maltese export sector. Public sector employment also declined significantly, reflecting both a reduction in the number of employees in Government departments and a shift of employees from the public

Table 3.4
GAINFULLY OCCUPIED BY SECTOR

number of persons

	September					
	2002			2003		
	Public	Private	Total	Public	Private	Total
Direct production	**2,814**	**38,025**	**40,839**	**2,771**	**36,818**	**39,589**
including:						
Footwear & clothing	0	2,882	2,882	0	2,137	2,137
Construction	133	6,853	6,986	133	6,844	6,977
Electronics, appliances & supplies	0	6,006	6,006	0	6,052	6,052
Food	19	3,044	3,063	19	3,027	3,046
Agriculture[1]	0	2,219	2,219	0	2,292	2,292
Transport equipment[2]	689	1,822	2,511	689	1,893	2,582
Other[3]	1,973	15,199	17,172	1,930	14,573	16,503
Market services	**12,922**	**50,954**	**63,876**	**12,494**	**52,177**	**64,671**
including:						
Wholesale & retail	0	15,593	15,593	0	15,993	15,993
Hotel & catering	455	9,144	9,599	452	9,132	9,584
Community & business	5,229	11,614	16,843	4,979	12,615	17,594
Transport	2,393	5,171	7,564	2,381	5,115	7,496
Malta Drydocks	1,971	0	1,971	1,924	0	1,924
Banks & financial institutions	454	3,598	4,052	451	3,588	4,039
Other	2,420	5,834	8,254	2,307	5,734	8,041
Temporarily employed	**279**	**771**	**1,050**	**293**	**692**	**985**
Government[4]	**31,956**	**0**	**31,956**	**31,735**	**0**	**31,735**
Gainfully occupied	**47,971**	**89,750**	**137,721**	**47,293**	**89,687**	**136,980**

[1] Includes fishing.

[2] Excluding Malta Drydocks.

[3] Other manufacturing and directly productive industries, including textiles.

[4] Includes Government departments, Armed Forces, Revenue Security Corps and airport security personnel.

Source: Employment and Training Corporation

Chart 3.2
LABOUR MARKET PARTICIPATION RATES

Source: National Statistics Office

to the private sector as a result of the privatisation of Malta International Airport (MIA).

Demand for labour in market services continued on the upward trend observed during recent years. Jobs lost in communications and recreation services were more than offset by gains in the wholesale and retail trades and in the community and business sub-sector. The demand for jobs in the tourism sector, which was characterised by a serious decline in 2002, remained broadly stable in 2003.

The unfavourable economic conditions of 2003 caused both the employment rate and the activity rate to decline from their previous year's level (see Chart 3.2).[3] While the employment rate was lower for both males and females, the activity rate fell for males but increased marginally in the case of females. This reflected the continued increase in the number of women seeking formal employment. The LFS data indicate that the female unemployment rate rose more sharply than that of males, although the number of women taking up part-time or reduced-hours employment increased further. The decline in female employment mainly involved plant and machine operators and assemblers affected by factory closures, while the number of women professionals rose significantly, narrowing the gender pay gap. The drop in the male activity rate mainly reflected the increasing use of early retirement schemes, particularly as many men who availed themselves of these schemes chose to stay out of the labour force. These schemes, which for many sectors constitute an integral part of restructuring, may also partly explain the increase in the number of self-employed men during the twelve months to September 2003.

Unemployment

In 2003 there was an increase in unemployment, with the number of persons registering as unemployed with the ETC edging up to 5.5% in September from 5.2% a year earlier, while over the same period the LFS unemployment rate rose by 1.8 percentage points to

Table 3.5
UNEMPLOYMENT BY SKILL CATEGORY

number of persons

	2003	December 2003 over 2002	December 2002 over 2001
All categories	**7,856**	**654**	**95**
Manual			
Unskilled	1,839	105	(1)
Skilled	397	61	(1)
Other	720	108	31
Non-Manual			
Skilled services	1,845	133	(3)
Technological & professional	370	74	33
Other	2,685	173	36

Source: Employment and Training Corporation

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

8.2%. As noted earlier, the difference between ETC and LFS measures of unemployment is due to differences in the definitions used. The ETC definition includes only those persons who register as unemployed, while the LFS definition includes all persons actively seeking employment. This difference has more significant implications for the female unemployment rate, which according to the LFS data stood at 9.7%, compared with 7.6% for males. The LFS female unemployment rate was higher than that reported by the ETC, which stood at 4%. Meanwhile, the ETC data indicate that the male unemployment rate stood at 6.1%.

At the end of December 2003 the number of persons on the unemployment register was up by 654 from the previous year's level (see Table 3.5).[4] A breakdown of the unemployed by skill category shows that while all categories were affected, other non-manual workers accounted for over a quarter of the increase. However, skilled workers, especially those in the clerical and supervisory grades, also contributed significantly to the increase in the number of the registered unemployed, while unskilled workers and other manual workers each represented around 16% of the increase. These developments reflect the redundancies in the footwear and clothing industries mentioned above, but also include a number of welders and construction workers. The increase in the number of unemployed professional and technical workers was less significant and may reflect the influx of new graduates not yet absorbed by the market at the end of the year.

The proportion of the unemployed who had been looking for a job for over a year stood at 38.2% at the end of December, while 45.4% had been actively seeking work for less than five months. Both these proportions are higher than those registered in the previous year. A breakdown of unemployment by age distribution indicates that 68.5% of job seekers were under 35 years of age, and that the number of unemployed in the 35 to 44 age bracket declined during the year.

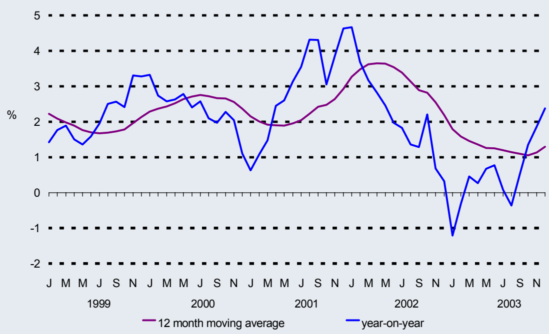
During the twelve months to September 2003 the number of advertised job vacancies rose by 7.5% to 7,548. The ETC, however, only managed to fill 45% of these vacancies out of the pool of registered unemployed - the same proportion as in 2002. About a third of these placements were in the public sector, while the number of private sector vacancies that were filled declined. The fact that the agency submitted nearly 14 registrants for every vacancy but was able to fill less than half of them, suggests a substantial mismatch between the skills available in the unemployment pool and the requirements of the economy. This may reflect the fact that many of the unemployed were seeking manual employment at a time when both the manufacturing sector and the tourism industry were shedding workers, resulting in an increase in structural unemployment.

Prices and wages

Retail prices

In 2003 the NSO introduced a new Retail Prices Index (RPI) series based on the Household Budgetary Survey (HBS) for the year 2000. The HBS is carried out approximately every five years, primarily for the purpose of updating the weights of the components of the RPI in line with evolving household expenditure patterns and changes in consumer preferences and tastes. The new series, which takes December 2002 as its base, indicates that the downward trend in inflation observed in 2002 continued through most of 2003.[5] The twelve-month moving average rate of

Chart 3.3
RETAIL PRICE INFLATION



Source: National Statistics Office

[4] At the time of writing, data on the number of registered unemployed were available up to December 2003.
[5] The official inflation rate in Malta is calculated by taking percentage changes in the 12-month moving average of the RPI.

inflation, which stood at 2.2% in December 2002, dropped to a record low of 1.1% in October before edging up to 1.3% in December 2003 (see Chart 3.3). Similarly, during the first nine months of 2003, the year-on-year inflation rate, which is a more timely indicator of price movements, was characterised by very low readings which were always less than 1% and which in three instances were even negative. During the last quarter, however, year-on-year inflation rose sharply to end the year at 2.4%, from 0.3% at the end of the previous year.

The decline in the official inflation rate in 2003 was mainly driven by the clothing and footwear sub-index, which accounts for over 8% of the overall weight of the RPI basket. This sub-index registered a sharp decline through most of the year, possibly due to differences in the measurement frequency between the new RPI and the previous one. During the twelve months to December, the prices of clothing and footwear were, on average, down by 6.4% from the previous year's level.

Lower inflation in the beverages and tobacco and recreation and culture sub-indices also contributed to the decline in the headline inflation rate in 2003 (see Table 3.6). Smaller price increases in the beverages and tobacco sub-index were due to drops in the prices of off-sale alcoholic and non-alcoholic beverages offsetting the increase in cigarette prices that followed the Budget for 2004. A fall in the prices of audio-visual equipment was responsible for the low inflation in the recreation and culture sub-index.

The trends observed in the three sub-indices mentioned above contrasted with higher inflation in the transport and communication, food and other goods and services sub-indices. Sharper increases in the transport and communications sub-index were mainly due to higher prices of air transport services and diesel. The price of diesel, which is linked to international market prices, was on average up by 13% during the year. Meanwhile, the food sub-index, which accounts for over 23% of the overall weight of the RPI basket, rose on average by 2.3% in 2003. This was mainly due to higher prices of fresh fruit and vegetables, which reflected a decline in the volume of agricultural produce passing through the organised markets that led to a 4.8% rise in their wholesale value. The other goods and services sub-index registered an average increase of 4.2% during the twelve months to December 2003, compared to a 1.7% increase in the preceding year. Higher prices of non-durable household goods and jewellery items were mainly responsible for this rise.

Imported inflation, which reflects developments in inflation in Malta's main trading partners and the exchange rate movements of the Maltese lira, is estimated to have remained relatively stable in 2003. The depreciation of the lira against the euro during the year offset the slight decline in inflation in the euro area, Malta's main source of imports.

Table 3.6
INFLATION RATES OF COMMODITY SECTIONS IN THE RPI
12- month moving average (% changes)

	Dec. 2002	Dec. 2003
Food	1.7	2.3
Beverages & tobacco	7.4	2.7
Clothing & footwear	-1.2	-6.4
Housing	3.2	2.2
Water, electricity, gas & fuels	5.1	0
Household equipment & house maintenance	0.2	-1.0
Transport & communication	1.5	2.6
Personal care & health	3.1	3.3
Recreation & culture	3.4	0.4
Other goods & services	1.7	4.2
All items	**2.2**	**1.3**

Source: National Statistics Office

Despite the decline in the twelve-month moving average inflation rate in 2003, the Bank's measure of underlying, or core, inflation remained broadly unchanged at around 2%. This measure of inflation is compiled on the basis of those sub-indices that show persistent price increases over the years, and is determined mainly by the trend rise in foreign prices and in domestic wages. As a result, supply side shocks or one-off fluctuations in prices, such as those seen in the clothing and footwear sub-index in 2003, do not affect it to the same extent that they affect the official inflation rate. The stability of core inflation during 2003 reflected the fact that wage inflation (see below) remained relatively unchanged during 2003 while imported inflation also hovered at around the 2002 level.

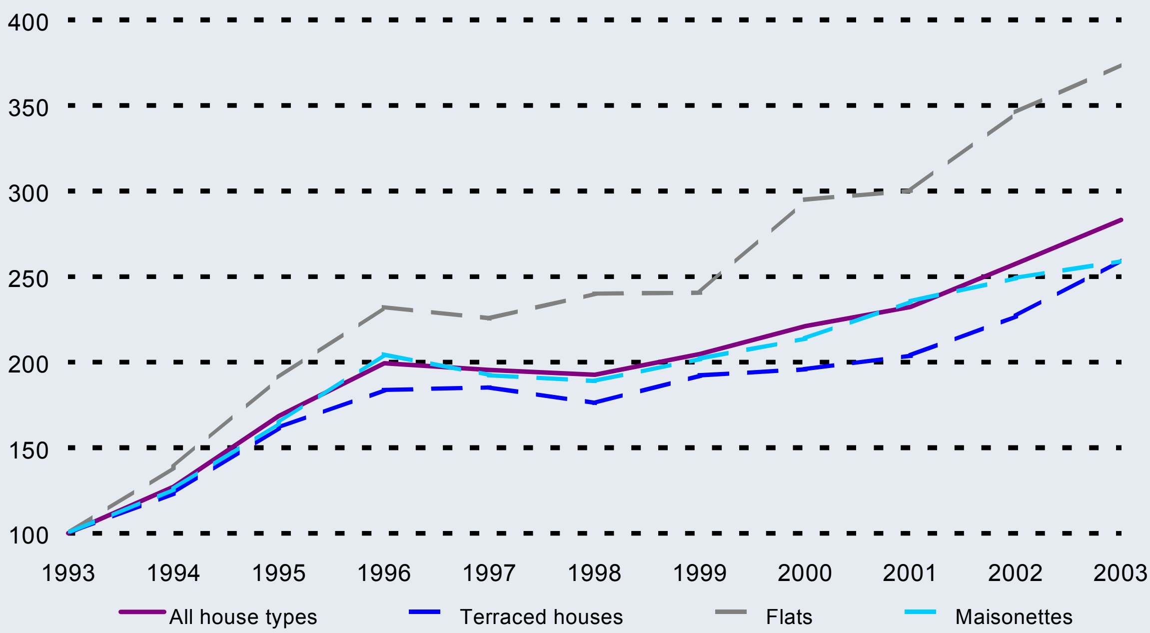
Real estate prices

Real estate prices, together with the prices of other assets held by households, affect private consumption through the wealth effect and may be indicators of future developments in output and demand. Furthermore, higher house prices often contribute to rapid growth in household debt, with implications for the stability of the financial sector. For these reasons, and also because developments in real estate prices are of interest *per se*, the Bank monitors house price movements on a quarterly basis through an index of asking prices, stratified by type and locality.

Chart 3.4 illustrates trends in the average asking price of dwellings (including finished terrace houses and flats and maisonettes in shell form) over the eleven years to 2003. This measure suggests that house prices doubled between 1993 and 1996, after which a short period of relative stability ensued. The upward trend resumed in 1999 although at a more moderate pace than in the early nineties. The rise in house prices in 2003 is estimated at around 10%, roughly the same as that recorded in 2002. Prices of all property types rose during the year under review, with flats and terraced houses showing the sharpest increases.

House price inflation in 2003, which was more rapid than consumer price inflation, may have been fuelled by the relative unattractiveness of financial assets,

Chart 3.4
ADVERTISED REAL ESTATE PRICES
(1993=100)



Sources: Central Bank of Malta estimates; Local press.

as interest rates continued to fall and the capital market remained weak. This, combined with the inflow of funds from abroad under the Investment Registration Scheme, may have induced investors to purchase real estate for investment purposes instead.[6]

Wages

Central Bank of Malta estimates, based on average weekly wage data gathered from collective agreements, suggest that overall wage inflation in 2003 was 3.4% for all workers and 3.5% when Government employees are excluded. They also indicate that unskilled workers obtained the largest, and skilled workers the smallest wage increases. However these estimates exclude overtime pay, production bonuses and any other allowances or income in kind, all of which also add to total labour costs.

While the Bank's estimate of wage inflation in 2003 was roughly at the same level as in 2002, it was higher than price inflation and exceeded the rate of productivity growth. However, these estimates focus only on the wages of unionised workers covered by collective agreements, roughly less than half of the gainfully occupied population, and may not be representative of developments in the non-unionised sectors of the economy (see Table 3.5). LFS results, which capture the overall change in remuneration across the entire labour market, show a smaller increase of 1.6%. However, in the light of evidence showing that a skills mismatch exists, this may indicate that employees with the required skills are better able to exert pressure on employers and make higher wage claims, even with rising unemployment.

The higher rate of increase in wages estimated by the Bank may also reflect the inclusion of collective agreements negotiated in 2000 when the economy was growing at a faster pace. These agreements would have locked in wage rises for three years, thus delaying the slowdown in wage increases for the covered employees. There are indications that the wage rises agreed upon in more recent collective agreements were smaller.

Unit labour costs, defined as the cost of labour compensation per unit of real output, are a widely used measure of competitiveness. Data for the first three quarters of 2003 indicate that while employment income per worker rose by 3.3% during the year, productivity (as measured by real output per person in employment) remained virtually unchanged, resulting in a 3.5% increase in Malta's overall unit labour cost.

Table 3.7
ESTIMATED CHANGE IN AVERAGE WAGES[1]

%

Category	1999	2000	2001	2002	2003
Unskilled	6.4	1.4	6.3	2.8	3.7
Skilled	5.5	2.2	7.0	4.3	3.1
Clerical	7.5	1.8	7.6	4.2	3.2
Administrative[2]	2.9	2.8	8.1	2.1	3.4
Average wage across categories	**6.0**	**1.9**	**7.0**	**3.6**	**3.4**
excluding civil service employees	**7.1**	**2.2**	**5.3**	**3.8**	**3.5**

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

[6] The Investment Registration Scheme allowed Maltese residents who had undeclared investments abroad to regularise their position by declaring them and paying a one-time fee. Repatriation was optional.

Table 3.8
MANUFACTURING PERFORMANCE - SELECTED INDICATORS[1]

Lm millions

	January- September		
	2001	**2002**	**2003**
Change in exports	**-100.1**	**-24.1**	**25.6**
of which:			
Radio, TV, telecoms, etc [2]	-122.2	-33.3	22.5
Others	22.1	9.2	3.1
Change in local sales	**9.9**	**10.2**	**-1.9**
of which:			
Food and beverages	6.0	1.5	4.0
Others	3.9	8.7	-5.9
Change in net investment	**-28.2**	**3.3**	**0.2**
of which:			
Radio, TV, telecoms, etc [2]	-30.6	-0.7	-0.8
Others	2.4	4.0	1.0

[1] Based on a survey of representative firms conducted by the National Statistics Office.

[2] Mainly comprising firms producing electronic components.

Source: National Statistics Office.

Sectoral analysis

Manufacturing[7]

During the first nine months of 2003, value added in the manufacturing industry rose to Lm246.5 million, from Lm242.8 million in the previous year. This increase was mostly generated by higher employment income and occurred despite a significant decline in the number of people employed in manufacturing, especially in the clothing and leather sub-sectors.

Turnover reached Lm761.8 million, up by 3.2% from the year-ago level, compared to the 1.9% decline registered in 2002. Underlying this increase in activity were exports by the radio, TV and telecoms sub-sector as international demand for electronic components picked up following the fall experienced in 2001. While almost the entire increase came from exports of semiconductors, other sub-sectors of manufacturing also reported a positive export performance. This was particularly true of manufacturers of other transport equipment, which more than doubled their export sales. By contrast, exports of clothing and leather goods contracted by Lm8.9 million when compared to the same period in the previous year, as local firms in this sub-sector continued to face stiff competition by other low-cost producers abroad.

