Central Bank of Malta

THIRTY-FOURTH ANNUAL REPORT

AND

STATEMENT OF ACCOUNTS

2001

Enquiries relating to this Report should be addressed to:
The Manager
External Relations Office
Central Bank of Malta
Castille Place
Valletta CMR 01
Malta

Telephone: (356) 21 247 480
Fax: (356) 21 243 051

Internet: www.centralbankmalta.com
E-mail: info@centralbankmalta.com

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MISSION AND OBJECTIVES

OUR MISSION

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

We will seek to achieve this mission by:

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

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

CENTRAL BANK OF MALTA

BOARD OF DIRECTORS

(As at 1st January 2002)

Mr Michael C Bonello
Governor

Mr David A Pullicino
Deputy Governor

Mr Saviour Falzon	Director
Mr Alfred F Lupi	Director
Prof Edward Scicluna	Director

Executive Management Committee
(As at 1st January 2002)

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Mr Michael C Bonello
Chairman

Deputy Governor
Mr David A Pullicino

Deputy General Manager
Economics Division
Mr Alfred Demarco

Deputy General Manager
Finance and Banking Division
Mr Godfrey Huber

Deputy General Manager
Financial Markets Division
Mr René G Saliba

Deputy General Manager
Financial Stability Division
Mr Herbert Zammit LaFerla

Deputy General Manager
Resource Management Division
Mr John Agius

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(As at 1st January 2002)

Governor
Mr Michael C Bonello
Chairman

Deputy Governor
Mr David A Pullicino

Director
Mr Saviour Falzon

Director
Mr Alfred F Lupi

Director
Prof Edward Scicluna

Deputy General Manager
Economics Division
Mr Alfred Demarco

Deputy General Manager
Financial Markets Division
Mr René G Saliba

Deputy General Manager
Financial Stability Division
Mr Herbert Zammit LaFerla

Investments Policy Committee
(As at 1st January 2002)

Governor
Mr Michael C Bonello
Chairman

Deputy Governor
Mr David A Pullicino

Deputy General Manager
Finance and Banking Division
Mr Godfrey Huber

Deputy General Manager
Financial Markets Division
Mr René G Saliba

Senior Manager
Economic Research Department
Mr Anton Caruana Galizia

Senior Manager
Financial Control Department
Mr Raymond Filletti

Senior Manager
Reserve Management Department
Mr Saviour Briffa

Manager
Correspondent Banking Office
Mr Stephen Attard

Manager
Investments and Reserves Office
Mr Mario Bugeja

THE BOARD OF DIRECTORS

(As at 1st January 2002)

Left to right:

Prof E Scicluna (Director), Mr H Zammit LaFerla (Secretary), Mr M C Bonello (Governor and Chairman), Mr D A Pullicino (Deputy Governor), Mr A F Lupi (Director), Mr S Falzon (Director)

Organisation Chart of the Central Bank of Malta

(As at 1st January 2002)

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

LETTER OF TRANSMITTAL

CENTRAL BANK OF MALTA
VALLETTA

28th March 2002

Dear Minister

In accordance with Section 23(1) of the Central Bank of Malta Act 1967, I have the honour to transmit a copy of the annual accounts of the Bank, certified by the auditors, for the financial year ended 31st December 2001, and a report on the Bank's operations during that year.

Yours sincerely
Michael C Bonello
Governor

Contents

Governor's Statement

At the start of a new year it is customary for economic analysts and policymakers alike to attempt an assessment of the likely impact of recent trends on near-term economic prospects. After the dramatic events of 2001 it would indeed be imprudent not to do so. For not only has the business cycle returned with a vengeance – the world economy has endured the most severe slowdown in more than a generation – but it is also clear that, contrary to recent experience, the largest economies and many emerging ones have lost momentum at the same time. As a result of this synchronized deceleration, the volume of world trade was virtually stagnant in 2001 and foreign direct investment flows slumped heavily from the previous year's level.

The suddenness and the pervasiveness of the downturn, and the uncertainty it has generated - both of which were reflected in the repeated revision of economic forecasts - highlighted the sharp increase in global interdependence in recent years. Integrated markets, whether for goods or capital, have on this occasion proved to be efficient channels for the transmission of disturbances. A new, and potentially more destabilizing manifestation of interdependence were the September 11 terrorist attacks on the United States, which served to further undermine business and consumer confidence.

This fundamental reality of today's globalized economy bears clear implications for policymakers everywhere. For Malta, the events of the past year are a sobering reminder of the economy's structural characteristics.

Foremost among these is the economy's openness that renders it highly dependent on exports for its livelihood and on imports to satisfy most of its needs. This implies that Malta's future development and its convergence to the output and income levels of its main trading partner, the EU, depend crucially on the economy's success in generating export-led growth.

The second critical characteristic is the economy's small size and dependence on a few market niches. This means that inefficiencies in even one sector could impose a relatively heavy burden on the economy, especially when the major foreign exchange earners, such as the electronics and tourism sectors, are particularly vulnerable to external shocks.

The third feature is the dualistic nature of the economy, with one productive sector fully exposed to international competition and another that is largely sheltered through protectionist measures, public sector intervention or monopolistic arrangements. Sheltered activities may prove to be more stable in the face of exogenous shocks, but they also tend to be less flexible and less dynamic, hampering the economy's efforts to become more competitive and converge to international benchmarks.

The hostile external environment which prevailed during the past year exposed these weaknesses in no uncertain manner. Central Bank estimates suggest that after having expanded by around 5 per cent in 2000, real GDP hardly grew in 2001. Highlighting the economy's openness, this contraction resulted mainly from a sharp drop in exports. Yet imports fell to an even larger extent due to the running down of inventories, such that net exports still contributed positively to economic growth, though less than in the previous year.

Other manufacturing sectors registered growth in 2001, though this did not show up in the aggregate figures as it was offset by the slowdown in the dominant electronics sector. It is to be further noted that the decline in

GDP growth itself mainly reflected lower profits earned by subsidiaries of foreign firms. Non-manufacturing productive sectors, including services and tourism, also made a positive contribution to growth, albeit to a lesser extent than in 2000.

Though clearly affected by the global slowdown, the economy nevertheless exhibited a degree of resilience. The unemployment rate was broadly stable over the year while employment levels generally held their ground, even in those sectors most affected by the slowdown. To the extent that this outcome reflects strong competitive positions that are able to withstand adverse shocks, it is welcome indeed. On the other hand, employment stability could also reflect the pervasiveness of sheltered sectors in the economy, of which the public sector is clearly one, as well as labour market rigidities. It is also likely to have been achieved in part at the expense of profit margins.

The inflation performance in 2001, too, testifies to the presence of market imperfections. Inflation rose from 2.4 per cent in 2000 to 3 per cent at a time when the average rate in Malta’s main trading partners was under 2 per cent. Higher food prices were mainly responsible for the rise in inflation. The collapse of a large chain of discount stores eventually led to a restructuring within the retail sector during the year, and this subsequently contributed to a rise in prices. Moreover, protectionist measures impeded imports of agricultural products from entering the domestic market during a period of scarcity caused by unfavourable weather, further adding to price pressures.

Looking ahead, it is to be expected that the transmission mechanisms which magnified the collapse of technology stocks in early 2001 will be equally efficient at radiating positive impulses throughout the global economy when these occur. In this regard, it would seem that though there are as yet only tentative signs of an incipient recovery, the premises do exist for an upturn in the cycle later in 2002. There has been a widespread easing of monetary policy, a protracted period of low oil prices, fiscal loosening in some countries and a strong correction in inventory levels. Moreover, inflation is generally under control so that interest rates should remain low for the foreseeable future.

These developments have the potential to impact favourably on domestic economic growth in 2002, aided by further investment expenditure on capital projects. The attendant increase in exports coupled with continued fiscal consolidation are likely to have a positive impact on the external account, though the fall in imports registered in 2001 due to the reduction in inventory levels is not expected to be repeated. Inflation should decline as the effect of last year’s shock to food prices begins to dissipate.

This cautiously optimistic outlook is, however, subject to an important caveat. For past experience has shown that the global recovery underpinning it may prove to be a selective phenomenon, so that while some countries will benefit, others will not. And those which benefit most are likely to be those whose governments and firms possess the capacity and the will to draw the necessary conclusions from the downturn and reposition themselves to take maximum advantage of new market conditions. Attempting to sit out the downturn with the minimum of change, on the other hand, is likely to prove as short-sighted as it is costly in terms of output foregone and jobs lost. Decisive action must, therefore, be taken to strengthen the economy’s productive capacity, including through cost-cutting measures. This not only to benefit from the expected upturn, but more importantly as a premise for raising the economy’s trend output growth rate.

Medium-term Outlook and Policy Implications

The challenges posed by the current cyclical phase should indeed be viewed within the broader context of longer-term economic goals. One such goal must be convergence to the income level of our main trading partner. Malta’s per capita income is just 56 per cent of the EU average. If the economy continues to grow at 4 per cent - the average growth rate of the past five years - convergence could take as long as thirty-five years. This is clearly insufficient.

Moreover, to the extent that recent growth was underpinned by fiscal expansion, the challenge ahead must be not only to achieve a consistently higher growth rate, but also to further pursue macroeconomic balance. For this latter reason, a sustained higher growth rate cannot be based on increases in private and public consumption, but can only materialise as a result of higher investment and export levels.

Economic policy must, therefore, focus more than ever on enhancing Malta's attractiveness as an investment location. This requires a wide-ranging effort, including a further consolidation of the fiscal balance; the preservation of financial and exchange rate stability; and the implementation of structural reforms, with a particular emphasis on greater supply-side flexibility.

The beneficial effects of fiscal consolidation are now well understood following the experience of the 1990s. A narrowing of the fiscal deficit increases the availability of resources to the private sector, alleviates upward pressures on domestic interest rates, improves the country's credit rating and assists in the process of convergence. On the other hand, these benefits can only be derived in full if accompanied by a tangible increase in the cost-efficiency with which public sector resources are deployed.

Exchange rate stability and maintaining interest rates at the lowest level compatible with price stability are other necessary, though not sufficient, conditions to promote investment and export competitiveness. The fixed exchange rate regime helps to avoid volatility in domestic production costs, as witnessed throughout the foreign exchange market turmoil of the past three years. On the other hand, the sustainability of the Maltese lira's peg to the trade-weighted currency basket depends crucially upon the level of the external reserves, which in turn is determined by the overall balance of payments performance. The latter was positive in 2001 and the external reserves of the Central Bank increased by almost a fifth to a level equivalent to over six months of imports. This strengthening of the reserve position against a background of easier monetary conditions abroad permitted the Bank to lower its official interest rates on two occasions during the year. The persistence of the current account deficit must nevertheless be addressed if the currency peg is to be sustainable over the long-term. To the extent that this factor impinges upon the country risk perceptions of investors, it would otherwise imply the need for relatively high interest rates in Malta compared to those of our main trading partners, which would dent competitiveness through a higher cost of corporate finance.

The maintenance of a fixed exchange rate also requires a strong financial sector. The Central Bank is strengthening its capacity to ensure the stability of the financial system, and in this context is closely monitoring the loan portfolio of the banking system, credit risk assessment procedures and gearing levels in the corporate sector. The health of financial investments undertaken by households is another important aspect of systemic risk management.

Macroeconomic and financial stability are necessary conditions for raising the underlying rate of growth, but they must be complemented by a more market-oriented approach in the operation of the goods, labour and capital markets. Competition is the best means available to achieve the flexibility and dynamism necessary for success in today's global marketplace. There is also, however, a role for proactive policies aimed at improving the availability and efficiency of resources within the public and private sectors, at securing the best possible access to target export markets and for the attraction of foreign direct investment, including through privatisation.

The Business Promotion Act and the Draft Industrial Policy document contain a number of worthy initiatives in this respect. It would, however, be useful to complement these initiatives by a more holistic approach to enhancing the country's competitiveness. Through the appropriate measurement of direct and indirect production costs, it should be possible to identify both the principal obstacles which stand in the way of more cost-efficient production as well as effective solutions. Such an exercise could be undertaken under the auspices of the Malta Council for Economic and Social Development.

A more market-oriented approach in the goods market implies the elimination of monopolistic practices that lead to inferior products at higher cost. Waste in the form of the public provision of goods and services at zero-cost to the user should also to be tackled. The time has come to redefine the concept of need and to reschedule social priorities, because it is clear that the country can no longer afford to provide such a wide range of goods and services for free to all, irrespective of income levels.

In the labour market, the need to remain internationally competitive dictates that wage levels should move in line with productivity. This maxim is currently undermined by the practice of linking adjustments in wage levels automatically to movements in the cost of living. It should be clear that wage increases not matched by productivity gains tend to reduce cost competitiveness and put jobs at risk.

It must be similarly understood that continuous improvements in wage levels and in employment conditions cannot be sustained at all times irrespective of economic realities. In to-day's global environment there is a fine balance between success and failure in competing for export orders. Wage moderation is more than ever necessary to protect not just existing employment levels, but also for the creation of new jobs in the years ahead. Above all, the achievement of efficiency gains, through the adoption of modern technology and more flexible working practices as well as through the upgrading and reallocation of labour, represents the best guarantee for sustainable improvements in living standards. This, therefore, should be the ultimate collective aim of the social partners in conducting industrial relations.

Structural reform is not painless because it implies that initially there will be both winners and losers. It therefore represents a formidable challenge. But it cannot for that matter be wished away. It need and should not be, for experience elsewhere suggests that it can be overcome. For a start, the more efficient, market-oriented economy open to change and innovation which is the object of the required reforms will in time generate the wealth necessary for the creation of new jobs and the fulfilment of rising expectations. And as for any short-term dislocations, particularly in the labour market, it should not prove beyond the means of the country, with its extensive social safety net and with the goodwill of all the social partners, to minimise and share equitably the costs of change. The challenge is to reconcile what is politically and socially desired with what is financially affordable.

Central Bank Operations

Throughout the year the Bank continued to review its policies, internal organisation and operations in line with developments in Malta and overseas. Particular attention was paid to the evolution of central banking functions and practices abroad, especially in the European Union.

In carrying out its monetary policy responsibilities the Bank continued to be guided by the ultimate objective of price stability. In this regard it is pertinent to note that the amendments to the Central Bank of Malta Act, which are about to be debated in Parliament, explicitly identify price stability as the primary goal of monetary policy. The amendments will also reinforce the Bank's statutory and operational independence. In particular, the Bank's role in the management and regulation of the local payment and settlements system will be considerably strengthened and the Bank will be prohibited from buying Government securities in the primary market.

The Bank seeks to achieve its price stability objective through the operation of a fixed exchange rate. The Maltese lira thus continues to be pegged to a basket of three low-inflation currencies, the euro, the US dollar and the pound sterling. In the light of the strong underpinning of the currency peg provided by the increase in the external reserves during the past year and of the decline in interest rates abroad, the Bank was able to ease its monetary policy stance. Official interest rates were reduced by twenty-five basis points on two occasions, in August and November, while the reserve ratio was lowered by one percentage point in September. This was the first time the ratio was adjusted following its introduction in October 1990.

The Bank's monetary policy strategy remains consistent with the objective of capital account liberalisation. During the year administrative controls on capital movements were in fact eased further. It is expected that the liberalisation of capital movements will reinforce competitive pressures in the financial sector, resulting in efficiency gains for the economy as a whole.

In implementing its monetary policy the Central Bank regularly conducted open market operations. In contrast with the previous year, the banking system was short of liquidity for most of 2001 and the Bank injected funds repeatedly through repos. The situation was reversed during the last quarter, however, when a liquidity surplus developed, mainly because the banks' holdings of foreign currency exceeded their requirements and were sold to the Central Bank. The Bank absorbed this liquidity by offering term deposits.

The Bank also continued to perform a market-making role by standing ready to buy and sell Government securities on the secondary market. During 2001 the Bank again refrained from participating in the primary market for Government securities, consonantly with the intent of the proposed amendments to the Central Bank of Malta Act. Furthermore, through the Financial Markets Committee, the Bank collaborated with the banks and the Treasury in the context of further developing the money and capital markets. The Bank was also active in the foreign exchange market, mainly as a net buyer of foreign currency. This reflected the surplus balance of payments position which emerged as the year progressed.

An important feature of the past year was the transfer of the banking supervision function from the Central Bank to the Malta Financial Services Centre (MFSC). A plan to ensure a smooth transition was drawn up in conjunction with the MFSC; it was successfully implemented during the second half of the year, when most of the Bank staff in the Banking Supervision Department opted to join the new banking unit that was set up by the MFSC. As planned, the Bank ceased to be the Competent Authority in terms of the Banking Act, 1994 and the Financial Institutions Act, 1994, with the responsibility to license, regulate and supervise banks and financial institutions, on 1 January 2002.

Concurrently with this move the Bank took further steps to strengthen its capacity to fulfil its ongoing legal responsibility to promote a sound financial structure and an orderly capital market in Malta. A plan has been drawn up to endow the Bank with the human and technical resources necessary to monitor the overall stability of the domestic financial system. An early emphasis is being placed by the recently set up Financial Stability Office on data collection and on analytical work.

Importance continued to be given during the year to the strengthening of relations with international organisations. Contacts with the European Central Bank (ECB), a number of national central banks of European Union member countries and of accession countries were further developed. As a result of this close interaction, new opportunities for skills development and for the exchange of views on legal, statistical and operational issues became available to a broad cross-section of the Bank's staff.

The Bank continued to play an important role in the harmonisation of domestic legislation with the *acquis communautaire*. Apart from amendments to the Central Bank of Malta Act, the Banking Act and the Financial Institutions Act, the Bank was also involved in amending legislation on insolvency, collateral and payment systems. With regard to the latter, substantial progress was achieved on upgrading the Bank's real time gross settlement system (RTGS) in line with international requirements. This mainly involved the introduction of an automated system to process interbank transfers, enabling banks to carry out automated payments that are settled in real time through their accounts with the Bank.

In the light of the introduction of euro notes and coin in the eurozone countries from the beginning of 2002, the Bank was actively involved in an information campaign primarily aimed at the tourism and commercial sectors. The Bank also ensured that banking and financial institutions were provided with sufficient quantities of euro notes at the time of the changeover. In this regard the Bank co-operated closely with the ECB and with the Banca d'Italia.

As in previous years the Bank continued to strengthen its human resources through staff recruitment and a wide range of training programmes. Further investment in information technology was also undertaken, mainly involving changes in the Bank's core operating system.

During 2001 the Bank's net profits amount to Lm26 million, the same level as in the previous year.

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

Michael C Bonello

Part I

FINANCIAL AND ECONOMIC DEVELOPMENTS

1. The International Environment

1.1 The World Economy

The year 2001 saw a sharp deterioration in the international economic environment, with world growth expected to drop to 2.5%, from 4.7% in 2000. This worsening of the global scenario began with a slowdown in the United States, which gradually spilled over to other countries. Even before the September 11 terrorist attacks, various factors - among which a sharp inventory correction in the technology sector and the lagged impact of rising oil prices - had brought global growth to a virtual standstill.

By the beginning of September economic activity in the United States had been slowing down for several months, undermined by a sharp drop in inventories and declining profits. In the third quarter, GDP even contracted slightly, as investment continued to decline and consumer spending remained subdued. Hopes of an early recovery were decisively shattered by the events of September 11, however, as further sources of uncertainty and risk dampened global demand for goods and services. As a result, layoffs increased rapidly and the unemployment rate rose to 5.9% by the end of the year.

In the euro area, GDP growth was expected to decline to 1.5%, from 3.4% in 2000, reflecting a contraction in exports and in investment. Private consumption also declined, as unemployment levels in the region crept upwards during the later months of the year. An additional deterrent to growth was the limited room for fiscal policy manoeuvring, as revenue shortfalls reduced the scope for discretionary stimulus measures. On the positive side, however, inflation in the euro area eased as a result of lower energy prices.