Domestic sales of locally-manufactured goods declined by 1.1% when compared to the same period last year. Furniture manufacturers, in particular, reported significantly lower sales to the domestic market following the complete lifting of levies on imported furniture in October 2002. This prompted certain small and medium-sized firms in the industry to diversify into the importation of foreign-made furniture. Reduced domestic sales were also recorded by firms in the clothing and textile industry. On the other hand, manufacturers of food and beverages, as well as those making metal products, reported strong growth in sales to the local market.

Despite the increase in activity, employment in manufacturing continued to decline. This mainly reflected the closing down of a number of firms in the labour-intensive clothing and leather sub-sectors, although lay-offs were also registered in the plastic

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

and rubber products sub-sector. These developments reflect the ongoing transformation of the manufacturing industry in Malta in response to globalisation, with employment shifting from low-paying labour-intensive industries to higher value added ones, such as electronics, which require superior skills and command higher wages. In spite of the decline in employment in manufacturing and weak economic conditions, however, the sector's wage bill for the nine months to September reached Lm92.8 million, up by 5% from the previous year's level. Significant increases in wages were reported by firms in the electronics and in the printing and publishing sub-sectors, as well as by firms manufacturing transport equipment. On the other hand, the wage bill of the clothing and leather sub-sectors declined considerably.

As a result of these developments, weekly earnings per employee rose by 9.7% during the first nine months of 2003, reflecting higher rates of remuneration in the chemicals, electronics, printing and publishing, electrical machinery, medical and precision equipment and transport equipment sub-sectors. This increase in wages was slightly higher than the rise in turnover per employee, which grew by 7.8% during the same period.

Net investment was flat when compared to the same period in 2002 (see Table 3.8). This was mainly due to lower investment in the first quarter as a result of the uncertainty prevailing in the run-up to the EU referendum and the general elections. During the second quarter investment picked up as a large firm in the food and beverages industry invested in new technology. This recovery did not continue into the third quarter, however, as firms in the chemicals and in the printing and publishing sub-sectors reported lower net investment. Furniture manufacturers, on the other hand, reported higher capital expenditure as they strove to modernise their operations so as to compete in the liberalised market.

Tourism

In 2003 the global tourism industry suffered significant setbacks as the war in Iraq, the SARS epidemic and the general economic slowdown discouraged travelling. These developments had an adverse impact, with tourist arrivals in Malta marginally down from the previous year's level. Thus, the recovery observed in the first half of the year stalled in the second half, when the anticipated increase in arrivals failed to materialise. Nevertheless, in contrast with the previous year's decline, gross receipts from tourism rose by 6.3%. Longer lengths of stay, coupled with increased demand for conference and incentive travel, were the main factors behind the significant growth in

Table 3.9
TOURISM ACTIVITY INDICATORS

	January - December			% change		
	2001	2002	2003	2001	2002	2003
Tourist arrivals	**1,180,145**	**1,133,814**	**1,126,601**	**-2.9**	**-3.9**	**-0.6**
of which:						
UK	451,530	444,335	459,565	5.3	-1.6	3.4
Germany	160,262	142,106	125,811	-21.7	-11.3	-11.5
Italy	93,564	100,875	94,175	1.1	7.8	-6.6
France	82,669	80,101	76,384	9.1	-3.1	-4.6
Others	392,120	366,397	370,666	-5.3	-6.6	1.2
Bed-nights stayed (millions)[1]	n/a	**10.5**	**11.1**	n/a	n/a	**5.7**
Average length of stay (days)[1]	n/a	**9.6**	**10.2**	n/a	n/a	**6.3**
Earnings (Lm millions)	**260.7**	**246.3**	**260.9**	**-3.9**	**-5.6**	**6.0**

[1] Data on bed-nights and average length of stay is based on the Air Tourist Departures survey.

Source: National Statistics Office.

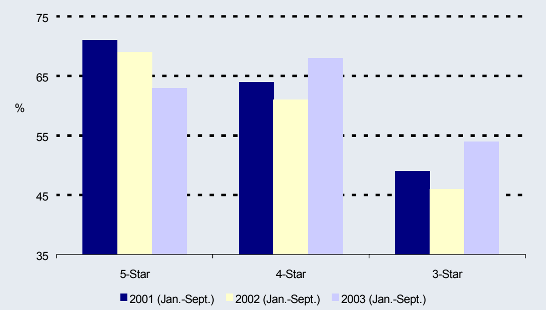
earnings.[8] The cruise liner business also remained buoyant, with passenger arrivals increasing by 11.6%.

Inbound tourism from Malta's largest market, the UK, grew by 3.4% in 2003, in contrast with the 1.6% decline reported the previous year (see Table 3.9). Favourable economic conditions in the UK coupled with intensive promotional efforts may explain the rebound in the number of British visitors to Malta. Other notable increases were recorded in the Scandinavian and Austrian markets. By contrast, the German market - Malta's second largest source market - failed to recover despite intense marketing efforts. The economic slowdown in Germany as well as the reduction in the number of direct flights to Malta may have contributed to the sharp decline in the number of German visitors.

The disappointing results in the German market, however, were not the sole factor behind the overall decline in tourist arrivals. The positive trend in the Italian market observed the previous year was reversed, with 6,700 fewer Italians visiting Malta in 2003 than in 2002. Drops were also registered in arrivals from France, another important source market, as well as from the Netherlands and Belgium, while the number of visitors from Libya also continued to decline.

The December survey on tourist departures carried out by the NSO indicates that, in spite of the decline in arrivals, the tourism industry as a whole sold 5.7% more bed-nights in 2003 than in the previous year. This was due to a higher average length of stay of 10.2 bed-nights, as against 9.6 in 2002. Hotels, however, did not report an increase in bed-nights sold, and the rise in turnover was solely due to tourists who stayed in alternative accommodation, such as private residences and with host families in the case of English-language students. 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 3.5). The decline in 5-star hotel occupancy reflected the fact that bed capacity in this category rose by nearly 35% due to the upgrading of a four-star hotel and the commencement of operations of a new 5-star establishment. The number of bed-nights sold by this category was higher than in the same period in 2002. Profit margins, however, are reported to have declined. The December survey of the Malta Hotels and Restaurants Association (MHRA) indicates that average achieved room rates for all the surveyed hotel categories were down from the previous year's levels, with the smallest drop registered by 5-star hotels.[9] This could imply that 4- and 3-star hotels achieved an increase in occupancy by cutting prices.

Chart 3.5
AVERAGE OCCUPANCY RATES IN MAJOR HOTEL CATEGORIES



Source: Economic Survey, Ministry of Finance & Economic Affairs.

Construction

During the nine months to September 2003, turnover in the construction industry was 5% higher than in the same period a year earlier. This increase in construction activity was mostly generated by the Government as work on capital projects such as the Mater Dei Hospital progressed (see Table 3.10). During the period, expenditure on construction by Government was up by Lm20.5 million, outweighing a drop in private sector construction activity. This drop occurred mainly in the first three months of the year, possibly on account of prevailing political uncertainty and the related slowdown in investment. By contrast, capital expenditure by public authorities and enterprises increased significantly partly due to developments in the telecoms sub-sector.

[8] See Malta Tourism Authority, *The Conference and Incentive Travel Market in Malta* (Malta, 2003). This report indicates that a business tourist spends three times as much as an average tourist.

[9] Calculated as the revenue net of VAT divided by the number of room-nights sold.

Table 3.10
CONSTRUCTION ACTIVITY INDICATORS

Lm millions

	January-September		
	2001	2002	2003
Total sales	**98.8**	**110.9**	**116.4**
of which:			
Private sector	58.7	62.8	45.8
Government enterprises	3.8	3.5	5.5
General Government	36.3	44.6	65.1
Value added	**30.9**	**36.0**	**35.7**
Share of value added in GDP (%)	3.0	3.4	3.3
Private employment (as at September)	**6,624**	**6,853**	**6,844**
Share in gainfully occupied (%)	4.8	5.0	5.0

Source: National Statistics Office.

After having risen for three consecutive years, the construction sector's value added fell marginally in 2003. Employment stalled, with the number of full-time employees with private construction firms dropping slightly from the level reported in 2002. Meanwhile, National Accounts and LFS data indicate that employment income per employee in construction contracted in 2003, partly reversing the increases registered in the previous years. The industry's profits were also down by 2.2%, during the first nine months of the year, a development that contrasted sharply with the double-digit growth rates recorded in 2001 and 2002.

Short-term outlook

Assumptions for the forecast

Domestic economic activity remains mainly influenced by developments in Malta's major trading partners. Projections by international analysts for 2004 point to a gradual recovery in continental Europe, which is Malta's most important trading partner, and a continuation of the positive growth trend in the US and the UK, two other major export markets for Maltese goods and services.

Central Bank of Malta projections for the Maltese economy in 2004 assume that external demand will grow by about 2.4% while inflation in Malta's main trading partners will stabilise at 1.9%. The Bank's forecast ignores the possible impact that EU membership could have on the Maltese economy this year, but it takes into account the financial flows - in the form of EU structural funds - that are expected to be received in 2004. The Bank's forecast also assumes that fiscal trends will remain in line with the Government's Budget projections, and that the monetary policy stance will remain unchanged. Finally, inventory changes in the economy, which also include the statistical discrepancy, are assumed to remain at 4% of GDP.

The Bank's forecast

The Bank's forecast shows that economic growth is expected to pick up in 2004, but will remain below its potential. Furthermore, while the increase in activity in 2003 was mostly underpinned by the strong fiscal stimulus, exports and higher government capital expenditure are expected to be the main contributors to economic growth in 2004. From an incomes-based perspective, the higher GDP is expected to benefit profits more than employment income.

The projected recovery in Maltese exports, which is mainly based on expectations of stronger external demand in trading partner countries, will be underpinned by a more buoyant electronics sub-sector. Global demand for electronic components is expected to grow strongly in 2004, although local firms are expected to face strong competition in international markets from low-cost Asian suppliers. A continuation of the weak US dollar trend could also

Table 3.11
OUTLOOK FOR SELECTED ECONOMIC INDICATORS

%

	2002	2003	2004
		Central Bank of Malta estimates	
GDP growth at constant market prices	1.7	0.7	1.1 - 1.7
Growth in GDP components at constant prices			
Private consumption expenditure	2.5	1.3	0.2 - 0.8
Government consumption expenditure	2.4	6.4	0.1 - 0.7
Gross fixed capital formation	(13.3)	16.2	6.0 - 6.6
Inventories (as % of GDP)	(4.0)	(4.0)	(4.0)
Exports of goods & services	3.0	(1.1)	1.3 - 1.9
Imports of goods & services	(2.0)	3.7	2.2 - 2.8
Unemployment rate	5.2	5.6	5.7 - 6.0
Inflation rate	2.2	1.3	3.3 - 3.7
Fiscal deficit (as % of GDP)	5.2	6.1	5.2 - 5.6
External goods & services deficit (as % of GDP)	1.5	6.0	6.6 - 7.2

Note: Figures in parenthesis are negative.

have a negative impact on the industry. Meanwhile, activity in other manufacturing sub-sectors, notably textiles and clothing, is set to decline further although this will to some extent be compensated for by growth in the pharmaceutical industry.

Exports of services, particularly tourism, are also projected to pick up in 2004. After recording growth in earnings in 2003, the tourism industry is expected to register a stronger performance, although the impact on the economy will be limited if the recovery in tourist traffic and a further increase in earnings is not accompanied by a rise in employment in the sector.

Gross fixed capital formation is expected to increase substantially, boosted by government expenditure on capital projects.[10] The new hospital should absorb a sizeable share of this expenditure, but significant outlays are also earmarked for the re-construction of roads. Private sector investment is also expected to rise, as restructuring in manufacturing industry proceeds at a faster pace in response to competition in export markets and a further opening up of the domestic market following EU accession in May 2004. Although foreign direct investment is seen to increase moderately, it may be negatively affected by skills shortages in the labour market.

Private consumption is projected to slow down further in 2004 in response to slower growth in household disposable income and slack labour market conditions. The rise in the value added tax rate is also expected to have a dampening effect on consumer demand although, to some extent, this has been offset by the special compensation payment awarded by Government to employees and pensioners. Meanwhile, the household saving rate is expected to decline further in 2004, since private consumption is expected to adjust only slowly to changes in disposable income. In view of fiscal tightening, Government consumption is also expected to slow down sharply in 2004 following the strong growth recorded in the previous year.

Merchandise imports should grow steadily, fuelled mainly by purchases of industrial supplies to sustain the rise in exports of manufactured goods. Imports of capital goods are also expected to increase in line with higher investment needs related to the new hospital and road development. On the other hand, imports of consumer goods are forecast to grow at a

[10] Although the projected rise in investment is much smaller than that recorded in 2003, it should be borne in mind that growth in investment in 2003 largely reflected the sale of Air Malta's fleet in 2002.

modest rate reflecting the slowdown in private consumption. These developments in the external sector are expected to result in a widening of the negative balance on goods and services. Imports of capital goods related to the development of the infrastructure will, however, be financed by official grants from Italy and structural funds emanating from the EU.

Inflation is expected to rise sharply in 2004, mostly under the impact of a three percentage point increase in the VAT rate introduced at the beginning of 2004. The tax rise is expected to have a one-off effect on consumer prices that should not persist in subsequent years. Inflation, however, is also expected to be boosted by higher seasonal food prices in the early part of the year. In addition, while the removal of levies on food purchased from the EU should have a benign effect on inflation, this may be partly offset by the imposition of the common external tariff on food products previously purchased from non-EU countries. Despite the net impact of these factors, the underlying rate of inflation should remain stable in the light of persistently weak consumer demand.

The envisaged recovery in economic growth in 2004 is not expected to lead to a tightening of labour market conditions. Indeed, unemployment is projected to edge up as growth in the labour supply, mainly arising from higher female participation in the labour force, outpaces growth in employment. Furthermore, manufacturing firms in the uncompetitive sub-sectors will continue to shed labour, while some public sector entities are expected to streamline their labour complement. By contrast, employment opportunities in the services sector, apart from tourism, should continue to rise, although these may be affected negatively by more restrained spending by the Government.

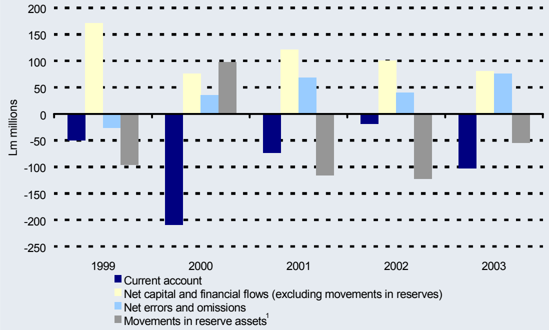
In summary, the Bank's forecast for 2004 is for a modest pick-up in economic activity, a rise in the rate of inflation due to a one-off factor and a slight increase in unemployment. The forecast is based on the assumption that external demand will strengthen as economic growth in Malta's trading partners becomes more robust than in the previous year. Domestic growth prospects are thus subject to downside risks. Furthermore, Malta's projected performance remains below potential, suggesting that progress in achieving higher rates of economic growth will depend not so much on cyclical factors, but rather on the successful implementation of structural reforms. A return to higher levels of growth will be necessary to narrow the gap between income levels in Malta and those of the more developed EU Member States.

4. The Balance of Payments and the Maltese Lira

The balance of payments[1]

Preliminary provisional data on the balance of payments indicate that the current account deficit increased substantially in 2003. This was mainly because the merchandise trade gap had narrowed significantly in 2002 due to a specific export item, the sale of the national airline's fleet of aircraft. The deterioration in the current account also reflected a smaller surplus on services. After excluding movements in reserves, net inflows on the capital and financial account declined. Meanwhile, the official reserves continued to expand, although they did so at a slower pace.

Chart 4.1
BALANCE OF PAYMENTS TRENDS



[1] A negative movement indicates an increase in reserve assets.
Source: National Statistics Office.

The current account

In 2003 the current account deficit widened to Lm101.8 million from Lm18.6 million in the previous year (see Chart 4.1). This widening was driven principally by a larger negative balance on merchandise trade. To a lesser extent, a reduction in the surplus on services and increased net payments for current transfers also contributed. These factors outweighed a higher surplus on the income account (see Table 4.1). As a proportion of GDP, the current account deficit rose to an estimated 6%.

Table 4.1
MAIN EXTERNAL BALANCES

Lm millions

	2001	2002 [1]	2003 [1]
Current account balance	**-73.6**	**-18.6**	**-101.8**
Goods balance	-254.7	-178.3	-258.6
Services balance	166.2	173.2	161.8
Transport	4.6	-6.1	-18.9
Travel	179.5	179.3	180.0
Other services	-17.9	0	0.7
Income (net)	11.1	2.6	15.4
Current transfers (net)	3.8	-16.1	-20.4
Capital and financial account balance [2]	**120.6**	**100.4**	**80.5**
Movements in reserves [3]	**-115.3**	**-121.8**	**-54.7**
Net errors and omissions	**68.4**	**40.1**	**76.0**

[1] Figures are based on the latest available provisional NSO data.
[2] Excludes movements in reserve assets.
[3] A negative sign indicates an increase in reserve assets.

Source: National Statistics Office.

[1] For the purposes of this chapter, the cut-off date for information is 23 March, 2004.

Table 4.2
MERCHANDISE TRADE
(based on Customs data)

Lm millions

	2001	2002	2003[1]	% Change 2002-2001	% Change 2003-2002
Imports	**1,225.1**	**1,227.5**	**1,279.8**	**0.2**	**4.3**
Consumer goods	279.1	294.0	311.1	5.3	5.8
Industrial supplies	644.9	630.7	658.2	-2.2	4.4
Capital goods & others	200.4	200.0	208.6	-0.2	4.3
Fuel and lubricants	100.7	102.8	101.9	2.1	-0.9
Exports	**880.6**	**960.7**	**930.0**	**9.1**	**-3.2**
Domestic	790.8	797.3	817.5	0.8	2.5
Re-exports	89.8	163.4	112.5	82.0	-31.2
Trade balance	**-344.5**	**-266.8**	**-349.8**	**-22.6**	**31.1**

[1] Provisional

Source: National Statistics Office.