Economic activity in the United Kingdom grew at a steady pace during the first half of the year, reflecting higher consumer and government spending along with rising output in the services and construction sectors. Weaknesses in the economy had in fact been largely concentrated in the manufacturing sector, though agricultural output was also badly hit by the outbreak of foot-and-mouth disease. Signs of a slowdown in

Table 1.1
INTERNATIONAL ECONOMIC INDICATORS
Percentage change from previous period

Country	Real GDP Percentage change			Inflation (Consumer prices) Percentage change			Current account balances US$ billions		
	1999	2000	2001[1]	1999	2000	2001[1]	1999	2000	2001[1]
United States	4.1	4.1	1.0	2.2	3.4	2.9	-324.4	-444.7	-392.0
European Union	2.6	3.4	1.7	1.4	2.3	2.7	6.6	-28.0	0.9
Euro area	2.6	3.4	1.5	1.1	2.4	2.7	26.1	-8.7	14.2
United Kingdom	2.1	2.9	2.3	2.3[3]	2.1[3]	2.3[3]	-30.9	-27.9	-24.3
Japan	0.7	2.2	-0.4	-0.3	-0.8	-0.7	106.8	116.9	90.8
Advanced countries	3.3	3.9	1.1	1.4	2.3	2.3	-139.5	-253.7	-199.6
Developing countries	3.9	5.8	4.0	6.8	5.9	6.0	-11.6	61.5	4.6
Countries in transition[2]	3.6	6.3	4.9	43.9	20.1	16.0	-2.1	27.0	13.2

[1] Forecasts.
[2] Includes countries of Central and Eastern Europe and the former USSR.
[3] Retail price index excluding mortgage interest.

Source: *World Economic Outlook*, Washington: International Monetary Fund, December 2001

Britain's GDP growth showed up in the final quarter of the year, as the travel and tourism sectors were hit by the terrorist attacks on the US and consumer confidence declined.

Early in the year the Japanese economy slipped back into recession for the third time in a decade, largely as a result of a downturn in private demand on account of excessive indebtedness and a sharp slowdown in the demand for high tech goods. During the second half of the year, economic conditions in Japan deteriorated further with business investment, exports and output declining sharply. As a result, Japan's unemployment rate shot up to a record 5.6%. Furthermore, the Japanese economy continued to sink into deflation, dragging down corporate profits, restraining consumption and making past debt increasingly expensive to repay.

1.2 Interest Rates and Exchange Rates

During 2001 short-term interest rates in the world's major economies fluctuated in line with inflation expectations and underlying economic conditions. Hence, in both the United States and the euro area, money market rates declined in response to the monetary policy-loosening stance adopted by the Federal Reserve (Fed) and the European Central Bank (ECB), respectively. In the UK, interest rates rose in the early months of the year but declined thereafter as the Bank of England eased its monetary policy stance. Meanwhile, money market rates in Japan stood at 0.25% until the end of February before declining to just above zero and remaining at that level for the rest of the year.

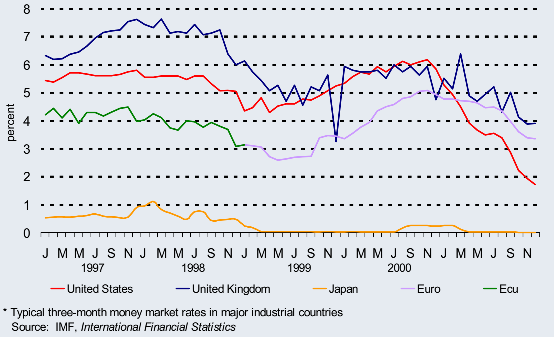
In the United States, money market rates tended to decline throughout 2001 as the Federal Reserve cut the Federal Funds rate by a total of 4.75 basis points to a forty year low 1.75%. Initially, the Fed tried to sustain slowing economic growth after a record 10-year expansion. Later in the year, however, the Fed sought to cushion the economy against the effects of the September 11 attacks. Short-term money market rates tended to stay below the Federal Funds rate throughout the year.

In the euro area, money market rates remained relatively stable until early May, reflecting the ECB's decision to keep official rates unchanged. Subsequently, however, as clear signs of a slowdown emerged, and the September 11 attacks made a quick recovery seem less likely, the ECB lowered its refinancing rates four times. Short-term money market rates in the euro area tended to stay above the ECB's refinancing rate throughout the year.

In the United Kingdom, money-market rates tended to rise early in the year before resuming a downward trend amid signs of a global slowdown. Against the backdrop of a weaker world outlook and increased uncertainty, which dampened business and consumer confidence, the Bank of England cut interest rates seven times during the year, bringing the repo rate down to 4%, in an attempt to keep the economy's momentum going.

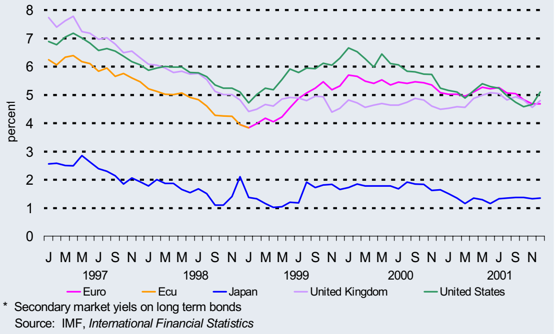
Concerned with persisting deflationary pressures, the Bank of Japan cut its discount rate three times to 0.1% during 2001, even lowering the target for its overnight

Chart 1.1
SHORT-TERM INTEREST RATES *
(monthly averages)



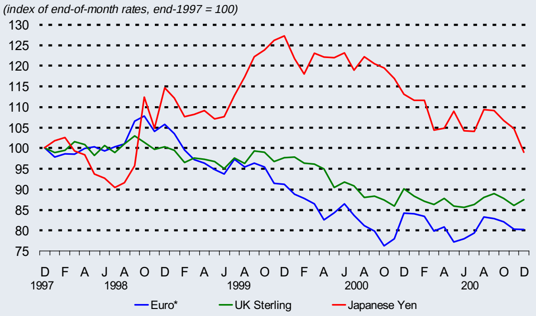
* Typical three-month money market rates in major industrial countries
Source: IMF, *International Financial Statistics*

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



* Secondary market yiels on long term bonds
Source: IMF, *International Financial Statistics*

Chart 1.3
EXCHANGE RATE MOVEMENTS OF SELECTED CURRENCIES AGAINST THE US DOLLAR
(index of end-of-month rates, end-1997 = 100)



* Ecu, until December 1998; euro, from January 1999

call rate from 0.15% to (effectively) zero. Meanwhile, as Chart 1.1 shows, Japanese money market rates fell to just over 0% by the end of February before stabilising slightly above that level for the rest of the year.

Long-term interest rates fluctuated according to inflation expectations and movements in short-term rates. Accordingly, long-term rates tended to rise above short-term rates in the United States and the euro area as central banks cut official interest rates to stimulate economic growth. Meanwhile, British long-term rates tended to rise until October, before easing on indications of a slowdown in the fourth quarter. Japan's long-term rates, however, remained largely unchanged throughout the year.

In the early months of 2001 the US dollar continued to strengthen against the other major currencies, particularly the euro and sterling. Concerns that the ECB had kept interest rates unchanged and a fall in the German business sentiment index further supported the dollar and weakened the euro, while sterling was depressed at this stage by news of a lower-than-expected rise in British GDP in the final

Table 1.2
AVERAGE EXCHANGE RATES OF THE EURO, STERLING AND THE YEN AGAINST THE US DOLLAR - 2001

	US$/euro	US$/Stg	Yen/US$
January	0.9393	1.4787	116.9
February	0.9223	1.4546	116.2
March	0.9113	1.4467	121.1
April	0.8933	1.4353	123.8
May	0.8755	1.4270	121.8
June	0.8546	1.4043	122.2
July	0.8603	1.4141	124.6
August	0.9004	1.4367	121.6
September	0.9106	1.4630	118.9
October	0.9068	1.4526	121.2
November	0.8886	1.4379	122.4
December	0.8943	1.4396	127.4
Average for the year	0.8964	1.4409	121.5
Closing rate on 31.12.01	0.8857	1.4498	131.3
Closing rate on 29.12.00	0.9289	1.4939	114.9
High for the year	0.9584 (Jan. 08)	1.5052 (Jan. 05)	131.8 (Dec. 27)
Low for the year	0.8366 (July 06)	1.3725 (June 12)	113.9 (Jan. 04)
Percentage appreciation (+)/depreciation (-) of the currency vs. the dollar from closing rate on 29.12.00 to closing rate on 31.12.01	-4.7	-3.0	14.3

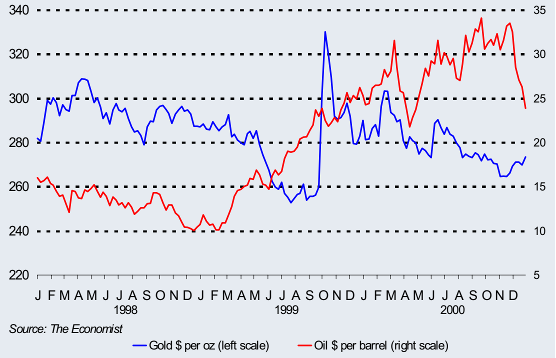
quarter of 2000. As Chart 1.3 shows, the US currency also appreciated against the yen at the beginning of the year, when the Japanese currency was undermined by Japan's internal political problems and deepening pessimism about its economic prospects.

After mid-April, the dollar continued to record gains across the board, despite clear indications of a more pronounced economic slowdown in the Unites States, while the euro was further weakened by a series of negative data from the euro area economy. Meanwhile, sterling, undermined by higher-than-expected UK inflation in May, also lost ground against the dollar. By the end of June, the dollar strengthened further against the other major currencies, in spite of the fact that the Federal Reserve cut interest rates again to stimulate the flagging economy.

In July, however, the US currency lost ground against both the euro and sterling, amid fears that a strong dollar was hurting US exports and signals from the Fed that the economy was heading towards a recession. In fact, falling manufacturing activity during August further undermined the dollar, which lost ground against the euro. After September 11, moreover, the dollar was further undermined by the uncertainty surrounding the United States economy and fears that the terrorist attacks could plunge it further into recession. As a result, the dollar lost more ground against the other major currencies.