Merchandise trade[2]

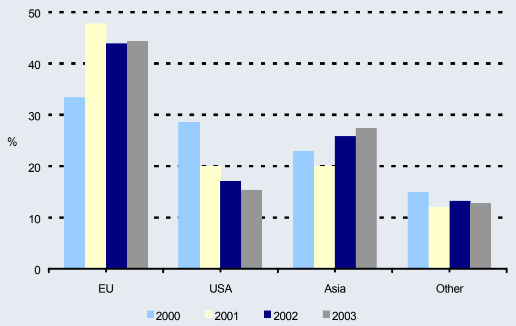
Customs data for the full twelve months indicate that the shortfall on merchandise trade widened in 2003 by Lm83 million to Lm349.8 million, after having narrowed in the previous two years (see Table 4.2). This was due to a drop in exports and a rise in imports.

In 2003 exports dropped by Lm30.7 million, or 3.2%. This was mainly because of the exceptional factor mentioned above, that is, a surge in re-exports in the second quarter of 2002, reflecting the sale of aircraft. The exclusion of this extraordinary transaction implies that exports would have increased by Lm10.7 million in 2003, driven by domestic exports which rose by Lm20.2 million, or 2.5%. The rise was almost entirely due to foreign sales of machinery and transport equipment, which largely consist of semi-conductors, as global demand for the latter picked up in 2003. On the other hand, exports of food, beverages and tobacco and of 'miscellaneous manufactured articles' - which includes clothing - decreased, offsetting a rise in exports of chemical products.

Imports increased by Lm52.3 million, or 4.3%. Imports of industrial supplies, particularly semi-finished goods, rose by 4.4%, accounting for more than half of the higher import bill. Over the past ten years industrial supplies have on average accounted for around 60% of Malta's imports, reflecting the structure of domestic industry and a lack of resource endowments. At the same time, imports of consumer goods increased for the fifth consecutive year, putting on Lm17.1 million to Lm311.1 million, with durable goods accounting for the largest share of the rise. Imports of capital goods went up by 4.3% in 2003.

The European Union (EU) remained Malta's main trading partner (see Charts 4.2 and 4.3). During 2003, the share of the EU in Malta's exports remained fairly static at around 44%, reflecting subdued demand within the EU. The share of exports to Asia increased

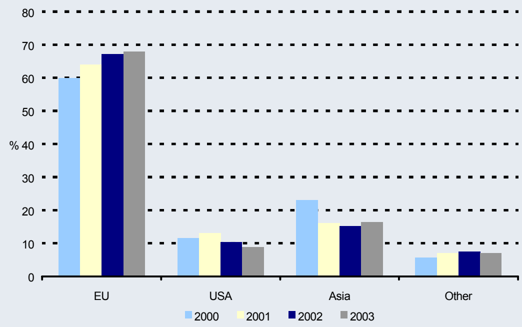
Chart 4.2
DIRECTION OF TRADE - EXPORTS



Source: National Statistics Office.

[2] Merchandise trade figures are compiled by the National Statistics Office (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. 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 4.3
DIRECTION OF TRADE - IMPORTS



Source: National Statistics Office

marginally to 27.5%, while that of exports to the United States fell further. The sources of Malta's imports remained largely unchanged in 2003, with the EU supplying 67.8% of the total and Asia and the United States accounting for 16.4% and 8.9%, respectively.

Services

The surplus on services decreased by Lm11.4 million, or 6.6%, with the transport component accounting for the entire decline. Net payments on this account increased by Lm12.8 million as freight charges rose in line with imports, while receipts connected with shipping and aircraft traffic fell. On the other hand, the net surplus on travel rose slightly to Lm180 million from Lm179.3 million in the previous year. Although gross travel receipts recovered significantly in 2003, this was offset by an expansion in expenditure on outward travel. A small surplus was also recorded on trade in other services, which includes business, professional and technical services.

Income and transfers

The income account captures flows between residents and non-residents related to earnings on cross-border investments and compensation paid to foreign workers. Investment income flows, which mainly consist of income on equity and on debt (interest), dominate this account in Malta, reflecting, in particular, the foreign investment activities of monetary and financial institutions.

This account is also characterized by wide fluctuations as a result of variations in the profits recorded by foreign-owned firms operating in Malta. Thus, during 2003 the surplus on income, which had dropped to Lm2.6 million in 2002, went up to Lm15.4 million as net interest income from abroad of the banking sector increased and interest payments by resident non-financial firms dropped.

Meanwhile, the deficit on current transfers widened by Lm4.3 million to Lm20.4 million during 2003 as a result of higher payments of tax refunds to non-residents and lower receipts of foreign pensions by residents.

The capital and financial account

Net inflows on the capital and financial account - excluding movements in official reserves - persisted, albeit at a less rapid pace than in the previous two years. In 2002, inflows had been boosted by the repatriation of assets in terms of the Investment Registration Scheme that ran for the entire year.[3] During 2003, the Scheme operated for a shorter period and less funds were repatriated. Partly reflecting these developments, net inflows on this account dropped by Lm19.9 million to Lm80.5 million.

Transactions on the capital and financial account are heavily influenced by the banking system, particularly international banks operating from Malta. During the first three quarters of the year, net portfolio investment outflows increased as banks continued to build up their holdings of foreign debt securities, while net inflows on the other investment component rose as banks' short-term liabilities to non-residents increased.[4]

Official reserve assets continued to grow, rising by Lm54.7 million during 2003 compared with Lm121.8 million in the previous year.

Net errors and omissions were large and positive in 2003, reinforcing a steady upward trend evident over the past four years (see Chart 4.1). This sizeable

[3] See fn. 6, p.37.
[4] A breakdown of the composition of the capital and financial account was not available at the time of writing.

Table 4.3
EXCHANGE RATES OF THE MALTESE LIRA AGAINST SELECTED MAJOR CURRENCIES FOR 2003

	US$/Lm	stg/Lm	yen/Lm	euro/Lm
Average for 2003	2.6543	1.6237	307.4	2.3470
Average for 2002	2.3100	1.5378	288.9	2.4468
% change	14.9	5.6	6.4	-4.1
Closing rate on 31.12.2003	2.9197	1.6351	312.2	2.3163
Closing rate on 31.12.2002	2.5074	1.5553	297.7	2.3910
% change	16.4	5.1	4.9	-3.1
High for the year	2.9197	1.6770	326.7	2.3942
	(Dec. 31)	(May 27)	(May 30)	(Jan. 08)
Low for the year	2.4818	1.5516	292.6	2.3163
	(Jan. 03)	(Jan. 06)	(Nov. 10)	(Dec. 31)

Source: Central Bank of Malta.

discrepancy implies an overstatement of the current account deficit or an understatement of net inflows on the capital and financial account, or both. It also points to the difficulties of capturing international transactions in an extremely open economy that has undergone a period of capital account liberalisation and has developed into a centre offering international financial services.

The Maltese lira and external competitiveness

The Maltese lira

Movements of the Maltese lira in 2003 continued to reflect international foreign exchange market developments. Given the dominant share of the euro in the Maltese lira currency basket, movements of the lira against the euro remained limited despite the significant appreciation of the euro in international foreign exchange markets. The lira depreciated by only 3.1% against the euro when compared to its end-2002 level, (see Table 4.3). Conversely, it advanced by 16.4% against the US dollar over the year as the latter fell sharply against the single European currency. The lira also continued to strengthen against the pound sterling and the yen, rising by 5.1% and 4.9%, respectively (see Chart 4.4).

Effective exchange rates

The Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) for the Maltese

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

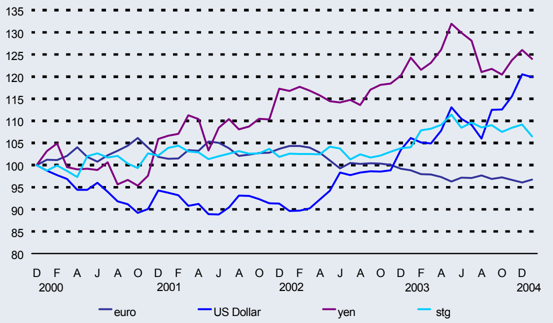
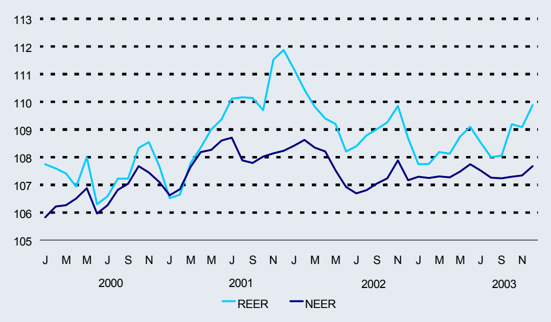


Chart 4.5
REAL AND NOMINAL EFFECTIVE EXCHANGE RATE INDICES FOR THE MALTESE LIRA
(1995 = 100)



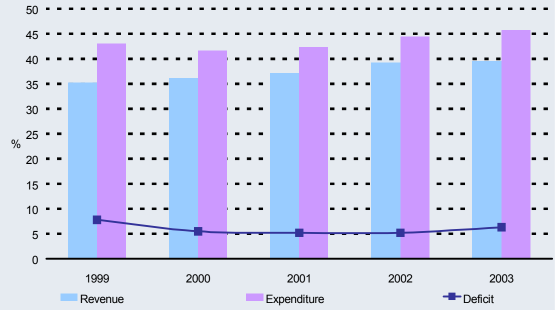
lira can be used as indicators of the country's external competitiveness. A rise in the REER, *ceteris paribus,* suggests a loss of price competitiveness and vice-versa.[5] Given the nature of the Maltese lira exchange rate basket, movements in the NEER are rather contained. It is therefore movements in relative prices that exert the major impact on the REER. The NEER rose by 0.5% during 2003 (see Chart 4.5). At the same time, the REER gained 1.1%, as a decline over the first three quarters was offset by a rise towards the end of the year, when year-on-year inflation in Malta picked up and exceeded inflation abroad.

[5] The Bank compiles the REER on the basis of consumer price indices for twenty-five countries that include Malta's main trading partners. The Bank uses double weights, allowing for the importance of competitor countries in foreign markets.

5. Government Finance[1]

The Consolidated Fund deficit widened in 2003 as growth in expenditure substantially exceeded a modest rise in revenue. As a result, the deficit to GDP ratio increased from 5.2% to 6.3%. This shortfall was financed through the issue of domestic securities and, to a lesser extent, through foreign loans, which were reflected in a higher gross Government debt to GDP ratio. In 2004 the Government aims to reduce the fiscal imbalance to Lm94.8 million, or 5.4%, of GDP, with revenue expected to grow at a faster rate than expenditure. Meanwhile, the general Government deficit also deteriorated slightly reaching 6.4% of GDP from 6.2% a year earlier.[2] The general Government deficit is expected to narrow to 5.7% of GDP in 2004.

Chart 5.1
FISCAL INDICATORS
(% of GDP)



Note: Figures refer to the Consolidated Fund.
Sources: Ministry of Finance and Economic Affairs; National Statistics Office.

Fiscal performance in 2003

In 2003 the deficit on the Consolidated Fund widened to Lm107.6 million (see Table 5.1). This was Lm19.9 million more than in 2002, implying an overshoot of Lm32.8 million from the original projections. The overall increase reflected a deterioration in the primary deficit, which widened by Lm20.6 million indicating that the fiscal stance remained loose.[3]

Total expenditure increased by 4.7%, whereas revenue grew by only 2.3%. Higher outlays on social security benefits and strong public capital spending boosted expenditure. On the other hand, a drop in non-tax revenue, which had been boosted by one-off factors in 2002, partly offset the rise in revenues from direct and indirect taxes. As a result, the increase in the revenue to GDP ratio evident in recent years stabilised in 2003, with the ratio rising only marginally to 39.5% (see Chart 5.1). In contrast, expenditure as a percentage of GDP maintained its upward trend, increasing from 44.5% in 2002 to 45.8%.

Revenue

Revenue rose by Lm14.8 million in 2003, with receipts from direct taxes and indirect taxes growing by Lm15.6 million and Lm11.5 million, respectively. However, non-tax revenues declined by Lm12.2 million.

More than four-fifths of the increase in direct taxes stemmed from income tax revenues, which grew by 6.9% as a result of efficiency gains in tax collection and rising incomes. Meanwhile, social security contributions increased by Lm2.4 million, despite a decline in the gainfully occupied population. Indirect taxes brought in Lm11.5 million more, driven mainly by higher VAT receipts that reflected growth in consumption expenditure. Revenue from VAT was up by 6.4%, or Lm7.5 million, whereas customs and excise duties increased by Lm3.5 million, or 5.9%, boosted by higher duties on cigarettes. Receipts from licenses, taxes and fines rose only marginally, as remaining levies on imports were lowered further.

The decline in non-tax revenue was mainly due to a sharp drop in receipts from dividends. These fell by Lm10.7 million as one-off revenues from land-

[1] This analysis is based on information contained in the *Financial Estimates 2004* and the *Budget Speech 2004*. More recent data for 2003 released on 16 March 2004, place the general Government deficit and debt at 9.7% of GDP and 72% of GDP, respectively. The upward revision in both the deficit and the debt principally reflects a one-off adjustment related to the restructuring of the shipyard sector, as the Government assumed the net liabilities of the Malta Drydocks and the Malta Shipbuilding Company Limited, which were liquidated.

[2] General Government captures all the operations of central Government, including entities that are mainly financed by the state as well as local Government.

[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.

Table 5.1
GOVERNMENT BUDGETARY OPERATIONS[1]

Lm millions

	2002	2003	2004	2003 % change	2004 % change
TOTAL REVENUE	**659.5**	**674.3**	**778.2**	**2.3**	**15.4**
Direct tax[2]	311.0	326.6	343.6	5.0	5.2
Indirect tax	263.4	274.9	318.1	4.4	15.7
Non-tax revenue	85.1	72.9	116.5	-14.4	59.8
TOTAL EXPENDITURE	**747.1**	**781.9**	**873.0**	**4.7**	**11.6**
Recurrent expenditure [3]	585.7	612.4	674.4	4.6	10.1
Interest payments	63.8	63.2	71.9	-1.0	13.9
Capital expenditure	97.7	106.3	126.7	8.8	19.2
Primary balance [4]	-23.9	-44.5	-22.9	-	-
BALANCE ON CONSOLIDATED FUND	**-87.7**	**-107.6**	**-94.8**	-	-
Central Government balance	-105.7	-110.5	-101.2	-	-
Local Government balance	0.9	0.9	0.9	-	-
GENERAL GOVERNMENT BALANCE	**-104.8**	**-109.7**	**-100.4**	**-**	**-**
General Government deficit to GDP ratio (%)	6.2	6.4	5.7	-	-

[1] Data for 2003 and 2004 are revised estimates and estimates, respectively, as shown in the *Financial Estimates 2004* and the *Budget Speech 2004* published in November 2003.
[2] Excluding the state contribution to the social security account.
[3] Excluding the state contribution to the social security account and interest payments.
[4] Total revenue less total expenditure excluding interest payments.
Source: Ministry of Finance and Economic Affairs.

revaluation gains related to the privatisation of Malta International Airport had boosted dividends during 2002. Furthermore, revenues from fees dropped by Lm3.9 million mostly due to a fall in receipts from the Investment Registration Scheme.[4] Thus, whereas fees collected under the Scheme in 2002 had amounted to Lm10.3 million, in 2003 (when the Scheme operated for a shorter period) they amounted to Lm7 million.

Expenditure

Total expenditure increased by Lm34.8 million in 2003. Recurrent expenditure rose by Lm26.7 million, or 4.6%, reflecting higher outlays on programmes and initiatives.[5] Meanwhile, capital spending was also up by Lm8.6 million, or 8.8%. Interest payments, however, were Lm0.6 million less than in 2002 as maturing debt was rolled over at lower interest rates.

Outlays on programmes and initiatives expanded by Lm21.4 million, or 7.7%, largely because of a rise in expenditure on pensions. Spending also rose on agricultural support schemes and public-private partnership projects, and to finance the organisation of the general elections and the referendum on EU membership.

The Government's wage bill remained stable as the drop in Government employment was offset by the wage increases awarded under the collective agreement. The decline in employment was attributable to the fact that a number of employees were transferred to other public entities outside the civil service, namely Mount Carmel Hospital, Heritage Malta and the Malta Council for Culture and the Arts. As a result, contributions to entities

[4] See fn.6, p.37.
[5] Recurrent expenditure excludes interest payments.

rose by Lm3.4 million. Meanwhile, an increase of Lm2 million in operational and maintenance outlays mainly reflected higher expenses on utilities and medical supplies.

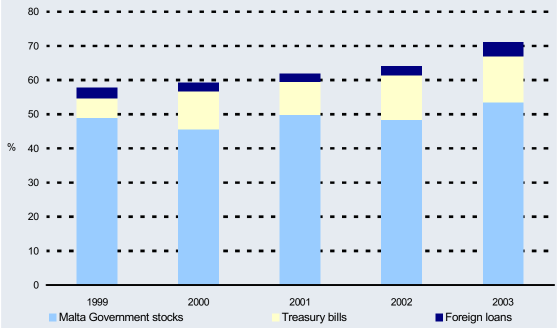
Capital expenditure continued to increase, driven by spending on subsidies for public transport and outlays on construction projects, including the new hospital. However, lower subsidies to the shipyards moderated the growth in overall capital expenditure.

The increase in the deficit on the Consolidated Fund also led to a worsening in the general Government balance, albeit to a lesser extent. The general Government deficit increased by Lm4.9 million to Lm109.7 million.

Government debt and financing operations

The general Government deficit was financed by an increase in debt, particularly in Malta Government stocks (see Table 5.2). The amount of stocks outstanding thus rose by Lm100 million to Lm913 million. Additional funding was derived from foreign loans, which went up by Lm27.5 million as the Government took out a loan from the Council of Europe Development Bank to part-finance the new hospital. Short-term borrowing in the form of

Chart 5.2
GROSS GOVERNMENT DEBT
(% of GDP)



Source: Central Bank of Malta.

Treasury bills also increased, by Lm13.5 million to Lm232.3 million. In contrast with the previous year, there were no proceeds from the sale of assets during 2003.

The combination of a wider deficit, slower nominal growth and reliance on debt financing led to a more rapid increase in the Government debt to GDP ratio (see Chart 5.2). During 2003 the ratio increased from 64.1% to 71.3% of GDP. Malta Government stocks account for the bulk of the debt, amounting to 53.4% of GDP at the end of the year. Treasury bills outstanding were equivalent to 13.6% of GDP, whereas the external debt to GDP ratio rose to 4.2% from 2.7% in 2002.

Table 5.2
GOVERNMENT DEBT AND FINANCING OPERATIONS

Lm millions

	2002	2003
GENERAL GOVERNMENT BALANCE	**-104.8**	**-109.7**
Contributions to sinking funds (foreign)[1]	-4.0	-5.8
Contributions to sinking funds (local)[1]	-6.9	-6.6
Sinking funds of converted loans	13.2	4.6
Proceeds from sale of assets	27.3	0
Public sector borrowing requirement	75.2	117.5
Changes in		
Gross Government debt[2]	**64.1**	**141.0**
Malta Government stocks	0.1	100.0
Treasury bills	59.3	13.5
Foreign loans	4.7	27.5

[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 and Economic Affairs.

Table 5.3
MEDIUM-TERM FORECASTS OF FISCAL DEVELOPMENTS

Lm millions

	2003	2004	2005	2006
Consolidated Fund balance	-107.6	-94.8	-73.3	-52.2
as % of GDP	-6.3	-5.4	-4.0	-2.7
Primary balance	-44.5	-22.9	-0.8	26.2
as % of GDP	-2.6	-1.3	0	1.4
General Government balance	-109.7	-100.3	-79.4	-58.6
as % of GDP	-6.4	-5.7	-4.3	-3.1

Sources: Ministry of Finance and Economic Affairs.

Projected fiscal performance in 2004 and medium-term outlook

In 2004 the Government aims to reduce the deficit on the Consolidated Fund to Lm94.8 million, as revenue is estimated to rise faster than expenditure. Revenue growth is expected to be boosted by tax measures introduced in the Budget for 2004, notably an increase in the standard VAT rate, and by faster economic growth.[6] In 2005 and 2006 the Government intends to lower the deficit to GDP ratio to 4% and 2.7%, respectively, recording a primary surplus in 2006 (see Table 5.3). Similarly, the general Government deficit is also projected to narrow to 3.1% of GDP by 2006.

[6] For an overview of the Budget estimates for 2004, see the Central Bank of Malta *Quarterly Review* Vol. 36 No. 4 (December 2003).

6. The Banking System[1]

In 2003 the banking system underwent various structural and legislative developments intended to enhance the services offered to customers and the environment in which the banks operate. These changes, complemented by continued upgrading and product innovation, were motivated by the authorities' commitment to fully prepare the sector for Malta's accession to the European Union.

At the end of 2003 the banking system consisted of sixteen credit institutions, eight of which do business with both residents and non-residents (henceforth referred to as domestic banks), while the rest deal mainly in foreign currency with non-residents (henceforth referred to as international banks).[2] The domestic banks accounted for over 60% of the lending portfolio and nearly 80% of the deposit liabilities of the banking system at the end of the year. While this analysis reviews developments in the banking system as a whole, it focuses mainly on the domestic banks as these account for the largest share of banking activity in Malta and have a significant impact on the domestic economy.

A number of innovative products and delivery channels, such as equity-linked deposits and mobile and internet banking, were developed further by the major domestic banks in 2003. Despite such innovations, the branch network is still considered an important element for the enhancement of customer relationships. On the legislative side, a major development affecting these banks was the introduction of the Depositor Compensation Scheme.[3]

The offshore regime for credit institutions was totally phased out in 2003 when the operating license of the last remaining bank under this regime was converted to onshore.[4] In the last quarter of the year, a subsidiary of a major foreign bank was licensed to operate as a domestic bank.

The balance sheet of the banking system

The aggregate balance sheet of the banking system as a whole grew by 11.8%, or Lm775.1 million, during 2003 while that of the domestic banks grew by 7.1%. The inclusion of a new international bank in the statistics contributed significantly to this expansion due to its high capitalisation.

Liabilities

The liabilities (excluding capital and reserves) of the banking system as a whole increased by 8.2% over the year, while those of the domestic banks grew by 1.4%.

Total deposits with the banking system fell by 0.7%, but deposits with the domestic banks increased by 0.6%. Non-interbank deposits made up over 93% of total deposits as at end-December 2003.[5] Such deposits remained virtually unchanged for the banking system as a whole, but those placed with domestic credit institutions increased by 1.2% over the year. The slowdown in deposit growth, which became more pronounced in the final quarter of the year, may have been partly due to customers seeking better returns in a low-interest rate environment and investing in the equity markets and in collective investment schemes instead. Funding through the interbank market decreased by 8.8% or Lm23.7 million, as three domestic banks reduced their participation in this market significantly during the year.

1 Due to changes in reporting requirements, the data for 2002 were revised or estimated in order to make them comparable to 2003 data. As a result, there may not be exact comparability between the figures.
2 The distinction between domestic banks and international banks is administrative rather than legal as all credit institutions are subject to the same regulatory and supervisory regime. The terms 'credit institutions' and 'banks' are used interchangeably in this chapter.
3 See Box 1, p.60.
4 Registration of off-shore activities ceased in 1996.
5 Non-interbank deposits are composed of customer deposits, deposits by insurance companies and pension funds, deposits by other financial intermediaries and financial auxiliaries, and deposits by money market funds.

Table 6.1
BANKS' BALANCE SHEET

Lm millions

	All banks		Domestic banks	
	2003	% Change over 2002	2003	% Change over 2002
Assets				
Non-financial assets	121.4	17.9	118.8	18.8
Financial assets	7,237.0	11.7	4,581.9	6.8
Currency and deposits	435.4	-32.3	411.8	-26.2
Loans *(net of specific provisions)*	*3,469.4*	*4.8*	*2,280.9*	*6.4*
Gross loans	3,527.0	5.2	2,338.5	6.9
Interbank loans	98.4	11.9	112.3	33.1
Non-interbank loans	3,428.6	5.0	2,226.2	5.9
Specific provisions	57.6	30.2	57.6	30.2
Debt securities	2,568.0	28.3	1,440.9	3.4
Shares and other equity	261.5	133.1	249.7	140.6
Other assets	502.8	21.6	198.7	117.8
Balance sheet total	**7,237.1**	**11.8**	**4,700.7**	**7.1**
LIABILITIES				
Currency and deposits *(total deposits)*	*3,772.9*	*-0.7*	*3,069.5*	*0.6*
Interbank deposits	247.4	-8.8	26.3	-41.5
Non-interbank deposits	3,525.5	-0.1	3,043.2	1.2
Loans	1,812.8	25.6	750.1	5.0
Debt securities	94.8	-4.7	83.9	-2.4
Other liabilities	946.2	21.0	197.5	1.8
Capital and reserves	731.6	59.7	599.8	74.3
Balance sheet total	**7,358.4**	**11.8**	**4,700.7**	**7.1**

Nearly a third of deposits with the banking system are held in current or savings accounts, and at the end of December 87% of time deposits were due to mature within a year. Although the data are not strictly comparable with previous periods, general trends point to an increased preference for deposits with shorter maturities, a tendency that is to be expected in view of the prevailing low level of interest rates. Deposits denominated in Maltese liri account for 53.3% of total deposits with the banking system, with the remainder denominated in foreign currencies. Domestic banks command a larger proportion of Maltese lira deposits, which made up 77.5% of their deposit liabilities at the end of the year.

The capital and reserves of the banking system as a whole expanded by nearly 60% to Lm731.6 million in 2003, of which Lm383.6 million was equity capital. A 178% increase in the capital of the domestic banks mainly reflected the inclusion of the new foreign bank mentioned previously.

Assets

An increase of 11.7% and 17.9% in financial and non-financial assets, respectively, contributed to the expansion in the banking system's aggregate balance sheet during the year. The growth in the two asset categories for the domestic banks stood at 6.8% and 18.8%, respectively. The two largest domestic credit institutions accounted almost entirely for the Lm18.8 million increase in the banking system's non-financial assets, while the international banks marginally reduced their holdings of such assets.

The growth in the financial asset holdings of the banking system as a whole mainly reflected an expansion in gross loans and holdings of debt securities that was partly offset by a fall in currency and deposit holdings. A rise in non-interbank loans granted by domestic banks was the main factor behind the overall increase in gross loans.[6] Lending by the domestic banks, largely to the household sector for purchases of real estate, rose by Lm123.1 million during the year.

Bank holdings of shares and other equity rose by 133.1% in 2003, mainly because one bank invested heavily in a local subsidiary. Excluding this extraordinary transaction, equity holdings would have fallen by 28.6%, as one credit institution disposed of a large part of its holdings. Meanwhile, a 28.3%, or Lm566 million, increase in holdings of debt securities mainly reflected a sharp rise in one international bank's portfolio of such securities.

Profitability[7]

The pre-tax profits for the banking system amounted to Lm70.5 million in 2003, an increase of Lm19 million, or 37%, over the previous year. This strong profit performance resulted from an improvement in both net interest and non-interest income, complemented by a drop in non-interest expenses. Despite the low level of interest rates both locally and abroad, credit institutions were able to report higher net-interest income as a result of a favourable asset and liability mix (see Table 6.2).

Interest income amounted to Lm402.6 million and interest expense to Lm259.8 million during the year, down by 4.9% and 14.4%, respectively, from 2002 levels. This resulted in an increase of nearly Lm23 million in net interest income, equivalent to a 19% rise over the previous year.

Domestic credit institutions, on the other hand, reported an increase of 27.4% in profits, registering a pre-tax profit for 2003 of Lm40.5 million. As with the banking system generally, the domestic banks registered a much larger drop in interest expense than in interest income, at 14.6% and 1.5%, respectively. Consequently, their net interest income went up by Lm15.6 million, or 21%, to reach Lm90.2 million. This

Table 6.2
INCOME AND EXPENDITURE STATEMENT

Lm millions

	All banks			Domestic banks		
	2002	2003	Change	2002	2003	Change
Interest income	423.5	402.6	-20.9	202.1	199.1	-3.0
Interest expense	303.5	259.8	-43.7	127.4	108.9	-18.5
Net interest income	**120.0**	**142.8**	**22.8**	**74.7**	**90.2**	**15.6**
Fees and commissions	16.2	17.1	0.8	15.6	16.2	0.6
Gains and losses on financial instruments	31.4	38.6	7.2	16.4	15.8	-0.7
Other non-interest income	1.6	2.8	1.2	0.3	2.0	1.7
Non-interest income	**49.2**	**58.5**	**9.2**	**32.3**	**34.0**	**1.6**
GROSS INCOME	**169.2**	**201.2**	**32.0**	**107.0**	**124.2**	**17.2**
Personnel costs	36.4	40.6	4.2	35.7	39.9	4.1
Other operating expenses	81.3	76.1	-5.2	39.1	30.8	-8.3
Non-interest expense	**117.7**	**116.7**	**-1.0**	**74.8**	**70.7**	**-4.1**
Provisions	**0.04**	**14.0**	**14.0**	**0.4**	**13.1**	**12.6**
PROFITS BEFORE TAX	**51.5**	**70.5**	**19.0**	**31.8**	**40.5**	**8.7**

6 The category 'non-interbank loans' refers to loans granted to the Government, other financial corporations, non-financial corporations, other domestic sectors and non-residents. It also includes deposits placed by credit institutions with the Bank.

7 This analysis does not include the data of one international bank.

accounted for nearly two-thirds of the net interest income earned by the entire banking system during the year.

As Table 6.2 also shows, during 2003 the banking system's non-interest income increased by Lm9.2 million, or 18.7%, to Lm58.5 million, mainly reflecting a 22.9% rise in gains on financial instruments. Income by way of fees and commissions receivable increased by less than 5% to Lm17.1 million, whereas other non-interest income, while accounting for a small share in the total, rose by over 75% to Lm2.8 million.

With respect to the domestic banks, non-interest income rose by a more modest 4.9% to Lm34 million in 2003, as an increase in fees and commissions receivable was offset by a drop in gains on financial instruments. The marginal rise in the domestic banks' non-interest income mainly reflected an increase in other income, largely as a result of fair value adjustments and other gains on securities not held for trading.

Thus it appears that low interest rates may have induced the domestic banks to divert part of their operations to non-interest income generating activities. The difference in the growth in non-interest income between the banking system as a whole and the domestic banks mainly reflected differences in gains from trade in financial instruments. However, it should be stated that notwithstanding the growth in non-interest income registered by the domestic banks, it is still the traditional banking activities that remain dominant within the domestic banking system.

The increases in net-interest and non-interest income pushed up the gross income of the banking system as a whole by 19% and that of the domestic banks by 16%. The proportion of net interest income to gross income for the banking system as a whole stood at 71%, unchanged from 2002 (see Chart 6.2a). In the case of the domestic banks, however, the ratio increased by 3 percentage points to 73% (see Chart 6.2b).

Charts 6.2a and 6.2b also show that the proportion of non-interest income to gross income, which in 2002 stood at 29% for the banking system and at 30% for the domestic banks, remained unchanged in 2003 for the banking system, but decreased by 3 percentage points to 27% for the domestic banks.

Non-interest expense incurred by the banking system in 2003, at Lm116.7 million, was down by 0.9% from the previous year's level (see Table 6.2). An increase in wages equivalent to Lm4.2 million was more than offset by a drop in other operating costs amounting to Lm5.2 million. Domestic banks reported a sharper 5.5% cut in non-interest expense. This mainly arose from a 21.2% drop in other operating costs that more than offset an 11.6% rise in the banks' wage bill. The drop in other operating costs reflected a decrease in write-offs of bad debts.

The larger increase in gross income together with the drop in non-interest expense pushed down the proportion of the banking system's non-interest expense to gross income ratio from 70% in 2002 to 58% in 2003 (see Chart 6.2a). The same can be said for the domestic banks, where the ratio dropped by

Chart 6.2a
INCOME AND EXPENSE RATIOS - ALL BANKS

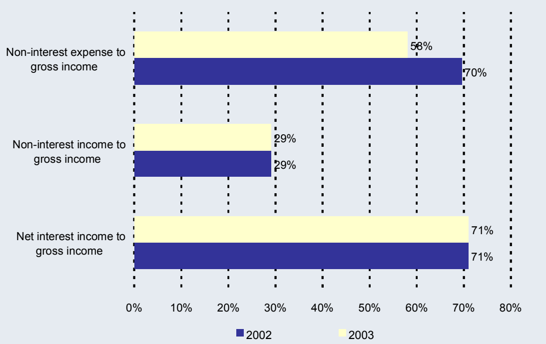
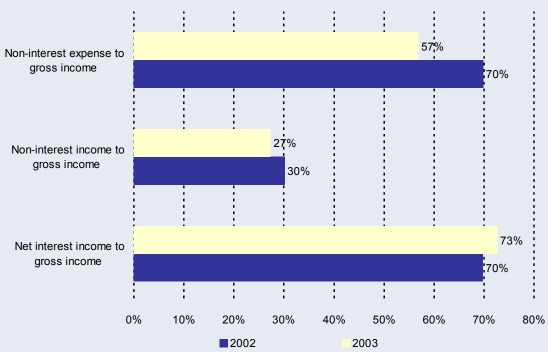


Chart 6.2b
INCOME AND EXPENSE RATIOS - DOMESTIC BANKS



roughly the same proportion, from 70% to 57% (see Chart 6.2b).

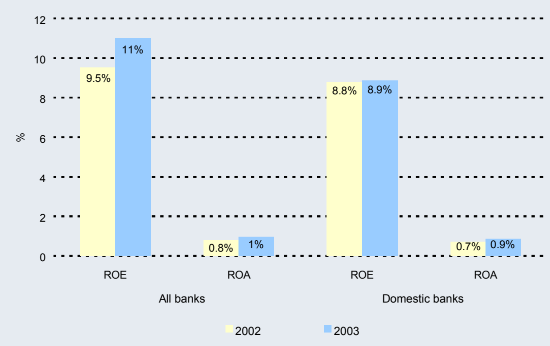
A Lm16.4 million charge in loan loss provisions to the aggregate profit and loss account of the banking system during 2003 contrasted with the write-back of Lm0.1 million reported in 2002. On the other hand, provisions against other financial assets were cut by Lm2.4 million in 2003, following a marginal increase of Lm0.2 million in the previous year. The net effect on total provisions for 2003 was an increase of Lm14 million, out of which Lm13.1 million was charged by the domestic banks.

Return on equity and return on assets

The return on equity (ROE) and the return on assets (ROA) ratios, two major indicators of profitability, both increased in 2003. The ROA of the banking system as a whole increased by 0.2 percentage points to 1% reflecting the banks' strong profit performance (see Chart 6.3). Similarly, the ROE improved by 1.5 percentage points to 11%, indicating that the banking system had earned a higher return on its equity.

Despite the increase in profits the domestic banks continued to register lower profitability, as defined by the ROA and ROE ratios, than the banking system as a whole. However, both ratios were slightly higher

Chart 6.3
RETURN ON EQUITY (ROE) AND ASSETS (ROA)



than in 2002. Thus, at the end of 2003 the ROE stood at 8.9%, compared with 8.8% the previous year, reflecting a proportional increase in both net profit before tax and in the banks' capital base. Concurrently, the domestic banks' ROA stood at 0.9%, up by 2 basis points from the 2002 level, reflecting a larger increase in profit before tax than in total assets.

Thus, the profitability of the banking system strengthened considerably in 2003, despite low interest rates and the uncertainties that prevailed both in Malta and abroad. Apart from the improvements in gross income and the reduction in non-interest expense, the banks increased their risk-mitigating measures by increasing provisions. Here it is relevant to mention that the domestic banks effected a 30% increase in specific provisions in accordance with the requirements of Banking Directive BD/09 in 2003.[8] By requiring banks to make provisions against the unsecured portion of non-performing loans, Banking Directive BD/09 is intended to safeguard credit institutions from the negative effects of potential loan defaults by customers.[9],

Liquidity[10]

Liquidity ratio

The banking system remained very liquid during 2003, with the overall liquidity ratio rising substantially. The banks' holdings of short-term assets rose by 14.8%, while their short-term liabilities increased by 10.8%. This mainly reflected the inclusion of two new banks within the system. An increase in holdings of Treasury bills, marketable debt securities and deposits with the Central Bank was partly offset by a drop of over Lm50 million in balances held with other credit institutions.[11] This resulted in a net increase of Lm194.2 million in holdings of short-term assets. The liquidity ratio of the banking system ended 2003 at 57%, up from 54.4% at end-2002 (see Chart 6.4).[12]

8 Banking Directive BD/09 on *Credit and Country Risk Provisioning* was issued in 2001. It allows for a transition period up to 31 December 2003 for full compliance by all credit institutions.