Early in the final quarter of the year, the dollar remained under pressure as data on the downturn in consumer confidence and the negative figures on unemployment and manufacturing in the United States shifted market sentiment in favour of the euro and sterling. Towards the end of the quarter, however, the dollar again recovered against the other major currencies, as investors expected dollar assets to offer a better return in the long run on account of the strong fiscal and monetary stimulus delivered by the United States authorities. In particular, the dollar appreciated against the yen, as declining business confidence, rising bankruptcies and record high unemployment renewed

CHART 1.4
COMMODITY PRICES



scepticism regarding Japan's economic prospects.

1.3 Key Commodities

During the first half of 2001 oil prices rose steadily, reflecting supply shortages following output reductions agreed by OPEC in response to the global slowdown, the Iraq-UN dispute over the 'oil-for-food' programme, and political uncertainty in the Middle East. During the second half of the year, however, the price of oil started to move on a downward trend on higher United States oil stock data. This trend was reinforced after September 11, when OPEC guaranteed to provide adequate supplies at all times. As a result, oil ended the year at US$19.38 per barrel, down from US$23.85 at the end of 2000.

The price of gold fluctuated widely during 2001. Until April, the price fell as investment demand for the metal declined by 3 per cent from a year earlier. In May, however, when the Federal Reserve started cutting interest rates aggressively and inflationary concerns induced a higher demand for the metal, gold rose sharply, as Chart 1.4 shows. This trend was subsequently reinforced by the increase in global uncertainty following the events of September 11, which caused a rise in safe-haven buying of gold by a number of countries. Towards the end of the year, however, the gold price eased slightly as the global slowdown hurt both consumer spending and industrial demand. Nevertheless, gold ended the year at US$277.70 per ounce, up 1.5% from the US$273.50 per ounce at which it had ended the year 2000.

2. The Domestic Economy

Growth decelerated sharply in 2001, as the progressive deterioration in global economic conditions took its toll on the Maltese economy. The electronics sector, which in previous years had been a major source of real GDP growth, was faced by a sharp decline in export demand and consequently experienced a significant drop in profits. After an initial spurt in activity during the first half of the year, other export-oriented manufacturers were similarly affected during the third quarter. The September 11 terrorist attacks on the United States further aggravated the situation for exporters. The tourism industry was already coping with a decline in arrivals from Germany following a cut in the capacity allocated to Malta by a leading tour operator. The events of September 11, however, induced an aversion to air travel, especially among conference organisers, and this resulted in a marked decline in tourism activity in the following months.

In the domestic market, consumption growth decelerated as disposable income expanded at a slower pace than in 2000, reflecting lower employment growth. The unemployment rate rose marginally due to a contraction in employment in hotels and catering establishments and redundancies in the distributive trades. The latter followed the closure of two large discount stores, a development that contributed to the sharp rise in food prices witnessed in the course of the year. However, higher import prices and a drop in local agricultural production on account of adverse weather conditions were the main factors behind the rise in retail price inflation during the year.

Table 2.1
GDP BY CATEGORY OF EXPENDITURE

Lm millions

	1997	1998	1999	2000	January-September 2000	January-September 2001
AT CURRENT MARKET PRICES						
Private consumption expenditure	803.5	846.0	915.0	996.0	739.2	775.5
Government consumption expenditure	264.1	269.0	272.6	291.1	212.8	240.3
Gross fixed capital formation	326.4	333.6	340.0	412.1	308.6	274.8
Inventory changes	3.0	-10.7	9.4	33.9	4.4	-38.4
Domestic absorption	**1,397.0**	**1,437.9**	**1,537.0**	**1733.1**	**1,265.0**	**1,252.2**
Exports of goods and services	1,095.8	1,194.7	1,321.3	1604.0	1,184.4	1,076.6
Imports of goods and services	1,204.6	1,270.3	1,402.2	1776.6	1,295.4	1,123.5
Balance of trade in goods and services	**-108.8**	**-75.6**	**-80.9**	**-172.6**	**-111.0**	**-46.9**
GROSS DOMESTIC PRODUCT	**1,288.2**	**1,362.3**	**1,456.1**	**1560.6**	**1,153.9**	**1,205.2**
AT CONSTANT 1995 PRICES						
Private consumption expenditure	762.1	781.5	829.0	884.3	656.2	672.7
Government consumption expenditure	252.0	242.0	240.6	253.1	185.1	191.3
Gross fixed capital formation	319.3	308.5	320.9	379.0	283.7	244.9
Inventory changes	2.9	-9.8	8.6	30.4	3.9	-32.8
Domestic absorption	**1,336.3**	**1,322.2**	**1,399.1**	**1,546.8**	**1,128.9**	**1,076.1**
Exports of goods and services	1,051.5	1,137.1	1,230.7	1299.1	959.3	889.1
Imports of goods and services	1,138.8	1,167.4	1,285.6	1430.0	1,042.7	922.7
Balance of trade in goods and services	**-87.3**	**-30.3**	**-54.9**	**-130.9**	**-83.4**	**-33.6**
GROSS DOMESTIC PRODUCT	**1,249.0**	**1,291.8**	**1,344.3**	**1,415.9**	**1,045.5**	**1,042.5**

Source: National Statistics Office

Table 2.2
YEAR-ON-YEAR PERCENTAGE CHANGES IN GDP

percent

	1997	1998	1999	2000	2001 Central Bank estimates
AT CURRENT MARKET PRICES					
Private consumption expenditure	5.0	5.3	8.2	8.9	5.4
Government consumption expenditure	1.7	1.9	1.3	6.8	12.5
Gross fixed capital formation	-5.5	2.2	1.9	21.2	-11.3
Exports of goods and services	4.8	9.0	10.6	21.4	-11.2
Imports of goods and services	-0.7	5.5	10.4	26.7	-15.3
GROSS DOMESTIC PRODUCT	**7.2**	**5.8**	**6.9**	**7.2**	**3.8**
AT CONSTANT 1995 PRICES					
Private consumption expenditure	1.6	2.5	6.1	6.7	2.5
Government consumption expenditure	-1.1	-4.0	-0.6	5.2	3.0
Gross fixed capital formation	-4.5	-3.4	4.0	18.1	-14.0
Exports of goods and services	4.0	8.1	8.2	5.6	-5.1
Imports of goods and services	-1.7	2.5	10.1	11.2	-11.2
GROSS DOMESTIC PRODUCT	**4.9**	**3.4**	**4.1**	**5.3**	**0.4**

Source: National Statistics Office , Central Bank estimates

2.1 Aggregate Demand

The Central Bank estimates that real GDP grew only marginally during the year. Nominal GDP growth decelerated to 3.8%, from 7.2% a year earlier, despite the substantial civil service pay award. The deceleration in real growth was due to a sharp contraction in exports of electronic components and in tourism activity, as well as a slower rate of increase in private consumption.

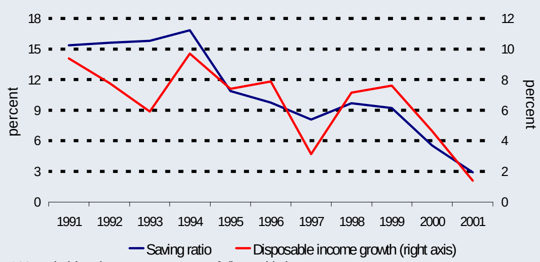
2.1.1 Consumption expenditure

As Table 2.2 shows, private consumption is estimated to have risen by around 2.5% in real terms during 2001, after two years of rapid expansion. Imports of consumer goods increased only slightly in nominal terms, as households appeared to delay purchases of durable goods, such as motor vehicles. Expenditure on foreign travel also declined significantly, in contrast with the strong growth registered in previous years. By contrast, local sales of manufactures, particularly food and beverages, rebounded, though this partly reflected price increases.

The deceleration in private consumption spending was mainly due to the slower growth of disposable income. The latter in turn mainly reflected a marked fall in non-wage income (i.e. interests, dividends and income from self-employment), a category that in previous years had increased substantially. The share of personal income taken by direct taxation also continued to grow, though at a more moderate pace than in 2000. Since the rise in private consumption continued to outstrip that of personal disposable income, the household saving ratio declined further during the year, as Chart 2.1 shows.

As explained previously, the strong growth in

Chart 2.1
HOUSEHOLD SAVING RATIO* AND DISPOSABLE INCOME



* Household saving as a percentage of disposable income
Data for 2001 are Central Bank of Malta estimates
Source: National Statistics Office, Economic Policy Division, Economic Survey

Government consumption in nominal terms mainly reflected the upward revision in civil service pay scales. In real terms, Government consumption grew at a more moderate pace, as employment with Government departments rose only slightly and outlays on medical supplies, which had been boosted by exceptional factors in the previous year, fell sharply.

2.1.2 Gross fixed capital formation

Overall, gross fixed capital formation declined in 2001, following the large investment undertaken by the electronics sector the previous year. Underlying investment activity, however, continued to expand in most sectors apart from electronics. Gross fixed capital formation in this sector had been boosted in 2000 by the expansion programme undertaken by a leading firm. By contrast it was the investment outlays of the other manufacturing sectors that rose significantly during 2001, as a number of firms sought to rationalise their operations and increase the capital intensity of their production processes in order to enhance competitiveness. Construction activity was also buoyant, due mainly to public sector projects such as the new hospital, various road works and the construction of the new Cirkewwa ferry terminal. On the other hand, private sector construction expenditure stabilised, after having contracted for a number of years.

2.1.3 External demand and supply

Several factors contributed to the sharp contraction in exports of goods and services during the year reviewed. The unexpectedly pronounced cyclical downturn in the global semiconductor market led to a 30% decline in exports by the local electronics sector, which in previous years been one of the main motors of export growth. At the same time the tourism sector suffered two major shocks: a reduction of the capacity allocated to Malta by the leading German tour operator and the repercussions of the September 11 terrorist attacks on the United States.