9 Non-performing loans (NPLs) are loans on which repayment is overdue by 90 days or more and those facilities considered as doubtful.

10 Branches of foreign banks operating from Malta are not required to submit data on liquid assets and liabilities.

11 In terms of Article 37 of the Central Bank of Malta Act, domestic banks are required to hold reserve deposit balances with the Bank equivalent to 4% of eligible deposit liabilities, as defined in Directive No.1 on *Reserve Deposit Requirements*.

12 The liquidity ratio, set at a minimum of 30%, is defined in terms of Banking Directive BD/05 as the proportion of eligible liquid assets to short-term liabilities.

Chart 6.4
LIQUIDITY RATIO

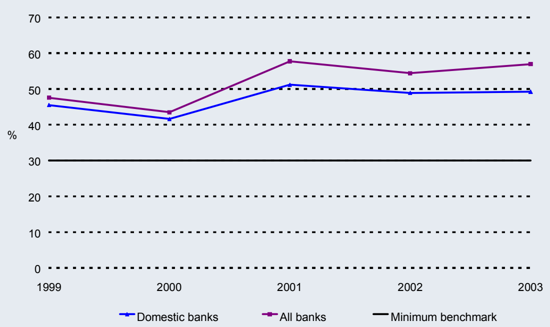


Chart 6.6
CAPITAL ADEQUACY POSITION
(all banks)

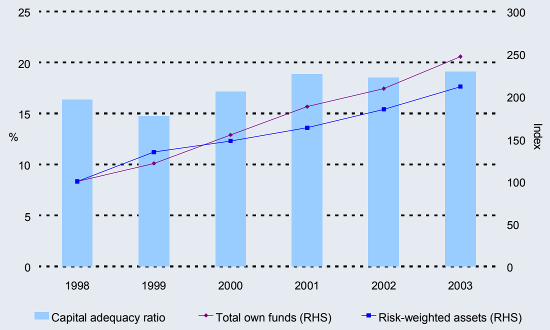


Chart 6.4 also shows that the liquidity ratio of the domestic banks increased marginally in 2003 to 49.2%, from 48.9% in 2002. Increases in Treasury bill holdings and deposits with the Central Bank, amounting to nearly Lm60 million, were partly offset by a Lm42.1 million drop in all other liquid assets. In addition, the banks' net short-term liabilities rose to Lm2,028.8 million, up by Lm39.5 million over the previous year.

Liquid assets to total assets

The ratio of liquid assets to total assets is higher for the domestic banks than for the banking system as a whole (see Chart 6.5). However, in 2003 the share of liquid assets to total assets of the domestic banks was, at 21.3%, slightly down from 22.2% in the previous year. Meanwhile, the ratio for the banking system as a whole increased by nearly one percentage point to 19.1% over the year.

Capital adequacy[13]

The capital base of the Maltese banking system continued to strengthen during 2003. The capital adequacy ratio (CAR) for the banking system as a whole resumed its upward trend, reaching 19.1% by the end of the year, an increase of 0.6 percentage points from 2002 (see Chart 6.6).[14] This was the result of an increase in the banks' own funds outweighing the growth in their risk-weighted assets.[15] The banking system's total own funds went up by Lm86 million (18%), while its risk-weighted assets rose by Lm371.4 million (14%). Apart from the addition of capital by new institutions, the increase in own funds was also due to higher retained earnings, gains on revaluation reserves and increases in the share capital of some of the banks.

In 2003 the CAR of the domestic banks stood at 16.7%, an increase of 0.5 percentage points over the previous year, reflecting a larger increase in total own funds than in risk-weighted assets (see Chart 6.7).

At the end of 2003 the banks' original own funds, which mainly comprise share capital and revenue reserves, accounted for 88.6% of their total own funds.

Chart 6.5
LIQUID ASSETS TO TOTAL ASSETS RATIO

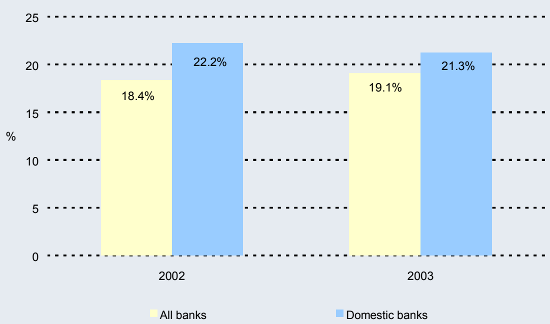
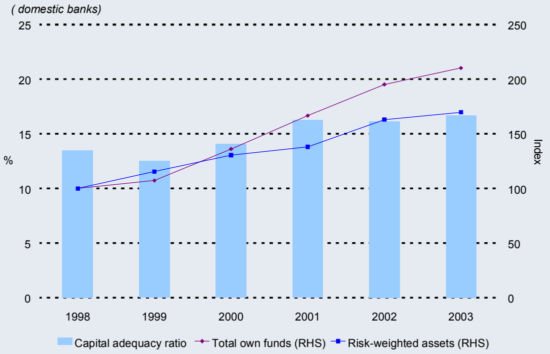


Chart 6.7
CAPITAL ADEQUACY POSITION
(domestic banks)

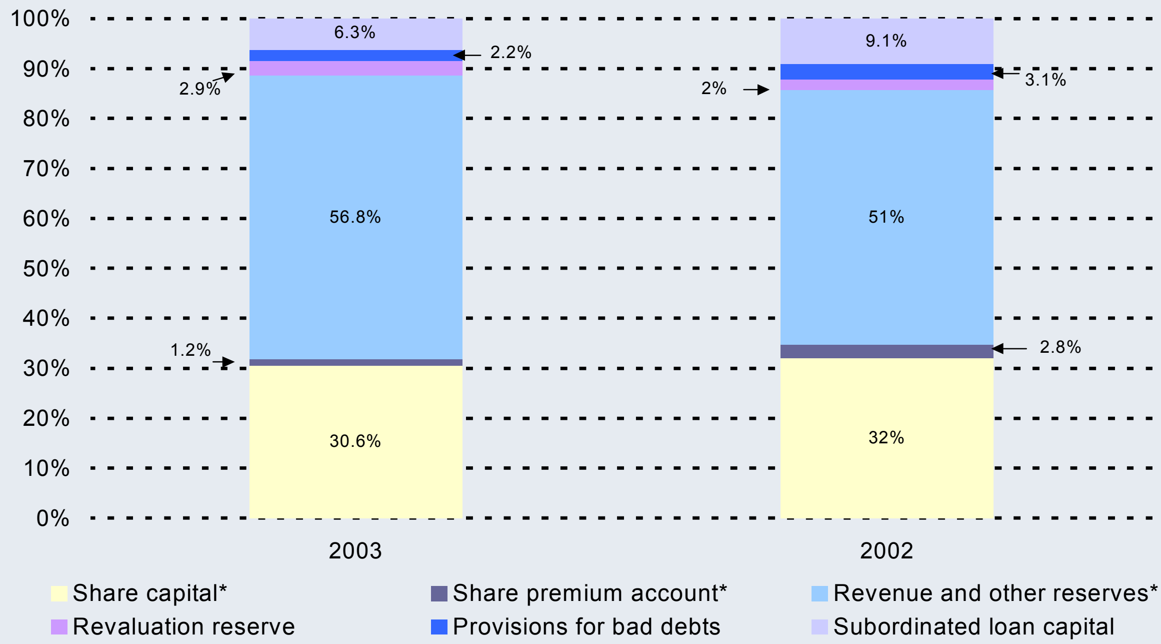


[13] Excludes the new international bank.

[14] The capital adequacy ratio is the ratio between a bank's total own funds and its risk-weighted assets.

[15] Total own funds, which is composed of original and additional own funds, mainly consist of share capital, revenue reserves, the share premium, other reserves, loan loss provisions and subordinated loan capital.

Chart 6.8
COMPONENTS OF TOTAL OWN FUNDS



* Net of deductions

The proportion of share capital to total own funds decreased to 30.6%, from 32% in 2002, despite the increase in paid-up share capital during the year. Revenue and other reserves accounted for 56.8% of total own funds at end-2003, up by nearly 5 percentage points from a year earlier (see Chart 6.8). On the other hand, the proportion of the share premium decreased marginally by 0.7 percentage points to 1.2% of total own funds.

Additional own funds, which mainly consist of subordinated loan capital, revaluation reserves and general loan loss provisions, accounted for 11.4% of total own funds, with the largest proportion relating to subordinated loan capital. At the end of 2003, subordinated loan capital accounted for 6.3% of total own funds, down by 2.7 percentage points from a year earlier. On the other hand, the share of the revaluation reserve in total own funds increased to 2.9%, from 2.0% in 2002. The share of general loan loss provisions dropped from 3.1% in 2002 to 2.2% in 2003, mainly reflecting lower provisions by one major domestic bank.

Conclusion

During 2003 the banks in Malta, particularly the domestic banks, reported satisfactory increases in profitability. This was achieved through judicious asset-liability management and cost-cutting measures during an extended period of low interest rates. Credit expanded while the deposits of the banking system fell marginally. With regard to the domestic banks, however, deposits increased slightly, while credit expansion was mainly driven by lending to the personal sector.

The capital base of the banking system continued to strengthen, as reflected in the higher capital adequacy ratio. Liquidity in the system remained high, with liquid assets making up around one-fifth of the banking system's total assets. On the domestic side, structural developments and innovations in delivery channels and customer products that took place during 2003 have enhanced the competitiveness of the Maltese banking system as it develops in line with other banking systems in Europe.

Box 1

Depositor Compensation Scheme

The Depositor Compensation Scheme (formerly referred to as the Deposit Guarantee Scheme) came into force in January 2003 and was extensively revised in November. Modelled on the EU Directive on deposit guarantee schemes (94/19/EC), the Scheme is designed to provide for the compensation of eligible depositors in the event of a bank failure.

The Scheme currently applies to deposits denominated in Maltese lira, and all banks licensed to operate in Malta that accept Maltese lira deposits are obliged to participate in it.

The main objective of the Depositor Compensation Scheme is to maintain a fund to be used for the payment of compensation so as to provide a means of protection for private depositors. The Scheme has a distinct legal personality and is governed by a Management Committee made up of representatives from the Malta Financial Services Authority (MFSA), the Central Bank of Malta, associations representing banks and a consumer.

The Committee is responsible for managing and administering the Scheme and the contributions paid into it by the participating banks. It is also responsible for verifying any claims made and deciding on the compensation to be paid to claimants.

The Committee is obliged to publish a set of audited financial statements on an annual basis in order to ensure complete transparency with respect to the transactions of funds within the Scheme. While it should ensure that the general public is adequately informed about the Scheme, and participating banks are required to make available adequate and clear information about its applicability, participants in the Scheme are subject to the Professional Secrecy Act, and are thus obliged to keep confidential any information obtained in the course of their operations.

Compensation to claimant depositors is only payable when a bank is unable to repay funds to the depositor and in cases where there is no prospect of the bank being able to do so in the foreseeable future. The total compensation to be paid out is the *lesser* of an amount representing 90% of a depositor's eligible deposits, or the Maltese lira equivalent of 20,000 euros calculated on the basis of the official exchange rate prevailing on the date of settlement of the claim.

Any depositor who entrusts funds on deposit to a credit institution – except for the purposes of a business, trade or profession – is eligible to make a claim.[1] The regulations exclude the following from the definition of a depositor:[2]

- Sole traders, companies and other commercial partnerships;
- Professional and institutional depositors;
- National and international institutions, governments and administrative authorities;
- Local and municipal councils or authorities.

Depositors have the right to claim all their eligible deposits, including the total aggregate deposits held with a bank (or banks) and any interest accrued thereon. However, the compensation paid out must be netted against any outstanding loans or other liabilities which a claimant may have from/to the failed credit institution.

1 For the purpose of the regulations, debt securities issued by the same institution and liabilities arising out of own acceptance and promissory notes do not constitute a deposit.

2 Refer to the First Schedule to the Regulations.

Part II

BANK POLICIES, OPERATIONS AND ACTIVITIES

1. The Implementation of Monetary Policy

The Central Bank of Malta's monetary policy is geared to the maintenance of the fixed exchange rate, which is pegged to a currency basket. Since the three components of the basket - the euro, the pound sterling and the US dollar - are low inflation currencies, the Bank seeks to achieve its primary objective of price stability by supporting the peg. This entails the use of monetary policy instruments to influence the level of liquidity in the banking system. It also involves the buying and selling of foreign currencies in response to domestic market conditions and adjustments in official interest rates (the central intervention rate), after taking into account movements in interest rates abroad.[1] Through these various operations the Bank has been able to maintain an adequate level of external reserves to support the exchange rate peg.

The Bank engages in open market operations to ensure that monetary conditions are compatible with its monetary policy stance. When the banking system is short of liquidity, the Bank injects funds into the system through reverse repos, whereby it buys Government securities from the credit institutions while agreeing to sell these back to them fourteen days later. Conversely, when the level of systemic liquidity is high, the Bank offers fourteen-day term deposits to absorb the excess liquidity. To limit, as much as possible, interest rate volatility arising from fluctuations in bank liquidity, the Bank additionally provides the credit institutions, or monetary policy counter-parties, with facilities for overnight lending and deposits. The Bank also relies on mandatory minimum reserve requirements to generate a shortage of liquidity and provide further leverage on credit expansion in the economy.

As part of the monetary policy decision-making process, the Bank's economists analyse economic and financial developments both in Malta and abroad and prepare policy papers for discussion at the Monetary Policy Advisory Council's monthly meetings. Senior Bank officials meet weekly to monitor developments in domestic financial markets and their impact on the external reserves.

External reserves management

The Bank is obliged by legislation to keep a minimum level of external reserves in proportion to its currency and deposit liabilities. This proportion is set at a minimum of 60%. The reserves, which are also used to support the fixed exchange rate, consist mainly of bank deposits and investment grade securities issued by non-residents.[2] As investment manager of these reserves, the Bank's policy is to ensure the availability of sufficient foreign currency to meet public demand while safeguarding the value of the reserves and generating income. The parameters for the management of the Bank's reserves are set by the Investments Policy Committee, which is chaired by the Governor and includes the Deputy Governor and other senior officials. The portfolio structure of the reserves is designed to limit exposure to exchange rate risk. The Bank also monitors its exposure to credit risk, and considerable progress has been made in establishing a comprehensive market risk model in line with international best practice.

The Bank computes and publishes daily spot and forward exchange rates for the Maltese lira against the major currencies. These rates are updated every day and displayed on Reuters. Forward rates are computed on the basis of spot rates and interest rate differentials vis-à-vis major currencies. Trades with financial institutions are conducted on a daily basis in the spot market for the euro, the pound sterling and the US dollar. Forward foreign exchange trades are also conducted.

[1] See the chapter 'Monetary and Financial Developments' for an overview of the conduct of monetary policy by the Bank in 2003.
[2] See the 'Financial Statements' section in this *Report* for more details.

In 2003 the Bank continued to be a net buyer of foreign exchange from the market. It also monitored closely developments in the foreign exchange market. Credit and financial institutions inform the Bank about all foreign exchange transactions with customers above a threshold value. Over the year purchases from credit and financial institutions amounted to Lm81 million, whereas sales totalled Lm59.6 million. The Bank also entered into forward purchase contracts worth Lm45.2 million and opened Lm60.6 million worth of swap contracts, of which approximately half were still open at the end of the year.

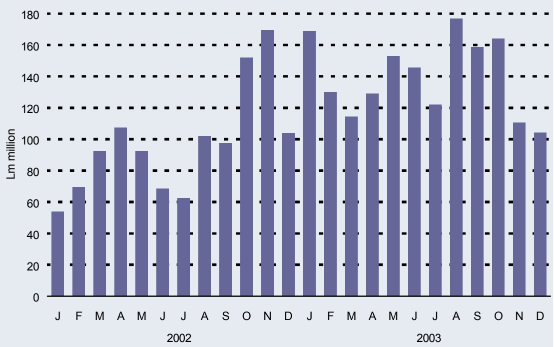
Transactions in the foreign exchange market, excluding interbank deals and deals between the Bank and financial institutions, amounted to Lm2.4 billion in 2003, which was slightly less than in the previous year. Activity in the interbank foreign exchange market amounted to Lm11.8 million compared with Lm12.4 million a year before.

Open market operations

The banking system remained highly liquid throughout 2003. As a result, the Bank repeatedly resorted to fourteen-day term deposit auctions to absorb liquidity and ensure that money market interest rates remained in line with the monetary policy stance.

These auctions are held weekly with the interest rate paid on the term deposits determined by the bids received. These are subject to a floor of 5 basis points below the central intervention rate. Following the cuts in official interest rates - and reflecting ample liquidity in the banking system - the term deposit rate ended the year at the 2.95% floor. Over the year the amounts absorbed through term deposit auctions rose from an aggregate of Lm2.4 billion in 2002 to Lm3.5 billion. Outstanding term deposits at the end of the year stood at Lm104 million (see Chart 1.1). No reverse repo auctions were held in 2003.

Chart 1.1
OUTSTANDING TERM DEPOSITS



Other standing facilities

Since the mid-nineties, the discount window has never been resorted to as a temporary source of liquidity. Its use as a monetary policy tool has been completely phased out. Credit institutions instead can rely on the marginal lending facility, an overnight loan secured by a pledge of collateral. In 2003 a credit institution borrowed Lm1 million through this facility. In contrast, again reflecting ample liquidity in the banking system, the Bank absorbed Lm106.4 million through its overnight deposit facility. Most of these overnight deposits coincided with the end of the reserve requirement maintenance period, when banks typically had excess liquidity. In the last quarter of the year, the Bank reviewed the method of setting the interest rates on these facilities and decided to introduce a symmetric band around the central intervention rate with effect from 15 January 2004.

Reserve requirements

Credit institutions are currently obliged to maintain reserve deposits with the Bank. Balances in these accounts may vary from day to day as long as the requirement is met on average during the maintenance period.[3] In 2003 the reserve requirement ratio was left unchanged at 4% of the institutions' specified liabilities, while the rate of remuneration on required reserves remained 2.7%. In late 2003 the Bank decided to link the remuneration rate to official interest rates as from 15 January 2004.