Table 2.3

LABOUR MARKET: MAIN INDICATORS

number of persons

	November	
	2000	2001
Labour supply	144,531	145,632
Males	104,066	104,415
Females	40,465	41,217
Registered unemployed	7,247	7,428
Males	6,192	6,126
Females	1,055	1,302
Unemployment rate (%)	5.0	5.1
Gainfully occupied	137,284	138,204

Source: Employment and Training Corporation

Imports of goods and services, however, dropped even more sharply than exports, bringing about a significant contraction in the deficit on goods and services in nominal terms. The lower import bill was essentially the counterpart of the decline in investment and lower export activity. Firms across the Maltese economy, particularly those in the electronics sector, also cut inventory levels, which had risen sharply during the previous year. Moreover, outlays on fuel declined, reflecting the drop in the international oil price.

The improvement in the goods and services balance in real terms was even greater than that in nominal terms. This was due to the fact that the prices of exports of electronic components dropped more sharply than those of their imported inputs, particularly during the fourth quarter. Furthermore, other manufacturing sectors reported a significant growth in export turnover.

2.2 The Labour Market[1]

Labour market data compiled by the Employment and Training Corporation (ETC) indicate that the unemployment rate rose marginally during the eleven months to November 2001[2], as the labour supply grew

[1] The ETC has recently carried out a wide-ranging revision of its employment data for the period 1983 - 2001. This entailed the exclusion of the greater part of the temporarily employed from the gainfully occupied population, which as a result contracted significantly. At the same time, the unemployment data were revised upwards to include those registering under Part 2 of the unemployment register.

[2] At the time of writing, the ETC had not yet released labour market data for December 2001. Furthermore, the revised data for December 2000 had not yet been finalised.

Table 2.4
GAINFULLY OCCUPIED BY SECTOR

number of persons

	November					
	2000			2001		
	Public	Private	Total	Public	Private	Total
i. Direct production	**3,013**	**37,960**	**40,973**	**2,950**	**38,243**	**41,193**
including						
Footwear and clothing	0	3,340	3,340	0	3,230	3,230
Construction	136	6,421	6,557	134	6,624	6,758
Electronics, appliances and supplies	0	5,916	5,916	0	5,860	5,860
Food	22	3,079	3,101	20	3,001	3,021
Agriculture[1]	0	2,195	2,195	0	2,216	2,216
Transport equipment[2]	819	2,026	2,845	809	2,026	2,835
Other[3]	2,036	14,983	17,019	1,987	15,286	17,273
ii. Market services	**12,894**	**50,164**	**63,058**	**13,098**	**50,376**	**63,474**
including						
Wholesale and retail	0	15,621	15,621	0	15,328	15,328
Hotel and catering	339	9,321	9,660	311	9,185	9,496
Community and business	4,414	10,543	14,957	4,777	11,179	15,956
Transport	2,359	5,348	7,707	2,345	5,257	7,602
Malta Drydocks	2,790	0	2,790	2,657	0	2,657
Banks and financial institutions	404	3,767	4,171	420	3,661	4,081
Other	2,588	5,564	8,152	2,588	5,766	8,354
iii. Temporarily employed	**339**	**873**	**1,212**	**320**	**815**	**1,135**
including						
Apprentices and trainees	339	873	1,212	304	815	1,119
Pupil workers	0	0	0	0	0	0
Student workers	0	0	0	16	0	16
iv. Government[4]	**32,041**	**0**	**32,041**	**32,402**	**0**	**32,402**
Gainfully occupied	**48,287**	**88,997**	**137,284**	**48,770**	**89,434**	**138,204**

[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

at a slightly faster pace than the gainfully occupied population[3]. The latter, in fact, increased by 1.5% during the first eleven months of 2001, as against 2.4% the previous year.

Much of the deceleration in the rate of job creation can be traced to weak labour demand in directly productive activities, employment in which had risen substantially during 2000 driven by both the manufacturing and construction sectors. By contrast, during 2001, although the construction industry continued to add to its existing complement, employment in manufacturing remained practically unchanged as a sharp rise in the textile industry was offset by small losses across a wide spectrum of other manufacturing sectors, including electronics.

Overall employment in the services sector was up by

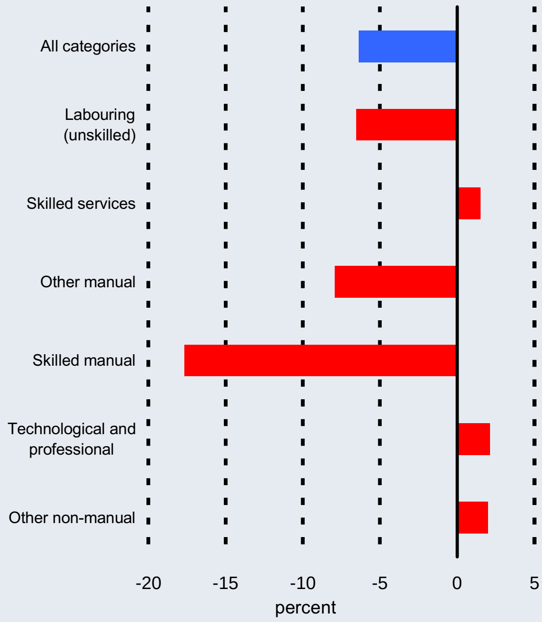
[3] The gainfully occupied population includes only those persons employed on a full-time basis. At the time of writing the ETC was in the process of revising its data on part-time employment, and final figures on this category of workers were not yet available.

0.7%, even though some sub-sectors shed labour. In fact, as can be seen from Table 2.4, there was a marked drop in employment in the wholesale and retail trades and in hotels and catering establishments. The jobs lost in these sub-sectors, however, were more than offset by strong gains in the community and business and the communications[4] sub-sectors. Public sector employment in service industries also rose, by 204, while the number of Government employees was up by 361.

In the course of the year, the National Statistics Office (NSO) began to publish the results of Labour Force Surveys (LFSs) conducted on a quarterly basis. These surveys are designed in accordance with the concepts and definitions set by the International Labour Organisation (ILO) and the European Union's statistical agency, Eurostat. Their results therefore differ from ETC data, which are compiled according to definitions set by local legislation on employment and social security benefits. For example, the LFS definition of unemployment includes all persons actively seeking employment, whereas the ETC definition includes only those who actually register as unemployed. Hence the unemployment rate indicated by the LFS tends to be higher than that implied by the ETC data.

Besides making it possible to compare local labour market data with those of other countries, the LFSs also provide detailed labour market statistics that had not previously been available on a regular basis, such as those on activity and employment rates. The former is defined as the ratio between the labour force (i.e. those employed on a full-time and/or part-time basis together with the unemployed) and the working age population (those aged between 15-64 years), while the employment rate is the proportion of the working age population that is actually employed. The Surveys carried out to date show that less than three-fifths of the working age population in Malta are either in employment or actively seeking it. This is low when compared with other developed countries, with the difference mainly reflecting the low, but growing, female participation rate. The activity rate remained stable

Chart 2.2
CHANGE IN UNEMPLOYMENT BY SKILL CATEGORY IN 2001



Source: Ministry for Economic Services; Economic Survey

during the first nine months of the year, while the employment rate rose slightly.

2.2.1 Unemployment

Data on the profile of persons registering under Part 1 of the unemployment register indicate that, for the first time in several years, there was a reduction in structural unemployment.

A breakdown of the unemployed by skill category, presented in Chart 2.2, shows that during the twelve months to September 2001[5] there was a substantial drop in the number of persons seeking manual employment, including skilled employment. This mainly reflected the increased demand for construction workers, though there was also a sharp drop in the number of persons registering for unskilled manual work. By contrast, the number of persons seeking non-manual jobs rose during the period, probably reflecting the contraction in employment in private services.

The average duration of unemployment also fell during 2001. Thus, the proportion of job seekers who

[4] Included under "others".
[5] The latest available information at the time of writing.

had been registering for more than 52 weeks fell to 43.4%, from 53.5% a year earlier. Unemployment levels among persons aged over 49 years, on the other hand, did not change much. Although there was a slight rise in absolute terms in this category, the proportion of the unemployed aged over 49 dropped from 15.7% to 15.4%.

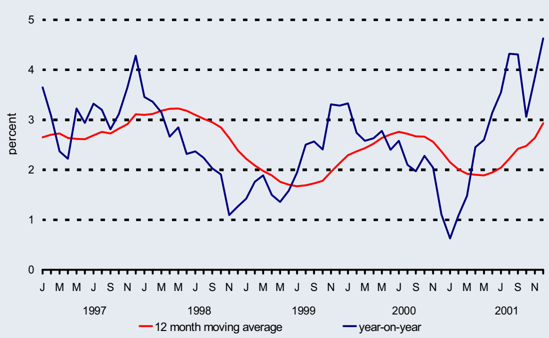
2.3 Prices and wages

2.3.1 Retail prices

Retail price inflation picked up during 2001, with the twelve-month moving average measure, the headline rate, rising by 0.56 percentage points to 2.93%. The year-on-year increase in the Retail Price Index (RPI) was more significant, at 4.63%, compared with 1.11% the previous year.

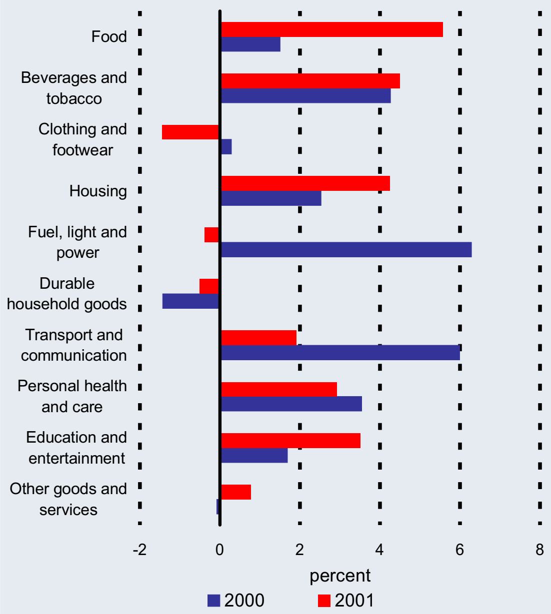
A surge in food prices was the main contributory factor. In fact, the food sub-index, which represents nearly a third of the overall weight of the RPI basket, rose on average by 5.57% during the twelve months to December, the highest increase since 1994. The rise in food prices was, in turn, brought about by a combination of supply-side factors. On the one hand, the outbreaks of BSE in several European countries and of foot-and-mouth disease in the UK pushed up the prices of imported food items and of domestic substitutes like poultry, rabbit and fish. At the same time, the domestic agricultural sector was affected by a shortage of rainfall, which drove the prices of fresh vegetables up by nearly 15%. In addition, the closure of discount stores referred to earlier, and the resulting

Chart 2.3
RETAIL PRICE INFLATION



Source: National Statistics Office

Chart 2.4
INFLATION RATES OF COMMODITY SECTIONS IN THE RPI *



Source: National Statistics Office

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

drop in competition, further compounded the upward pressure on food prices. By contrast, the impact of tax measures on the inflation rate was minimal during the year under review, at just over 0.1 percentage points.