Exchange controls

In 2003 the Bank continued to administer exchange controls as the agent for the Minister of Finance and Economic Affairs in terms of the Exchange Control Act. In 2003 this Act was amended substantially,

[3] This runs from the fifteenth day of each month to the fourteenth day of the following month.

Table 1.1

TRANSACTIONS UNDERTAKEN IN TERMS OF THE EXCHANGE CONTROL ACT

Lm millions

	2002	2003
Cash gifts	7.8	9.3
Portfolio investments in foreign currency	23.7	44.3
Borrowing by resident companies from overseas lenders	44.9	94.4
Borrowing by resident persons from overseas lenders	1.4	0.8
Borrowing by non-residents from domestic banks	3.6	5.6

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

taking into account the anticipated regime of total capital liberalisation upon accession to the European Union (EU). The new Act, named the External Transactions Act, specifically provides a legal framework for the liberalisation of exchange controls while retaining safeguards to protect the country in the event of negative external developments. The Act re-appoints the Bank as agent and gives it the authority to collect information on external transactions, which will be necessary for statistical purposes even when the controls have been completely liberalised. A number of controls are expected to remain in force until EU accession in May 2004.

In his November Budget for 2004, the Minister of Finance and Economic Affairs announced further exchange control liberalisation measures, which came into effect in January 2004. The limits on cash gift allowances and foreign currency holdings were raised further. Foreign portfolio investment was completely liberalised, subject to the restriction that funds cannot be placed in assets with a maturity of less than six months. Businesses were exempted from surrendering foreign exchange earnings, which can be held in foreign currency accounts and used for overseas payments.

The Bank monitors transactions between residents and non-residents on the basis of information provided by authorised dealers. Table 1.1 summarises this information, which supplements data on the balance of payments gathered from other sources.

Money and capital markets

The conduct of a market-oriented monetary policy depends upon the existence of properly functioning money and capital markets. The Bank continued to foster the development of such markets during 2003, acting as market maker in Government securities and promoting initiatives to upgrade market practice. The Bank also continued to sustain the liquidity of the Government securities market by being prepared to trade in Malta Government stocks and Treasury bills on the initiative of the market. In line with the Central Bank of Malta Act, which prohibits the Bank from providing direct financing to the Government through overdraft facilities or the direct purchase of debt instruments, the Bank participated only in the secondary market for Government securities.

In the secondary market for Government stocks, the Bank continued to publish daily bid prices to indicate the closing price at which it had traded or was prepared to trade. It also started to quote redemption yields, based on the methodology adopted by the International Securities Market Association (ISMA). Yields quoted in this way represent an annualisation of the yields to maturity and thus enable investors to compare bonds paying annual and semi-annual interest. From August onwards, the Bank refrained from publishing indicative offer prices for Malta Government stocks, as its balance of such stocks available for trading was very low.

In the secondary Treasury bill market, the Bank regularly quoted selling and buying rates for retail and wholesale amounts, based on average weighted yields determined in the weekly Treasury bill auctions. Meetings were held between the Bank, the Treasury and the Malta Stock Exchange (MSE) with the objective of implementing the dematerialization of Treasury bill certificates by the first half of 2004.

Over the year, the Bank continued to collect and analyse market data on Government debt. Work was also carried out to identify the measures necessary to bring the domestic market in line with international standards.

The Financial Markets Committee, which includes representatives from the Bank and the domestic credit institutions, continued to meet monthly throughout the year. Two new institutions were admitted as members in 2003. One of the tasks undertaken by the Committee was to review the Interbank Compensation Agreement in order to align it with market developments. The Committee also discussed developments in the monetary policy operational framework of the Eurosystem, particularly regarding collateral management arrangements. Additionally, the Committee was briefed on the proceedings of the Primary Dealer System Working Group, which continued to assess the feasibility of establishing a primary dealer system for domestic Government securities. The Working Group includes representatives from the Bank, the Treasury, the Malta Financial Services Authority (MFSA), the MSE, credit institutions, stock brokers and fund managers. Other discussions focused on changes to the Bank's interest rate structures and a master agreement for interbank lending.

2. Financial Stability

In line with its statutory responsibility to ensure the stability of the financial system in Malta, the Bank continued to monitor domestic and international developments with the aim of identifying threats to its robustness and any weaknesses in its structure and operations. The Bank's approach is to consider the general risks to the financial system and not the situation in the individual institutions themselves, which is the responsibility of the Malta Financial Services Authority (MFSA). The Bank's remit also extends to the regulation and supervision of domestic payment and settlement systems, since well functioning clearing systems are essential for the safety and soundness of the financial system. In addition, the Bank follows closely developments in international financial standards with a view to updating domestic standards accordingly.

In February 2003, the Bank and the MFSA signed a Memorandum of Understanding, whereby both institutions agreed to co-operate in the field of financial services, particularly by exchanging information, so as to ensure the overall safety and soundness of the financial system in Malta. The Memorandum provides for the setting up of a Standing Committee made up of representatives from both institutions, which discusses policy issues. The two institutions also exchanged information necessary for the monitoring of the financial system and continued working on principles of co-operation to assess and manage potential disturbances or crises in the system. In May, the two parties signed a second Memorandum to cover the regulation, oversight and smooth running of payment and securities settlement systems.

The Bank uses a number of approaches to identify possible threats to financial stability. It analyses data from prudential returns submitted by credit and financial institutions. This, coupled with further analysis of the corporate sector in terms of leverage, profitability and liquidity, complemented the monitoring of credit risk within the banking system. Stress testing was also carried out to identify potential losses resulting from abnormal market conditions. This was applied both to the loan portfolio of the credit institutions as well as to market risks arising from their foreign currency, interest rate, liquidity, equity and commodity risks. Relevant issues that arise from the Bank's assessment are then discussed with the MFSA in the Standing Committee.

In compliance with EU legislation on the promotion of efficient international payments, the Bank brought into force the Directive on Cross-border Credit Transfers in January 2003. Another Directive, on Electronic Payment Services, is expected to come into force on May 1, 2004. This Directive seeks to ensure a high level of consumer protection in the field of electronic payment instruments.

During the year, the Bank assessed the securities settlement system operated by the Malta Stock Exchange against the standards set by the European System of Central Banks (ESCB) where credit operations are concerned. It is expected that with the planned introduction of the Malta Automated Securities Settlement System (MASS), the securities settlement system will start operating on a delivery versus payment basis in 2004.

The Bank will also continue to focus on the payment and securities settlement system and the framework that is required to regulate such systems. Further work will also be undertaken on the infrastructure for retail payment instruments to ensure that this complies with international standards.

Financial Sector Assessment Programme (FSAP)

Following the first phase of a comprehensive assessment of Malta's financial system conducted by an IMF/World Bank mission under the FSAP in late 2002, the Bank co-ordinated the second phase of this examination in January 2003. During this second visit by the mission the draft report was discussed with the Bank and the MFSA. In May the mission finalised the Financial Sector Stability Assessment (FSSA) report, which was then approved by the IMF Executive Board and published in August. The report noted that Malta's financial system appears to be healthy and well supervised, but very concentrated and exposed to the country's narrow economic base. It also concluded that domestic banks are profitable, liquid and well capitalised. The Bank is co-ordinating the implementation of the report's recommendations.

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 and other Government departments, the Government sinking funds and a number of public corporations. It also offers various foreign exchange facilities to public sector entities and Government departments.

In 2003 the Bank encashed 1.6 million cheques drawn by Government departments, down from 1.9 million in the previous year, with the total value of such cheques falling by 17.1% to Lm342.1 million. This decline mainly reflected increased use by the Government of the direct credit system when effecting payments – a system that the Bank continued to promote because of its cost-efficiency.

The number of direct credit entries expanded by a third of a million to 1 million in 2003, while their value rose by 68.1% to Lm287.9 million. This increase reflected payments of salaries, social security benefits and interest on Government stocks. By the end of the year, almost all Government salaries were being credited directly to the recipients' accounts and these accounted for over half the total value of direct credit payments.

The foreign exchange services provided by the Bank include the use of documentary letters of credit, inward and outward bills for collection, inward transfers, guarantees, and 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 2003 the value of foreign exchange receipts processed by the Bank on behalf of the Government and public corporations rose to Lm92.8 million from Lm64 million in 2002. Meanwhile, foreign exchange payments totalled Lm90.6 million compared with Lm104.3 million in the previous year.

The Bank is also responsible for effecting external debt repayments on behalf of the Government. Capital repayments amounted to Lm4.6 million in 2003, down from Lm5.3 million in the previous year. On the other hand, interest payments on outstanding foreign loans rose to Lm1.8 million, from Lm1.5 million in 2002. A further Lm5.9 million was transferred to sinking funds earmarked for foreign debt servicing.

The Bank continued to manage the Foreign Pension Subsidy Scheme on behalf of the Government. The amount paid under the scheme fell to Lm15,572 in 2003, from Lm21,851 in the previous year.

The Bank also administered and maintained 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 also maintains settlement accounts for the Malta Stock Exchange (MSE), enabling brokers to settle trades in listed securities.

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

In January, the Deposit Guarantee Scheme and the Investor Compensation Scheme entered into force and the Bank was appointed investment manager of the two schemes.[2] Apart from managing the funds of the schemes, the Bank is also responsible for providing financial, accounting and other support services in connection with the activities of the schemes. The Bank also acts as custodian of assets under the Insurance Business Act of 1998, whereby assets backing the guaranteed funds are held in the name of the Bank.

Payment 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 started operating fully towards the end of 2002 and processed 37,250 interbank payments with a total value of Lm14.5 billion during 2003.

The Bank also worked closely with the MSE in order to establish an eventual link between the payment system operated by the Bank and the MSE's securities settlement system.

During the year, the Bank, in collaboration with the domestic credit institutions, finalised preparations for the introduction of the International Bank Account Number (IBAN) as from 1 January 2004. This followed the coming into force of legislation aimed at regulating cross-border credit transfer services and promoting the efficiency of cross-border payments. 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. Its use should facilitate the automated processing of cross-border credit transfers, and provide for safer cross-border payments.

The Bank is also responsible for the management of the Malta Clearing House, through which most cheques issued are settled. The number of cheques cleared decreased slightly to 6.7 million in 2003, from 6.9 million in 2002, while their value remained unchanged at Lm2.6 billion.

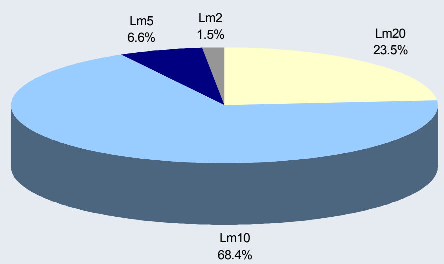
Currency operations

The stock of currency notes and coins issued and outstanding at the end of 2003 amounted to Lm485.4 million, an increase of 5.2% on the previous year. The share of currency notes and coins in broad money, which had been declining steadily over the past twenty years, edged up slightly to 17%, from 16.6% in 2002, possibly reflecting the lower opportunity cost of holding cash as nominal interest rates fell over the year.

Movements in the amount of currency in issue were broadly in line with the usual seasonal pattern (see Table 3.1). Currency in issue fell by Lm10.9 million in January, as credit institutions disposed of excess holdings accumulated during the festive season. Conversely, there was a rise of Lm11 million in December reflecting the seasonal demand over the Christmas period. Unusually strong demand in April may have been related to uncertainty ahead of the general elections held that month.

At the end of December the value of notes in issue stood at Lm467.1 million, 5.2% higher than the previous

Chart 3.1
COMPOSITION OF CURRENCY NOTES ISSUED AND OUTSTANDING AS AT END-2003



[2] The Deposit Guarantee Scheme (later referred to as the Depositor Compensation Scheme. See Box 1, p.60) 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 2003

Lm thousands

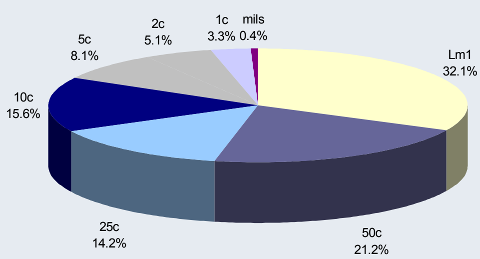
	Issued	Notes and Coins Paid-In	Net Issue	Issued and Outstanding[1]
January	12,035	22,888	-10,853	450,395
February	16,363	14,068	2,295	452,690
March	16,634	12,533	4,101	456,791
April	22,935	14,693	8,242	465,033
May	19,366	18,585	781	465,814
June	20,521	15,224	5,297	471,111
July	22,130	21,666	464	471,575
August	21,171	20,329	842	472,417
September	22,669	19,291	3,378	475,795
October	23,923	23,900	23	475,818
November	20,154	21,602	-1,448	474,370
December	29,072	18,069	11,003	485,373
2003	**246,973**	**222,848**	**24,125**	**485,373**
2002	252,061	232,642	19,419	461,248

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

year's level. Their composition remained relatively unchanged, with the Lm10 note remaining the most widely used denomination, accounting for 68.4% of the total value of notes in issue. Its share in the total increased slightly at the expense of the Lm20 note, which was the second most common currency note (see Chart 3.1).

The value of the outstanding stock of coins rose by 5.4% to Lm18.3 million during the year under review, with the increase spread more or less evenly across all denominations. The shares of the various denominations in the total thus remained broadly unchanged, with the Lm1 coin still the most important by value, followed by the 50c coin (see Chart 3.2).

Chart 3.2
COMPOSITION OF COINS ISSUED AND OUTSTANDING AS AT END-2003



In April the Lm1 banknote of the third series was withdrawn from circulation, ten years after its demonetisation in April 1993. No new note or coin issues were introduced during the year.

Commemorative coins

On 13 February the Bank issued the second commemorative coin in the Distinguished Maltese Personalities Series. The coin commemorates the renowned Maltese composer Nicolò Isouard (1775-1818). The coat of arms of Malta and the year of issue are shown on the obverse of the coin while the reverse shows a portrait of Nicolò Isouard. 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, UK. It weighs 28.28g, with a finesse of 0.925 and a diameter of 38.61mm.

On 24 November the Bank issued another coin in the same series. This third coin commemorates Chief Justice Sir Adriano Dingli (1817 - 1900). The coat of arms of Malta and the year of issue appear on the obverse of the coin. The reverse shows a likeness of Sir Adriano Dingli. 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, UK. 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 2003, analysing local and foreign banknotes suspected to be counterfeit. In preparation for membership of the European System of Central Banks (ESCB), the Bank strengthened its collaboration with the European Central Bank (ECB) in this field. Thus, it began reporting any cases involving notes denominated in euro to the ECB and continued to prepare for its eventual linkage with the Counterfeit Monitoring System of the ECB. The Bank also provided counterfeit detection training to interested parties from the commercial sector.

4. Internal Management

Administration

The Board of Directors

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

At the beginning of March 2004, the Board 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. Bernadette Muscat served as Secretary to the Board. Eleven meetings were held in 2003.

On 31 October Mr Bonello was reappointed Governor of the Bank with effect from 1 October 2003 for a period of five years. On 16 December 2003 Mr Pullicino was reappointed Deputy Governor with effect from 1 September 2003, also for a period of five years.

Alfred Lupi's term as Director expired on 21 January 2003, and on 7 March Philomena Meli was appointed as Director for a period of five years with effect from 21 January 2003. Charles J. Falzon was appointed as Director with effect from 7 February 2004 to replace Saviour Falzon, whose appointment expired on 14 November 2003.

Management

The Executive Management Committee is responsible for advising the Governor on all matters to do with internal management and administration, and is composed of the Governor as Chairman, the Deputy Governor and the five Deputy General Managers. The Committee held 48 meetings over the year.

In April 2003 the Board of Directors approved a new Internal Audit Charter which introduced new concepts and added responsibilities to the Bank's internal audit function in line with international auditing practices and standards. These changes were designed to strengthen the internal audit function in preparation for the specialist tasks that will be undertaken when the Bank joins the European System of Central Banks (ESCB) in May 2004.

In October 2003 the Bank restructured the Statistics Office. This organisational change included the merger of the Data Compilation and External Debt sections of the Balance of Payments Office with the Statistics Office.

During the year, the Bank set up a briefing committee to co-ordinate ESCB-related work. This committee, which is chaired by the Governor and includes observers who represent the Bank on the twelve committees of the ESCB, meets approximately every two weeks. The committee drew up a master plan outlining the various tasks to be implemented in view of Malta's obligations under EMU, with the relevant time frames. These preparations are described elsewhere in this *Report*.

Governors' official activities in Malta

In January the Governor and the Deputy Governor hosted a visit by a delegation from the People's Bank of China headed by the Deputy Governor. The delegation was briefed on recent trends in the Maltese economy and on the role of monetary policy. Later in the year, the Governor of the Central Bank of Luxembourg visited the Bank and delivered a presentation to senior management on his Bank's integration into the ESCB.

The Bank continued to act as advisor to Government on economic and financial matters. As an appointee on certain official agencies, the Governor participated actively in meetings of the Malta Council for Economic and Social Development (MCESD) and the Board of Governors of the Malta Financial Services Authority (MFSA). Over the year Mr Bonello was also invited to address a number of seminars organised by constituted bodies and professional organisations on economic and financial issues.

Governors' official activities overseas

In April the Governor attended the 31st Economic Conference in Vienna organised by the Österreichische Nationalbank, as well as a Bank of England symposium. That same month the Governor also attended as an observer the Annual General Meeting of the Bank for International Settlements (BIS) and, for the first time, the General Council of the European Central Bank (ECB). In May the Deputy Governor attended the Annual Meeting of the European Bank for Reconstruction and Development (EBRD).

In September the Governor accompanied the Minister of Finance and Economic Affairs to the EU Economic and Finance Ministers (ECOFIN) informal Council Meeting held in Stresa, Italy. In the same month, the Governor participated in the International Monetary Fund (IMF)/World Bank annual meetings held in Dubai. In November the Governor attended the Vienna East-West Conference 2003 organised by the Österreichische Nationalbank and the Joint Vienna Institute and participated in a panel discussion on EU accession countries. The Deputy Governor also attended the 75th anniversary celebrations organised by the Bank of Greece in Athens in November.