Central Bank estimates suggest that underlying inflation[6] rose by one percentage point during 2001. This can, to some extent, be gauged from Chart 2.4, which shows that inflation was broadly based, affecting most sub-indices of the RPI during the year. The increase in underlying inflation was driven by higher import prices, reflecting the rise in inflation rates in Malta's main trading partners, particularly as higher prices of imports from the euro area countries were not offset by an appreciation of the Maltese lira against the euro, as in previous years.

During the final months of 2001, however, the headline rate of inflation and the Central Bank's measure of underlying, or core, inflation followed diverging trends. Whereas the former accelerated, driven by further food price increases, the core inflation measure

[6] The Central Bank's measure of core, or underlying, inflation is made up of the same components as the RPI, but each is assigned a weight based on its degree of persistence in price inflation instead of the standard weight based on household expenditure patterns.

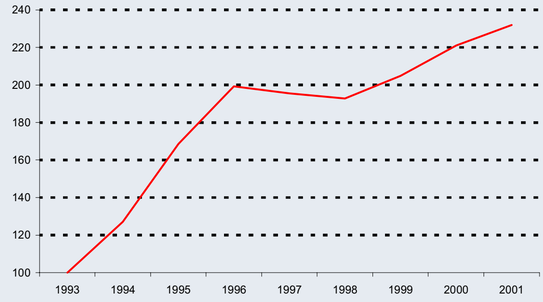
eased. In fact, price pressures in the non-tradable sector, that is those goods and services that are not traded internationally such as hairdressing or house maintenance, began to ease during the fourth quarter when domestic demand was not strong enough to generate such pressures.

2.3.2 Real estate prices

Since movements in property prices may lead to an increase in underlying inflationary pressures, the Central Bank monitors trends through an index of asking prices for property, stratified by type and locality. This approach, however, has a number of shortcomings. Asking prices are usually higher than contracted prices, and properties placed on the market at different points in time may not be strictly comparable.

Chart 2.5 illustrates movements in average asking prices of real estate (including finished terraced houses and flats, and maisonettes in shell-form) as advertised in the local press over the last nine years. The Chart suggests that house prices doubled between 1993 and 1996. This was followed by a short period of relative stability, as the property boom came to an end. But the upward trend resumed in 1999, though the rise of these last years was more moderate than the double-digit growth of the early nineties. In fact, the rise in real estate prices during 2001,

Chart 2.5
ADVERTISED REAL ESTATE PRICES
(1993=100)



Source: Local Press

estimated at under 5%, was only slightly more rapid than that in the RPI. The increase was also slower than that recorded in 1999 and 2000, and was mainly concentrated in the central region.

In recent years the demand for residential property has shifted away from terraced houses towards flats and maisonettes. This probably reflects demographic and social trends which are giving rise to smaller family units. Since the supply of flats and maisonettes is much larger than that of terraced houses, this shift in preferences may be one of the factors behind the recent slowdown in property price inflation.

2.3.3 Wages

Table 2.5 presents the Central Bank's estimates of average wage trends based on data from collective agreements. These estimates, however, exclude

Table 2.5

ESTIMATED CHANGE IN AVERAGE WAGES[1]

percent

Category	1997	1998	1999	2000	2001
Unskilled	5.7	6.2	6.4	3.2	6.1
Skilled	5.4	3.3	5.5	2.7	7.5
Clerical	7.7	3.7	7.5	2.5	8.8
Administrative[2]	3.2	2.0	2.9	2.7	7.5
Average wage across categories	**5.8**	**4.2**	**6.0**	**2.9**	**7.3**
excluding civil service employees	***7.0***	***5.3***	***7.1***	***3.6***	***5.2***

[1] The Table shows Central Bank estimates based on data drawn from collective agreements and provided by the Department of Labour, 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.

overtime pay, production bonuses, and any other allowances or income in kind, which also add to total labour costs. Moreover, the coverage is limited to wages in unionised firms, and these may not be representative of developments in the rest of the economy[7].

As can be seen from the Table, the growth in nominal wages during 2001 was significantly higher than in the previous years. This spike was, however, largely attributable to the revision in civil service salary pay scales resulting from the 1998 collective agreement. The latter had provided for relatively small annual cash payments for the period 1996-2000, following which pay scales were revised at one go in 2001 so as to restore the relativity that existed in 1991. This resulted in sharp salary increases.

However, as Table 2.5 also shows, the rise in the average wage during 2001 would have been higher than that recorded in 2000 even if the civil service wage factor were to be excluded. This, however, was mainly attributable to a few collective agreements, prevalently covering public sector firms. In some cases this involved a reclassification of grades, or changes in the spread between the minimum and maximum pay for each grade.

2.4 Sectoral Analysis

2.4.1 Manufacturing[8]

In contrast with previous years when manufacturing industry had generated the greater part of the increase in value added, this sector reported a drop in gross earnings during 2001 which was mainly a reflection of the downturn in the global market for electronic components. As the electronics sector had been the prime contributor to economic growth during 2000, this accentuated the magnitude of the contraction in activity, as can be seen from Table 2.6.

Official data indeed indicate that during the nine months to September 2001 the other manufacturing

Table 2.6

MANUFACTURING PERFORMANCE - SELECTED INDICATORS[1]

percent

	January- September		
	1999	2000	2001
Growth in exports	**7.9**	**36.5**	**-15.2**
of which:			
Radio, TV, Telecom, etc [2]	5.9	36.4	-17.8
Others	2.0	0.1	2.6
Growth in local sales	**-3.5**	**1.8**	**5.3**
of which:			
Food and beverages	-0.3	0.2	4.3
Others	-3.2	1.5	1.0
Growth in net investment	**46.7**	**137.0**	**-50.1**
of which:			
Radio, TV, Telecom, etc [2]	16.0	142.1	-51.3
Others	30.7	-5.2	1.3

[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

[7] The analysis covers over 110 private and public sector firms, employing some 24,000 workers, together with the civil service.

[8] The analysis here is based on the official data for the nine months to September available at the time of writing. Some data for the fourth quarter have since been published, but these do not change the general picture given by the nine-month figures.

sectors turned in an improved performance when compared with the corresponding period of the previous year. Since a detailed breakdown of the value added of each sector was not yet available at the time of writing, the following analysis will focus on the results of a survey carried out by the NSO. It should be noted, however, that the Survey data are based on current market prices, and thus developments in the volume of sales cannot be clearly identified.

The export sales of manufacturing industry contracted by Lm104.5 million, or over 15%, during the first nine months of 2001, but remained nevertheless well above the 1999 level. A weaker foreign demand was already apparent during the first quarter of the year when growth in export sales slowed down significantly. Export turnover began to contract during the second quarter, as the demand for electronic components weakened further. During the same quarter, however, firms in other sectors reported an increase in export sales of nearly Lm13 million, or 20%, compared with the same period of 2000. Manufacturers of electrical machinery accounted for around three-fifths of this increase. Meanwhile, chemical and wearing apparel firms also reported an improved export performance. During the third quarter, however, a marked deterioration in external demand led to a 30% overall decline in manufactured exports. Though producers of electronic components accounted for the greater part of this drop, most other sectors were also affected.

The domestic market for manufactured goods, on the other hand, fared much better in 2001 and sales expanded by Lm7.8 million, or 5.3%. Though this was more than double the increase registered during the same period a year earlier, it was primarily concentrated in the food and beverages sub-sector, suggesting that demand in other sectors remained weak. Many locally-oriented firms, therefore, tried to penetrate foreign markets, with successful results being achieved by those in the furniture, tobacco and food and beverages sub-sectors.

As noted above, whereas the surge in net investment during 2000 was entirely attributable to the electronics sector, it was firms in other sectors that reported a higher rate of capital accumulation during the first nine months of 2001. The increase, of 5.7%, mostly reflected expansion programmes undertaken by producers of plastic and rubber goods, medical and precision equipment, and food and beverages. This notwithstanding, the rate of capital formation in the non-electronics sectors remained relatively low, at 3.8% of overall turnover, compared with 3.9% and 4.3% in 1999 and 1998, respectively.

Table 2.7
TOURISM ACTIVITY INDICATORS [1]

	1999	2000	2001[2]	Percentage change 1999	2000	2001
Tourist arrivals	**1,162,298**	**1,153,840**	**1,130,997**	**3.4**	**-0.7**	**-2.0**
of which:						
UK	404,054	405,170	431,634	-5.6	0.3	6.5
Germany	202,711	195,716	155,122	4.9	-3.5	-20.7
Rest of Europe	456,999	449,651	451,402	10.1	-1.6	0.4
Others	98,534	103,303	92,839	12.5	4.8	-10.1
Bed-nights stayed (millions)	**11.2**	**9.7**	**10.6**	**3.1**	**-13.1**	**9.1**
Average length of stay (days)	**9.6**	**8.4**	**9.4**	**-0.3**	**-12.5**	**11.3**
Earnings (Lm millions)	**271.4**	**268.2**	**260.7**	**6.6**	**-1.2**	**-2.8**

[1] Data on tourist arrivals, bed-nights stayed and average length of stay cover the period January to November, whereas the earnings figures are for a twelve-month period.

[2] Provisional

Source: National Statistics Office.

2.4.2 Tourism

The tourism sector experienced two major setbacks during 2001: the decline in arrivals from Germany and the post-September 11 fear of air travel. As a result, both arrivals and gross earnings were down from the previous year's level. On the other hand, the number of bed-nights stayed increased significantly, partly reversing the drop registered during 2000, as the average length of stay rose by one day to 9.4 days. This helped to improve occupancy levels in the major hotel categories. Cruise passenger arrivals also rose sharply, up by over half from the previous year's level.

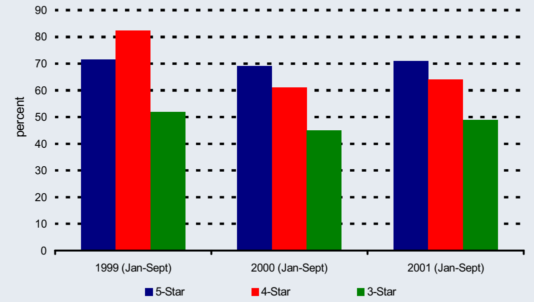
The eleven months to November 2001 saw a 6.5% increase in the number of arrivals from the UK to levels last seen in 1995. This reflected the introduction of new incentive schemes and marketing efforts targeted at the British market. Moreover, the average UK tourist's length of stay rose by nearly a day-and-a-half, or 15%. The increase in the number of British visitors mainly benefited four-star hotels, though three- and five-star establishments also reported double-digit growth in bed-nights sold. Holiday complexes, on the other hand, reported a sharp decline in business from this market.

As can be seen from Table 2.7, however, the recovery in the British market was not enough to offset the contraction of nearly 40,600, or 21%, in the number of German arrivals. The three- and four-star hotel categories bore the brunt of this drop, though holiday complexes also reported lower activity. On the other hand, five-star hotels reported a small rise in the number of German guests.

The weaker German market was not, however, the sole reason for the drop in total arrivals. Visitors from the Benelux countries were 18% fewer, mainly affecting the lower accommodation categories, which were also the hardest hit by a 28% drop in arrivals from Libya. The decline in arrivals from Sweden, on the other hand, mostly affected five-star hotels.

During the eleven months to November 2001, the number of bed-nights sold by the tourist industry

Chart 2.6
AVERAGE OCCUPANCY RATES IN MAJOR HOTEL CATEGORIES



Source: Ministry for Economic Services; Economic Survey.

was up by 9% from the corresponding period of 2000, with the greater part of the increase being recorded by three- and four-star hotels and rented accommodation. Thus, as Chart 2.6 shows, three- and four-star hotels reported higher occupancy rates than in 2000[9]. By contrast, occupancy rates in five-star hotels remained stable throughout the last three years.

Preliminary data indicate that in December 2001 tourist arrivals dropped even more sharply than in the first eleven months of the year. Following the September 11 terrorist attacks, in fact, there was a sharp decline, estimated at around 13%, in conference and incentive travel – the major source of business during the otherwise lean winter months – while a number of cruises were also cancelled. The latter, however, appear to have been offset by the diversion to Malta of a number of cruises originally destined for the Eastern Mediterranean.

2.4.3 Construction

During the nine months to September 2001 turnover in the construction industry was some 10% higher than in the corresponding period of the previous year. Work on Government projects was mainly responsible, as the industry's sales to the private sector remained unchanged – as Table 2.8 shows. Government outlays continued to expand, rising by over 20%, mostly reflecting work on the new hospital. The latter is expected to accelerate further during 2002, as the amount allocated to it in the latest Budget has been almost doubled. Expenditure on a number of

[9] At the time of writing, the breakdown of occupancy rates by category of accommodation was available up to September only.

Table 2.8
CONSTRUCTION ACTIVITY INDICATORS

	January-September		
	1999	2000	2001
Total sales (Lm millions) of which:	**82.3**	**82.4**	**90.4**
Private sector	53.1	50.7	50.7
Government enterprises	2.0	1.9	3.7
General Government	27.2	29.8	36.0
Value added (Lm millions)	**24.9**	**25.5**	**28.9**
Share of value added in GDP (%)	2.6	2.6	2.8
Private employment (as at September)	**5,753**	**6,165**	**6,421**
Share in gainfully occupied (%)	4.3	4.5	4.7

Source: National Statistics Office, Ministry for Economic Services; Economic Survey.

infrastructural projects by public enterprises, notably the Cirkewwa ferry terminal, also contributed.

The increased construction activity in 2001 raised the sector's value added, and its share in aggregate earnings rose for the first time since 1997. Both employment income and profits expanded, up by 11.7% and 15.5%, respectively. The growth in employment income reflected the recruitment of a considerable number of construction workers over the past two years. It should be noted, however, that the rate of job creation in construction during the first nine months of 2001 was less than half that recorded in the same period a year earlier, reflecting the relative tightness in this segment of the labour market. Many contractors have, in fact, been reporting a shortage of skilled construction workers, forcing them to offer higher wages. Despite the increase in operating costs, however, profitability in the sector improved for the first time in five years.

2.5 Outlook for 2002

As Table 2.9 shows, Central Bank projections point to an economic recovery during 2002, mainly on the back of an improved export performance, a build-up of inventories, and construction-related investment.

Table 2.9
OUTLOOK FOR SELECTED ECONOMIC INDICATORS

percent

	2000	2001	2002 Central Bank estimates
GDP growth at constant market prices	5.3	0.4	2.5 - 3.0
Growth in GDP components at constant prices			
Private consumption expenditure	6.7	2.5	2.3 - 2.8
Government consumption expenditure	5.2	3.0	0.7 - 1.3
Gross fixed capital formation	18.1	(14.0)	3.5 - 4.0
Exports of goods and services	5.6	(5.1)	4.8 - 5.2
Imports of goods and services	11.2	(11.2)	7.3 - 7.8
Unemployment rate	5.0	5.1	5.0 - 5.5
Inflation rate	2.4	2.9	2.3 - 2.8
Fiscal borrowing requirement (% of GDP)	5.5	5.0	4.5 - 5.0
External goods and services deficit (% of GDP)	9.2	5.0	5.5 - 6.0

Figures in parenthesis are negative.

The recovery is expected to take place during the second half of the year, when the pickup in economic activity in the major industrialised countries should become firmly established. The projected growth rate for the year, however, remains below its potential.

Patterns of economic growth in Malta during 2000 and 2001 reflected the fluctuating fortunes of the electronics industry, which was severely affected by the global slowdown. As the Table shows, these years were marked by volatility in Malta's exports, imports and investment. Such wide swings are not expected to occur in 2002, since economic activity in the major industrialised countries is expected to pick up progressively, and with it the demand for electronic components.

Furthermore, it appears that electronics firms reduced inventory levels to very low levels as the year 2001 progressed. Hence, exports during 2002 should be generated entirely from new production, giving rise to resumed imports of raw materials. And as the electronics sector still appears to have spare capacity, investment is unlikely to increase. At the same time, in view of the improvement in economic conditions in Malta's major trading partners, other exporting sectors are expected to consolidate their 2001 performance. In view of the excess capacity existing abroad, however, competition is likely to be stiff, and the pressure for restructuring in the domestic manufacturing sector will persist. As a result, investment in 2002 should be sustained, although the projected growth in gross fixed capital formation is likely to be underpinned mainly by construction activity.

As regards tourism, business is likely to be weak initially on account of the reduction in flight capacity worldwide. By the peak season, however, and for the remainder of the year, tourism is expected to recover, such that the performance recorded in 2001 should be more-or-less matched, sustained mainly by the UK market.

The other components of domestic demand, namely private and public consumption, should continue growing in 2001. Incomes are likely to rise at a slower pace, especially in the public sector. Consequently, the household savings rate is expected to remain unchanged from the 2001 level of around 3%. Meanwhile, the rate of growth in Government consumption should decline, reflecting a further tightening of the fiscal stance.

Unemployment is expected to edge up slightly in 2002, partly on account of a lower rate of job creation and a reduction in the labour complement of manufacturing firms that are restructuring. New employment opportunities should arise mainly from construction-related activity and the private services sector, though perhaps not so much from tourism.

Inflationary pressures are forecast to subside during 2002. Although an appreciation of the euro could have an adverse impact on import prices, inflation abroad is expected to fall, while the projected rise in unemployment should dampen domestic wage pressures, and hence price inflation, particularly in non-tradable goods and services. Meanwhile, the sharp rise in food prices witnessed in 2001 is unlikely to be repeated in 2002. The effects of the food price hike, however, will continue to be reflected in the Retail Price Index during the early part of 2002. Furthermore, unfavourable weather conditions may have some negative impact on the supply of local agricultural produce and consequently on prices. Nevertheless, in the absence of unforeseen shocks, overall inflation should ease in the course of the year.

3. The Balance of Payments and the Maltese Lira

The Balance of Payments[1]

Provisional balance of payments data for 2001 show that the current account deficit narrowed considerably from the previous year's peak level, which had been caused by a number of exceptional factors. At the same time, after excluding movements in the official reserves, net inflows on the capital and financial account increased, mainly reflecting lower portfolio investment outflows. As a result of these movements, the official reserves rose sharply.

3.1 The Current Account

As Table 3.1 shows, the current account deficit narrowed by Lm151.8 million to Lm80.9 million during 2001, roughly equivalent to 5% of GDP. Nearly half of this contraction was attributable to lower net outflows on the investment income account due to a reduction in the repatriation of profits by foreign-owned enterprises, though a considerable narrowing of the merchandise trade gap and higher net receipts from services also contributed.

3.1.1 Merchandise trade balance

The merchandise trade gap narrowed by Lm51.7 million to Lm220.4 million, as Table 3.2 shows, with both exports and imports sharply down from the previous year's levels. Merchandise exports fell by Lm186.5 million, mainly reflecting the slowdown in world demand for electronic components. Indeed, customs data suggest that most other manufacturing sectors, such as food, beverages and tobacco and chemicals, registered an improved export performance compared with 2000. At the same time, imports declined by an even larger amount than exports, down by Lm238.2 million to Lm1120.8 million. The drop in imports was closely linked to that of exports, as more than four-fifths of the contraction was attributable to lower imports of inputs for the electronics sector. The latter was also mainly responsible for a sharp drop in imports of capital goods following the large investment undertaken by the leading firm in the sector during 2000, though lower imports of commercial motor vehicles and a reduction in the value of fuel imports, reflecting a lower oil price, also contributed. At the same time, imports of consumer goods rose only marginally from the previous year's level.