Economic research and statistics

During 2003 the Bank undertook research projects dealing with the equilibrium exchange rate and the development of econometric models useful for forecasting and policy-simulation purposes. A working paper titled "Assessing Employment in Malta" was published on the Bank's website.

Over the course of the year, the Bank strengthened its co-operation with other agencies involved in the collection of statistics, through the Memorandum of Understanding with the MFSA and the co-operation agreement signed with the National Statistics Office (NSO). The latter clarifies the division of responsibilities between the NSO and the Bank in the statistical field. The agreement reflects similar arrangements found in EU Member States and will help both institutions fulfil their statutory obligations.

To fulfil its obligations at both the national and international levels, the Bank continued to collect, process, disseminate and publish a wide variety of statistics. Co-operation with the ECB was thus strengthened further.

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

Over the course of the year the Bank harmonised its monetary statistics with the European System of Accounts (ESA1995) and the latest ECB statistical regulations. The Technical Committee on Financial Statistics, which is chaired by the Bank and includes representatives from the credit and financial institutions, the MFSA, the NSO, the Malta Bankers' Association and the Malta Stock Exchange, met regularly to synchronise the upgrading of the relevant reporting systems and to ensure a smooth transition to the new system. The Bank's balance sheet was also reformatted accordingly. Other institutions began submitting data based on the new balance sheet format, but for an interim period data were also compiled under the old methodology to ensure a smooth phasing in. Monthly information provided by reporting agents to the Bank and the MFSA are to be kept in a common database, housed and maintained at the Bank but accessible to both institutions.

During the year under review, the Bank contributed updates to the ECB publications *Bond Markets and Long-term Interest Rates in EU Accession Countries* and *Other Financial Intermediaries in EU Member States and Acceding Countries*. The Bank also provided descriptive information on resident Monetary Financial Institutions (MFIs) to the ECB.

In collaboration with the NSO, the Bank also started preparing for the introduction of a new direct reporting system for collecting data on the balance of payments. Under this system each economic sector will report its stock of external assets and liabilities and external flows and income directly to the Bank and the NSO, rather than through the banks. As a result, the present cash settlement reporting system will be gradually phased out. Preliminary work on the compilation of the international reserves template was also started. This template is designed to provide information on the country's international reserves. It also includes information on selected external assets and liabilities of the monetary authority, its off-balance sheet activities, and its receipts and payments of foreign exchange.

In 2003 the Bank and the NSO agreed to co-operate on the compilation on financial accounts under the ESA framework. Templates were designed to obtain statistical information from insurance companies, and quarterly data were received for the first time in March 2003. The ultimate aim is to extend the coverage of these statistics to the rest of the financial sector.

The Bank, in conjunction with the Ministry of Finance and Economic Affairs and the NSO, continued to contribute to the compilation of data on Government deficit and debt levels under the Excessive Deficit Procedure (EDP) notification that is regularly submitted to Eurostat. In 2003 the Bank also started providing general economic and Government finance statistics to the ECB.

Human resources

At the end of 2003 the Bank's full-time staff complement comprised 306 employees, with a further sixteen engaged on a part-time basis. Over the year, the Bank recruited nine Trainee Economics Officers and a Publications Officer. A candidate who was given temporary employment and training as a Technician under one of the ETC's schemes in 2002 was offered full-time employment following his successful completion of the programme. Two employees retired on medical grounds, while two others retired on reaching pensionable age.

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

Human resource audit

In June 2003 the Bank launched a programme of Divisional Workshops. The main objective of these workshops was to carry out an organisational and human resource audit, which would assist the Bank in preparing for the challenges ahead as a member of the ESCB. Revised job descriptions were drawn up, taking into account current and anticipated future needs.

Training and development

The Bank continued to invest in human resources, providing staff members with extensive training both in-house and through external courses organised by local and foreign institutions (see Table 4.1).

Over the year, the Bank maintained its arrangement with the Faculty of Economics, Management and Accountancy of the University of Malta concerning a one-year transition course designed to upgrade the skills of suitably qualified employees to enable them to join a postgraduate course leading to qualification at Masters level in economics. One member of the Bank's staff successfully completed this programme in 2003.

As indicated in the Table, a large number of staff attended training programmes organised by local and foreign institutions. Local courses dealt with topics related to information technology, management, accounting and auditing, risk management, legal matters, industrial relations, health and safety, currency and security issues, the EU and economic developments. The foreign programmes focused more specifically on subjects related to the core functions of central banks.

Table 4.1

STAFF TRAINING

Type of Training Courses	No. of courses	No. of participants
Overseas courses	31	35
In-house training	11	368
Local External courses	54	115

The Bank's in-house training courses covered various topics, including management and supervisory development; information technology; induction courses; internal control and auditing; the Bank's policy on confidentiality of information; and health and safety. A more specialised course on the drawing up of job descriptions was organised for office managers.

Academic and professional courses

An increasing number of employees continued to make use of the Bank's study scheme, and several staff members completed their programmes in 2003 (see Table 4.2). To encourage and promote research in areas relevant to central banking, the Bank also introduced a bursary scheme. This scheme is designed to enable postgraduate students, or holders of a postgraduate degree, to obtain work experience at the Bank through work-related research projects covering areas of study of interest to the Bank. One participant benefited from the scheme during the year.

Translating capacity

In view of the Bank's future commitment to translate selected publications of the ECB into Maltese, the Bank took a number of initiatives to develop a translating capacity. Due to limited internal resources in this area, the Bank also issued a call for expressions of interest from individuals and organisations that offer translation services.

Gender equality

The Bank continued to give due importance to gender equality. Throughout the year the members of the internal committee that monitors this issue attended various meetings held by the Department for Women in Society to keep abreast of developments. Female staff members constitute 36.3% of the Bank's full-time staff complement, while 46.3% of staff members currently involved in self-development programmes are female. Participation by female staff members in external courses organised by both local and foreign organisations increased in 2003.

Collective agreements with trade unions

In July 2003 the Bank renewed its agreement with the Malta Union of Bank Employees (MUBE), the Union Ħaddiema Bank Ċentrali (UHBĊ) and the Media and Services Section of the General Workers Union (GWU), the unions representing the executive, the clerical and the non-clerical categories, respectively. The new agreement covers a period of three years ending 31 December 2004.

Premises

Substantial works on office structures and refurbishment at both Bank premises were carried out to meet the needs arising from ongoing changes in the Bank's functions and activities. A survey of air quality in the St James Counterguard building was undertaken to ascertain comfort levels and identify possible improvements. The upgrading of the Bank's security system was also finalised.

The Bank, in collaboration with the Valletta Local Council, carried out embellishment works on the area in front of the Bank's main building. This project resulted in better parking facilities and traffic management, the protection of St James' Bastion from water corrosion and enhanced security around the Bank's premises.

Table 4.2
ACADEMIC AND PROFESSIONAL COURSES

Type of Programme	No. of employees who successfully completed programmes during 2003	No. of employees pursuing programmes
Postgraduate courses	4	19
Honours first degree courses	10	34
General first degree courses	1	0
Diploma courses	4	1
Transition course	1	1

Information technology

In the course of the year the Bank enhanced its core accounting and payment systems. These were upgraded to improve the monitoring of risk and to bring them in line with ECB accounting requirements. Other improvements included the updating of systems to comply with the International Bank Account Number (IBAN) standard and with the SWIFT MT103 and MT103+ message types to conform with international payment system standards and EU requirements. A computer room used solely for equipment that runs ESCB systems is being upgraded.

Another development was the replacement of the analogue PABX telephone system with a new digital system that provides additional resilience and enhanced reporting.

The Bank continued to develop a number of software applications to meet its own needs. A database was developed to cater for the compilation of monthly money and banking statistics. In 2004, this database will also be made available to the MFSA through an electronic link. The library software system was also enhanced, providing additional functionality.

Risk management and audit

In 2003 the Bank reviewed its internal Policies and Procedures Manual to ensure that its operational procedures and controls are kept updated and that they reflect changes in business processes within the Bank. Considerable progress was made on the Bank's Risk Matrix, and several risk assessments were carried out on business processes. Potential high risk areas were identified and appropriate mitigation strategies were set in place to contain them. Business continuity plans are being developed to safeguard critical processes and to enable the Bank to recover from potential disruptions in a timely manner. It is envisaged that the testing of the business continuity plan will commence in 2004.

The Bank also implemented a confidentiality policy and drew up an action plan to ensure compliance with the provisions of the Occupational Health and Safety Authority Act.

During the year the Bank's internal auditors enrolled with the Institute of Internal Auditors, UK. This not only helps them in their continued professional development but also requires them to abide by the Institute's Code of Ethics.

The Bank's Audit Office carried out several audits in all the main operational areas of the Bank. These audits evaluated the Bank's risks, controls and monitoring procedures and provided the Board of Directors and the Audit Committee with the necessary assurances in terms of internal controls and the mitigation of risks.

Legal issues

The Bank collaborated with the MFSA in drafting Financial Collateral Arrangements Regulations. These Regulations are modelled on the EU Directive 2002/47/EC.

Following the enactment of the Data Protection Act in July 2003, a Data Protection Officer was appointed and steps were taken to ensure that the Bank was in compliance with the Act. The Bank co-operated with the Ministry of Finance and Economic Affairs in extending the Investment Registration Scheme. This Scheme, relaunched from 1 September until 15 November 2003, allowed Maltese residents who held undeclared foreign assets to regularise their position.

The Bank is currently evaluating the legal implications of master agreements that apply to foreign reserve management, monetary policy operations and domestic and cross-border transactions.

Information services

Awareness campaigns

Over the year the Bank brought a number of issues to the attention of the public through the media. These included the final withdrawal from circulation of the third series of the Lm1 banknote and the relaunching of the Investment Registration Scheme. In December the Bank, in collaboration with the Malta Bankers' Association, published a leaflet on the newly-introduced IBAN.

Publications

The Bank continued to publish regular analyses of economic and financial developments in Malta and abroad in its *Quarterly Review.* In 2003, the *Review* carried a number of specialised articles, including one on employment and the contribution of labour to production in the Maltese economy, another on issues regarding Economic and Monetary Union, and another on changes in the compilation of money and banking statistics in Malta. Results from the quarterly survey on business perceptions, administered on the Bank's behalf by a private marketing agency, were also analysed and published in the *Review*.

In March the Bank published its *Annual Report 2002*, which included a review of its policies, operations and activities as well as its financial statements for that year. The *Report* included an extensive analysis of economic and financial developments in 2002.

The Bank continued to publish a weekly money market report as well as a monthly release on monetary data and developments. Press releases were also issued following the monthly meetings of the Monetary Policy Advisory Council to communicate the Bank's decisions. The Bank's publications were regularly posted on its website. Over the year the website was reviewed and updated regularly, enabling users to obtain a wide range of information and services.

The Library

The Bank's library continued to serve as an important source of information on banking, finance and economic matters in Malta. The library met requests for information from Bank staff, Government departments, public and private sector bodies and the general public, particularly students involved in research work.

New books, periodicals and specialised publications related to the Bank's functions and operations were acquired. The Bank maintained and upgraded its collection of databases on CD-ROM and its newspaper clipping files, and catalogued journal articles. It also continued to act as the official depository for publications issued by international organisations, such as the IMF, the World Bank Group and the EBRD.

Social, cultural and educational activities

In March the Bank hosted a seminar on *Securing Financial Stability – Problems and Prospects for new EU Members*. This activity was jointly organised with the *Société Universitaire Européenne de Recherches Financières* (SUERF), and was attended by experts of international repute including central bank officials from current and future EU Member States. During the same month, the Bank also hosted the biennial Central Bankers' Club seminar on IT Management and Application Architecture, which was attended by IT experts from thirteen European central banks.

Over 2003 the Bank organised a number of social, cultural and educational activities for its staff. In June the Bank organised a concert of classical music at the Mediterranean Conference Centre to commemorate its thirty-fifth anniversary. In November the Bank presented a painting from its collection to Heritage Malta, the national agency for museums and cultural heritage. The painting, by the eighteenth-century Maltese painter Giuseppe Grech, will be on permanent display at the National Museum of Fine Arts.

The Bank continued to organise educational visits on its premises for secondary and post-secondary school students throughout the year.

5. Relations with International Institutions

In 2003 the Central Bank of Malta continued to strengthen its relations with international and regional financial institutions. These include, in particular, the International Monetary Fund (IMF), the European Bank for Reconstruction and Development (EBRD) and, in view of Malta's accession to the European Union (EU), the European Central Bank (ECB).

The Governor and Deputy Governor of the Bank are, respectively, Governor and Alternate Governor for Malta at the IMF. The Governor is also Alternate Governor for Malta at the EBRD. Following the signing of the EU Accession Treaty by the ten acceding countries in April, the Bank's relations with the ECB were strengthened further, with the Governor being invited to attend meetings of the General Council of the ECB as an observer. The Bank also co-operated with the Ministry of Finance and Economic Affairs and the Malta Financial Services Authority (MFSA) in the implementation of EU legislation where monetary and financial matters were concerned.

The Bank continued to collaborate with the Ministry of Finance and Economic Affairs 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. Meanwhile, in the field of financial sector oversight and development, the Bank continued to monitor initiatives endorsed by the Bank for International Settlements (BIS).

International Monetary Fund

As Malta's representative at the IMF, the Central Bank of Malta voted, in consultation with the Minister of Finance and Economic Affairs, on a number of resolutions proposed by the Fund's Executive Board.

The Bank also collaborated with the Fund on matters related to its operational budget, although it was not requested to effect any payments in this regard in 2003. 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 2002, at SDR61.8 million (around Lm31.5 million) and SDR40.3 million (around Lm20.5 million), respectively.[1] However, the Bank participated in a number of transactions related to the operations of the Fund's SDR Department. Malta's total SDR holdings stood at SDR29.8 million at the end of the year, compared to SDR28.9 million at the end of 2002.

In May an IMF mission visited Malta for bilateral discussions in terms of Article IV of the Articles of Agreement of the Fund, according to which the IMF must carry out regular surveillance exercises of its members' economic performance and policies. Discussions were held with the Bank, the Ministry of Finance and Economic Affairs, the MFSA and the National Statistics Office (NSO). Discussions were also held with representatives from the private and parastatal sectors, including the Malta Council for Economic and Social Development (MCESD). The main conclusions of the mission were subsequently published in an IMF Staff Report. As described in more detail earlier in this *Report,* during the year an IMF/World Bank mission completed an assessment of Malta's financial system under the Financial Sector Assessment Programme (FSAP).

Over the year the Bank continued to co-operate with the Fund on statistical matters related to the Fund's General Data Dissemination System (GDDS), and continued with its preparations for adherence to the Special Data Dissemination Standard (SDDS). It also reviewed the IMF's *Draft Compilation Guide on Financial Soundness Indicators* issued in May.

World Bank Group

The Bank continued to monitor relevant developments at the World Bank and its affiliates. It

[1] Stock data in Lm are based on exchange rates prevailing at year-end.

co-operated with the Ministry of Finance and Economic Affairs on a number of resolutions proposed by the Executive Boards of the IBRD and MIGA, and on which the Ministry was expected to vote. The Bank also contributed to an IBRD questionnaire titled *International Initiative on the Legal, Regulatory and Institutional Aspects for the Resolution of Insolvent Banks*.

European Bank for Reconstruction and Development

As in past years, the Bank collaborated with the Ministry of Finance and Economic Affairs 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, which required the approval of member countries.

On behalf of the Government, the Bank effected the sixth annual payment of Malta's contribution to the general capital increase of the EBRD approved at the Annual Meeting of the Board of Governors in 1996. In 2003, the amount paid was 28,750 euros (Lm12,346 at the prevailing exchange rate).

European Union

The Bank continued to work with the Ministry of Foreign Affairs and other Government entities on updating Maltese legislation to bring it in line with the *acquis communautaire*, particularly in the areas of the free movement of capital, economic and monetary union (EMU) and statistics. The Bank also collaborated with the Ministry of Finance and Economic Affairs in the preparation of Malta's Pre-Accession Economic Programme for 2003, which was submitted to the European Commission in early September.

Towards the end of the year, senior officials from the Bank began to attend, as observers, meetings of the Economic and Financial Committee (EFC) and its Alternates. The EFC monitors economic and financial developments in the Member States and contributes to the work of the ECOFIN Council, with a particular focus on EMU matters. It includes two representatives from each Member State, the ECB and the Commission. During the year, Bank officials also attended as observers two meetings of the EU's Economic Policy Committee (EPC), another specialised committee within the EU framework focusing on economic and structural policies in Member States.

The Bank followed developments related to the financial rights and obligations that Malta will assume as a member of the European Investment Bank (EIB) upon EU membership. As the body responsible for administering receipts and payments ensuing from foreign loans/grants on behalf of the Government, the Bank also continued to monitor the Government's financial position vis-à-vis the EIB.

European System of Central Banks

The Bank continued to strengthen its relations with the ECB and the national central banks of the current Member States, which collectively form the European System of Central Banks (ESCB). In June the Governor attended for the first time the General Council meeting of the ECB in an observer capacity. Officials from the Bank also began attending meetings of the ECB's internal committees and working groups as observers.

Bank staff attended various seminars and conferences organised by the ESCB. The Bank benefited from visits by experts from the ECB and members of the ESCB, including the central banks of Austria, Italy and Luxembourg. These provided substantial advice on the practical preparations for full membership in EMU in the areas of statistics, information management systems, financial stability, clearing and settlement systems and the changeover to the euro.

The Bank continued to foster closer ties with the central banks of the other acceding countries. The Deputy Governor visited the Central Bank of Cyprus and held talks on future co-operation. Towards the end of the year the two institutions agreed to extend their Co-operation Agreement, which aims at strengthening the two institutions ahead of EU membership. Officials and members of staff participated in seminars and workshops organised by acceding central banks, including those of Cyprus, Poland and Slovenia.

Part III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2003

Directors' report

The Directors present their report and the audited financial statements of the Bank for the year ended 31 December 2003.

Principal activities and review of operations

The Central 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 10 to 14 and pages 61 to 79 respectively, give a detailed account of the Bank's activities and operations during 2003.

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 2003, 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 2003 are set out on pages A-6 to A-30 and disclose an operating profit of Lm18.2 million (2002: Lm19.8 million). The amount payable to Government is Lm18.2 million (2002: Lm24.8 million).

Directors' report – continued

Board of Directors

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

Mr Michael C Bonello - Governor (whose term of office expired on 30 September 2003; reappointed on 1 October 2003)
Mr David A Pullicino - Deputy Governor (reappointed on 1 September 2003)
Mr Saviour Falzon (whose term of office expired on 15 November 2003)
Mr Joseph V Gatt (appointed on 1 January 2003)
Ms Philomena Meli (appointed on 21 January 2003)

During the financial year under review, Dr Bernardette 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

16 February 2004

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 2003, 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 2003 are included in the Annual Report 2003, 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 2003 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

16 February 2004

PRICEWATERHOUSECOOPERS
Malta

16 February 2004

Profit and loss account

	Notes	**2003** **Lm'000**	2002 Lm'000
Profit for the financial year	3	**18,233**	19,782
Transfer from reserves for risks and contingencies to profits payable to Government	21	**-**	5,000
Payable to the Government of Malta in terms of Section 24(4) of the Central Bank of Malta Act (Cap. 204)		**18,233**	24,782

Balance sheet

	Notes	**2003 Lm'000**	2002 Lm'000
Assets			
Cash and balances with banks	4	**12,839**	8,737
Gold balances		**497**	473
Placements with banks	5	**665,168**	600,236
Available-for-sale investment securities	6	**220,540**	233,045
Claims on the International Monetary Fund	7	**35,686**	37,512
Other foreign currency assets		**818**	844
Total external assets		**935,548**	880,847
Available-for-sale local assets:			
Treasury bills	8	**437**	2,177
Domestic debt securities	9	**7,335**	2,112
Derivative financial instruments	10	**2,133**	610
Other assets	11	**35,258**	37,314
Tangible fixed assets	12	**4,693**	4,936
Prepayments and accrued income		**7,612**	7,946
Total assets		**993,016**	935,942
Liabilities and equity			
Liabilities			
Notes and coins in circulation	13	**485,373**	461,247
Deposits by:			
Banks	14	**242,162**	255,558
Government	15	**83,198**	42,961
Others	16	**8,455**	7,595
Profits payable to Government		**18,233**	24,782
Foreign liabilities	17	**25,496**	6,987
Derivative financial instruments	10	**4,048**	604
Other liabilities	18	**33,762**	35,889
Accruals and deferred income		**4,064**	4,978
		904,791	840,601
Capital and reserves			
Capital	19	**5,000**	5,000
General reserve fund	20	**23,000**	23,000
Special reserve fund	20	**13,000**	13,000
Reserves for risks and contingencies	21	**43,050**	43,050
Fair value reserve	22	**4,175**	11,291
		88,225	95,341
Total liabilities and equity		**993,016**	935,942

The financial statements on pages A-6 to A-30 were approved for issue by the Board of Directors on 16 February 2004 and were signed on its behalf by:

M C Bonello Governor	D A Pullicino Deputy Governor	G Huber Deputy General Manager Finance and Banking	R Filletti 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 2002	5,000	23,000	13,000	48,050	6,019	-	95,069
Arising in the financial period:							
- net gains from changes in fair value of available-for-sale assets	-	-	-	-	9,017	-	9,017
Transfers:							
- net gains transferred to net profit on disposal of available-for-sale assets	-	-	-	-	(3,745)	-	(3,745)
Net gains not recognised in the profit and loss account	-	-	-	-	5,272	-	5,272
Profit for the financial year	-	-	-	-	-	19,782	19,782
Total recognised gains	-	-	-	-	5,272	19,782	25,054
Transfer to profits payable to Government	-	-	-	(5,000)	-	(19,782)	(24,782)
Balance at 31 December 2002	5,000	23,000	13,000	43,050	11,291	-	95,341
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**

Cash flow statement

	Notes	**2003 Lm'000**	2002 Lm'000
Cash flows from operating activities			
Profit for the financial year		**18,233**	19,782
Decrease in prepayments and accrued income		**334**	2,735
(Decrease)/increase in accruals and deferred income		**(914)**	1,208
Depreciation of tangible fixed assets	12	**321**	348
Amortisation of premiums and discounts on investments		**(397)**	(252)
Profit on sale of investments		**(3,880)**	(3,745)
Profit on sale of tangible fixed assets		**(46)**	-
Cash flows from operating profits before changes in operating assets and liabilities		**13,651**	20,076
Net changes in operating assets and liabilities:			
Placements with banks		**4,211**	(62,945)
Other foreign exchange assets		**1,828**	1,312
Treasury bills		**(138)**	415
Malta Government securities		**(5,166)**	2,722
Derivative financial instruments		**1,921**	1,610
Other assets		**2,056**	1,686
Deposits		**(24,230)**	25,574
Other liabilities		**(2,127)**	(1,589)
Net cash used in operating activities		**(7,994)**	(11,139)
Cash flows from investing activities			
Purchase of securities		**(313,626)**	(380,700)
Proceeds from sale and maturity of securities		**323,170**	346,252
Purchase of tangible fixed assets	12	**(123)**	(441)
Proceeds from sale of tangible fixed assets	12	**91**	-
Net cash from/(used in) investing activities		**9,512**	(34,889)
Cash flows from financing activities			
Net movement in currency in issue		**24,126**	19,418
Payment to the Government under Section 24(4) of the Central Bank of Malta Act (Cap. 204)		**(24,782)**	(25,682)
Net cash used in financing activities		**(656)**	(6,264)
Movement in cash and cash equivalents		**862**	(52,292)
Cash and cash equivalents at 1 January		**205,861**	258,153
Cash and cash equivalents at 31 December	23	**206,723**	205,861

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

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

1. Accounting policies - continued

(d) Gold balances

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

(e) Claims on the International Monetary Fund

The International Monetary Fund Reserve Tranche Position and Special Drawing Rights are shown at the prevailing representative rate for the Maltese lira of SDR1.96431 to Lm1 as quoted by the Fund at the close of business on 31 December 2003.

The International Monetary Fund Maltese lira holdings, including the Non-Interest Bearing Notes, are revalued against the SDR at the representative rate for the Maltese lira quoted by the Fund at 31 December 2003. Adjustments on revaluations of the International Monetary Fund holdings are reflected in the corresponding asset - Currency Subscription.

(f) Sale and repurchase agreements and lending of securities

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

(g) Other financial instruments

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

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

1. Accounting policies - continued

(g) Other financial instruments *- continued*

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

(h) Offsetting financial instruments

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

(i) Foreign currency translation

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

(j) Tangible fixed assets

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

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

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

(k) Leases

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

1. Accounting policies - continued

(l) Interest income and expense

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

(m) Cash and cash equivalents

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

2. External reserve ratio

The ratio of external assets to notes and coins issued, excluding coins issued for numismatic purposes, and deposit liabilities is 114.20% (2002: 114.78%). 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:

	2003	2002
	Lm'000	Lm'000
Fees and salaries:		
Directors' remuneration	**50**	50
Staff costs	**2,921**	2,545
Depreciation of tangible fixed assets	**321**	348
Auditors' remuneration	**16**	16
Expenditure in connection with transfer of the functions of the Competent Authority under the Banking Act and the Financial Institutions Act to the Malta Financial Services Authority	**250**	250

4. Cash and balances with banks

	2003	2002
	Lm'000	Lm'000
Cash in hand	**257**	451
Balances with banks – repayable on call and at short notice	**12,582**	8,286
	12,839	8,737

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

	2003	2002
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**88,467**	172,153
- Three months or less but over one month	**216,636**	210,339
- One month or less	**360,065**	217,744
	665,168	600,236

6. Available-for-sale investment securities

	2003	2002
	Lm'000	Lm'000
By remaining maturity		
- Over five years	**58,834**	74,607
- Five years or less but over one year	**130,670**	137,332
- One year or less but over three months	**27,507**	15,404
- Three months or less	**3,529**	5,702
	220,540	233,045

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 2003, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of USD20 million or Lm7 million approximately (2002: USD20 million or Lm8 million approximately). No amounts were borrowed under these facilities at the balance sheet dates. At 31 December 2003, investment securities with a fair value of Lm18,682,000 were subject to sale and repurchase agreements. Also, as at the balance sheet date, investment securities with a fair value of Lm244,000 (2002: Lm552,000) were lent out under a securities lending programme with a counterparty.

7. Claims on the International Monetary Fund

	2003	2002
	Lm'000	Lm'000
Reserve Tranche Position	**20,495**	21,824
Special Drawing Rights	**15,191**	15,688
	35,686	37,512

Malta's membership subscription to the International Monetary Fund amounts to SDR102,000,000 (2002: SDR102,000,000).

The Bank's position with the International Monetary Fund at 31 December 2003 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 SDR29,838,718. 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 16), 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 11) is stated at Lm31,431,390 and represents the balance of the quota paid in Maltese liri. A corresponding liability included with "Other liabilities" (see Note 18) exists in the form of Non-Interest Bearing Notes of Lm14,614,000 or SDR28,706,426 and IMF current accounts of Lm16,817,390 or SDR33,034,567.

8. Treasury bills

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

	2003	2002
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**2**	-
- Three months or less but over one month	**204**	-
- One month or less	**231**	2,177
	437	2,177

9. Domestic debt securities

	2003	2002
	Lm'000	Lm'000
Malta Government Stocks listed on the Malta Stock Exchange	**7,335**	2,112

Amounts include:

	2003	2002
	Lm'000	Lm'000
By remaining maturity		
- Over five years	**5,777**	1,157
- Five years or less but over one year	**1,013**	763
- One year or less	**545**	192
	7,335	2,112

10. Derivative financial instruments

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

	Assets	
	2003	2002
	Lm'000	Lm'000
Foreign exchange derivatives held for trading:		
Contracts maturing within six months from the balance sheet date		
- forward purchase of EUR3.4 million (2002: EUR20 million) against Lm	**13**	49
- forward purchase of EUR52.4 million against USD	**1,536**	-
- forward purchase of GBP4.1 million against USD	**172**	-
Contract expiring in 2010		
- forward sale of EUR31.8 million (2002: EUR39.9 million) against Lm	**412**	561
	2,133	610

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

10. Derivative financial instruments - continued

	Liabilities	
	2003	2002
	Lm'000	Lm'000
Foreign exchange derivatives held for trading:		
Contracts maturing within six months from the balance sheet date		
- forward purchase of USD120 million (2002: USD60 million) against Lm	**3,935**	416
- forward sale of Lm3 million (2002: Lm11 million) against GBP	**9**	188
- forward sale of JPY1,250 million against USD	**104**	-
	4,048	604

11. Other assets

	2003	2002
	Lm'000	Lm'000
International Monetary Fund Currency Subscription	**31,431**	33,470
Others	**3,827**	3,844
	35,258	37,314

12. Tangible fixed assets

	Leasehold property Lm'000	Others Lm'000	Total Lm'000
Year ended 31 December 2003			
Opening net book amount	4,296	640	4,936
Additions	7	116	123
Disposals	-	(91)	(91)
Depreciation charge for the year	(66)	(255)	(321)
Depreciation released on disposals	-	46	46
Closing net book amount	**4,237**	**456**	**4,693**
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
At 31 December 2002			
Cost	4,493	2,296	6,789
Accumulated depreciation	(197)	(1,656)	(1,853)
Net book amount	4,296	640	4,936

13. Notes and coins in circulation

	2003 Lm'000	2002 Lm'000
Notes	**467,098**	443,905
Coins	**18,275**	17,342
	485,373	461,247

14. Bank deposits

	2003	2002
	Lm'000	Lm'000
Reserve deposits held in terms of Section 37 of the Central Bank of Malta Act (Cap. 204)	**137,862**	151,558
Liabilities arising from monetary policy instruments	**104,300**	104,000
	242,162	255,558

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

Amounts include:

	2003	2002
	Lm'000	Lm'000
By currency		
Maltese liri	**230,073**	250,256
Foreign	**12,089**	5,302
	242,162	255,558

15. Government deposits

Amounts include:

	2003	2002
	Lm'000	Lm'000
Current accounts by currency		
Maltese liri	**27,275**	19,067
Foreign	**4,986**	3,974
Sinking fund accounts by currency		
Maltese liri	**38,695**	9,479
Foreign	**12,242**	10,441
	83,198	42,961

Government deposits are repayable on demand.

16. Other deposits

	2003 Lm'000	2002 Lm'000
Deposits by Public Sector Corporations and similar entities:		
- Repayable on demand	**2,336**	1,293
International Monetary Fund SDR allocation	**5,746**	6,119
Others:		
- Repayable on demand	**373**	183
	8,455	7,595

Amounts include:

	2003 Lm'000	2002 Lm'000
By currency		
Maltese liri	**1,472**	454
Foreign	**6,983**	7,141
	8,455	7,595

17. Foreign liabilities

	2003 Lm'000	2002 Lm'000
Amounts payable under banking arrangements:		
- Repayable within three months	**6,587**	6,987
Amounts payable to counterparties under sale and repurchase agreements in respect of investment securities:		
- Repayable within three months	**18,909**	-
	25,496	6,987

18. Other liabilities

	2003 Lm'000	2002 Lm'000
International Monetary Fund Non-Interest Bearing Notes	**14,614**	16,651
International Monetary Fund current accounts	**16,817**	16,819
Others	**2,331**	2,419
	33,762	35,889

19. 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.

20. 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.

21. 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.

22. 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 2002	6,048	(29)
Net gains from changes in fair value	8,987	30
Net (gains)/losses transferred to net profit on disposal	(3,797)	52
At 31 December 2002	11,238	53
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**

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

23. Cash and cash equivalents

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

	2003	2002
	Lm'000	Lm'000
Cash and balances with banks (Note 4)	**12,839**	8,737
Treasury bills maturing within three months (Note 8)	**234**	2,177
Placements with banks maturing within three months (Note 5)	**409,353**	340,210
Deposits maturing within three months (Notes 14, 15 and 16)	**(190,207)**	(138,276)
Foreign liabilities maturing within three months (Note 17)	**(25,496)**	(6,987)
	206,723	205,861

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.

24. 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 21 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.

24. 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:

	2003	2002
	%	%
EUR	**73.43**	70.82
GBP	**18.87**	19.72
USD	**7.60**	9.23
Others	**0.10**	0.23
	100.00	100.00

Interest rate risk

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

Liquidity risk

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

24. 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.

25. Contingent liabilities and commitments

	2003	2002
	Lm'000	Lm'000
Contingent liabilities		
Guarantees and letters of credit	**4,637**	19,817
Commitments		
Repayment of foreign loans received by the Bank on behalf of the Government under Financial Conventions	**12,600**	15,275
Total	**17,237**	35,092

By remaining maturity:

Guarantees and letters of credit

	2003	2002
	Lm'000	Lm'000
- Five years or less but over one year	**561**	-
- One year or less but over three months	**1,303**	15,698
- Three months or less	**2,773**	4,119
	4,637	19,817

25. 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

	2003	2002
	Lm'000	Lm'000
- Over five years	**3,367**	5,112
- Five years or less but over one year	**7,174**	7,954
- One year or less but over three months	**1,917**	2,055
- Three months or less	**142**	154
	12,600	15,275

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

26. 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.

27. 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 Central Bank of Malta.

During 2003, demonetised currency notes presented for redemption amounted to Lm585,644 (2002: Lm680,932). At 31 December 2003, the value of unpresented demonetised currency notes amounted to Lm2,873,876 (2002: Lm4,047,488) analysed as follows:

	2003	2002
	Lm'000	Lm'000
Ten year period expires in:		
- 2003	**-**	591
- 2008	**957**	1,009
- 2010	**1,917**	2,447
	2,874	4,047

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 Central Bank of Malta.

During 2003, demonetised coins presented for redemption amounted to Lm5,820 (2002: Lm23,719). At 31 December 2003, the value of unpresented coins amounted to Lm994,124 (2002: Lm999,431) and Lm383,485 (2002: Lm383,998) in respect of the 50c 1st series and 25c 1st series coins respectively. The two year period from the notice of demonetisation in respect of these demonetised coins expires on 16 June 2004.

27. General - continued

(b) Average number of employees

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

	2003 Number	2002 Number
Governors and Deputy General Managers	**7**	7
Heads and Executives	**69**	69
Supervisory and clerical staff	**195**	182
Non-clerical staff	**45**	47
	316	305

(c) Assets held in custody

At 31 December 2003, assets held in custody by the Bank in terms of the Insurance Business Act amounted to Lm24,120,000 (2002: Lm28,259,000).

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

During the financial year under review, the Central Bank of Malta has 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 Central Bank, is adjusted by the amount of investments so effected. Accordingly as at 31 December 2003, the Investor and Depositor Compensation Schemes had interest-bearing deposits of Lm45,739 and Lm397,684 respectively, with the Central Bank.

28. 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.

28. 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	130	57	43	27	257
Balances with banks repayable on call and at short notice by exposure country					
France	65	-	-	-	65
Germany	189	-	-	-	189
Italy	82	-	-	-	82
United Kingdom	47	219	-	37	303
United States of America	-	-	11,352	-	11,352
Other countries	66	4	3	80	153
International financial institutions	325	107	1	5	438
	774	330	11,356	122	12,582
Gold balances by exposure country					
United Kingdom	-	-	-	434	434
Others	-	-	-	63	63
	-	-	-	497	497
Placements with banks by exposure country					
Australia	26,769	14,060	-	-	40,829
Belgium	54,833	9,781	-	-	64,614
Canada	35,404	15,283	-	-	50,687
Denmark	28,064	-	-	-	28,064
France	70,376	6,113	-	-	76,489
Germany	63,467	-	-	-	63,467
Ireland	28,064	-	-	-	28,064
Italy	38,210	4,891	-	-	43,101
Netherlands	53,969	12,226	-	-	66,195
Sweden	22,451	-	6,167	-	28,618
Switzerland	21,933	7,030	-	-	28,963
United Kingdom	105,347	32,095	-	-	137,442
International financial institutions	8,635	-	-	-	8,635
	557,522	101,479	6,167	-	665,168
Available-for-sale investment securities by issuer category					
International banks and financial institutions	48,972	29,922	11,419	248	90,561
Sovereign	59,334	17,849	20,286	-	97,469
Sovereign agencies	11,211	-	1,834	-	13,045
Supranationals	5,080	11,947	2,438	-	19,465
	124,597	59,718	35,977	248	220,540
Claims on the International Monetary Fund	-	-	-	35,686	35,686
Other foreign currency assets	-	-	-	818	818
Total external assets	**683,023**	**161,584**	**53,543**	**37,398**	**935,548**