As Chart 3.1 and Chart 3.2 show, the EU remained Malta's most important trading partner. Indeed, during

Table 3.1
MAIN EXTERNAL BALANCES

Lm millions

	1999	2000	2001 [1]
Overall balance	**122.4**	**-141.7**	**39.2**
Current account	-49.3	-232.7	-80.9
Short-and long-term financial flows	161.3	82.7	119.4
Capital account	10.4	8.3	0.7
Movements in reserve assets [2, 3]	**-96.3**	**97.6**	**-108.7**
Statistical discrepancy	**-26.1**	**44.1**	**69.5**

[1] Provisional

[2] A negative sign indicates an increase in reserve assets.

[3] Excludes revaluation adjustments.

Source: National Statistics Office

[1] Compiled on an accruals basis.

Table 3.2
THE CURRENT ACCOUNT

Lm millions

	1999		2000		2001 [1]	
	Credit	Debit	Credit	Debit	Credit	Debit
CURRENT ACCOUNT BALANCE		**49.3**		**232.7**		**80.9**
GOODS AND SERVICES BALANCE		**79.2**		**170.1**		**80.1**
GOODS BALANCE		**228.7**		**272.1**		**220.4**
Goods	805.0	1,033.7	1,086.9	1,359.0	900.4	1,120.8
SERVICES BALANCE	**149.5**		**102.0**		**140.3**	
Transport	132.9	165.3	135.4	196.8	145.4	171.9
Travel	271.4	80.1	268.2	88.0	260.7	81.2
Other services	83.4	92.7	81.3	98.1	89.2	101.9
INCOME (NET)	**12.9**			**69.2**		**2.5**
Compensation of employees	3.9	3.4	4.3	3.2	2.5	2.8
Investment income	503.2	490.7	383.7	454.0	442.1	444.3
CURRENT TRANSFERS (NET)	**17.0**		**6.5**		**1.6**	

[1] Provisional

Source: National Statistics Office

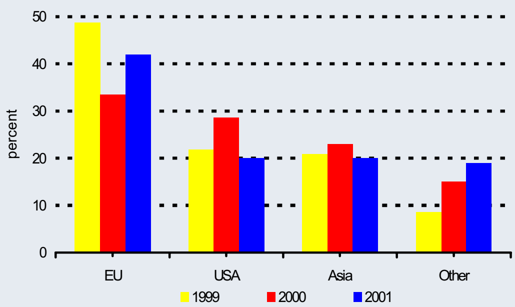
2001 the EU's share in total exports rose to 42%, from 33% a year earlier, while those of the US and Asia fell back to 1999 levels. This mainly reflected the developments in the electronics sector, which exports heavily to the US and Asian markets. As regards imports, the EU's share went up to 64%, from 60% in 2000, while the share of the US rose by 2 percentage points to 13%. In contrast, the share of imports from Asia fell by 7 points to 16%, after it had risen by 5 points during the previous year. As a result of these developments, Malta's merchandise trade surplus with the US shrank by 85% to Lm 20.8 million, while its deficit with the EU and Asia narrowed by 23% and 74%, respectively: the deterioration in the former surplus was mainly attributable to a decline in exports, while the narrowing of the deficit with Asia was due to lower imports, mainly of inputs for the electronics sector.

3.1.2 Balance on services

During 2001 net receipts from services rose by Lm38.2 million to Lm140.3 million, mainly reflecting lower net payments for transportation services, which in turn were linked to the drop in merchandise imports. This also represented a reversal of the events observed during 2000, when a sharp rise in merchandise imports had pushed the transportation bill up just as sharply.

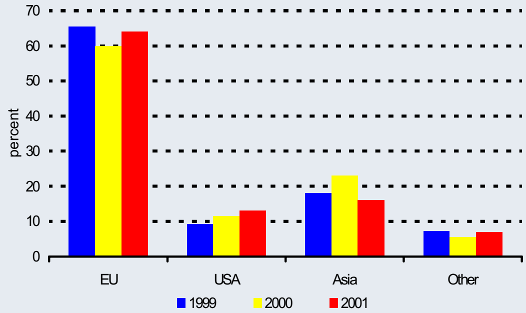
At the same time, net travel receipts were down marginally, by Lm0.7 million, as a Lm7.5 million decline

Chart 3.1
DIRECTION OF TRADE - EXPORTS



Source: National Statistics Office

Chart 3.2
DIRECTION OF TRADE - IMPORTS



Source: National Statistics Office

in gross tourism earnings was largely offset by a Lm6.7 million contraction in expenditure on outward travel. Meanwhile, net payments for other services declined by Lm4.1 million to Lm12.7 million.

3.1.3 Investment income and transfers

Net outflows on the investment income account, which during 2000 amounted to Lm70.2 million, shrank to Lm2.2 million during the year under review. Indeed, this factor accounted for almost half of the overall contraction in the current account deficit during 2001. The reduction in net outflows of investment income, in turn, reflected the fact that during 2000 there had been a sharp rise in profits earned by foreign-owned manufacturing enterprises in the machinery and transport sector. At the same time, net labour income earned by Maltese residents working abroad fell by Lm1.4 million to a negative balance of Lm0.3 million, while net inward current transfers were some Lm5 million lower.

3.2 The Capital and Financial Account

Net inflows on the capital and financial account after excluding movements in the official reserves rose by Lm29.1 million to Lm120.1 million during the year. This was wholly attributable to developments in the financial account, as capital inflows were down by Lm7.6 million. The decline in the latter mainly reflected lower receipts by way of grants and contributions following the expiry of the fourth Financial Protocol with Italy. Meanwhile, the Lm36.7 million increase in net inflows on the financial account reflected a decline in portfolio investment outflows, though higher inflows from other investment items also contributed. At the same time the latter were to a large extent offset by lower net inflows of foreign direct investment.

3.2.1 Long- and short-term financial flows

As Table 3.3 shows, long-term financial transactions gave rise to net inflows of Lm12.9 million during 2001, against the Lm138.7 million net outflows recorded in 2000, while the balance on short-term flows remained in surplus. As a result, the financial account balance, excluding movements in the official reserves, registered a surplus of Lm119.4 million, up from Lm82.7 million in the previous year. The greater part of this increase was attributable to a significant decline in net outflows by way of long-term loans to non-residents, which offset the contraction in direct

Table 3.3
THE FINANCIAL ACCOUNT
(Net balances)

Lm millions

	1999	2000	2001 [2]
FINANCIAL ACCOUNT BALANCE [1]	**65.0**	**180.2**	**10.8**
Long-term	**174.8**	**-138.7**	**12.9**
Direct investment	310.1	272.9	138.2
Long-term loans	-131.7	-407.5	-122.8
Other long-term investment	-3.6	-4.1	-2.5
Short-term	**-13.5**	**221.4**	**106.5**
Portfolio investment	-201.3	-339.6	-200.4
Other short-term investment	187.8	561.0	306.9
Reserve assets [3]	**-96.3**	**97.6**	**-108.7**

[1] A positive sign indicates an increase in foreign liabilities and a negative sign indicates an increase in foreign assets.
[2] Provisional
[3] Excludes revaluation adjustments.
Source: National Statistics Office

Table 3.4
FOREIGN DIRECT INVESTMENT

Lm millions

	1997	1998	1999	2000	2001 [1]
Direct investment in Malta by non-residents					
Share capital	4.2	4.5	101.1	53.1	54.0
Reinvested earnings	16.9	35.4	37.5	130.0	46.9
Other investment	10.1	63.8	189.4	102.6	40.2
Total	31.2	103.7	328.0	285.7	141.1
Direct investment abroad by residents					
Share capital	7.1	6.9	17.6	10.8	2.7
Reinvested earnings	-0.7	-1.1	0.3	1.9	0.2
Total	6.4	5.8	17.9	12.7	2.9
Net direct investment	24.8	97.9	310.1	273.0	138.2

[1] Provisional

Source: National Statistics Office

investment inflows. The former was in turn attributable to the monetary sector, particularly international banks operating from Malta. During the year, in fact, these banks reported a decline in both foreign borrowing and foreign lending. However, loan repayments by non-residents exceeded loan repayments abroad by the banks.

Table 3.4 throws more light on direct investment flows to and from Malta. It shows that inward direct investment by non-residents was down by Lm144.6 million during 2001, mainly in the form of lower reinvested earnings. The previous year, in fact, had been marked by a sharp increase in retained profits which were reinvested and which featured accordingly in the financial account. On the other hand, the decline in the non-equity component of direct investment was almost wholly attributable to an increase in claims on the overseas parent of a local subsidiary.

Additional information on new equity investment involving non-resident shareholders is available at the Central Bank of Malta and the Malta Financial Services Centre (MFSC). This shows that 64 new companies with non-resident shareholding were established in Malta during 2001, as opposed to 87 during 2000. As Table 3.5 shows, the value of paid-up share capital in these companies amounted to almost Lm1 million, or Lm2.5 million less than in 2000. The greater part of this decline reflected developments in the services sector, direct investment in which in 2000 had been boosted by inflows connected with the setting up of a new international banking institution. In fact, without this factor, the decline in new equity investment in 2001 would have been marginal.

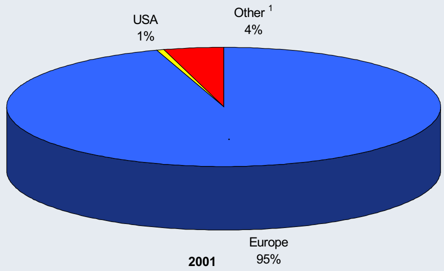
Table 3.5
NON-RESIDENT PAID-UP CAPITAL

Lm

	1999	**2000**	**2001**
Manufacturing and construction	295,676	293,103	208,599
Services	826,706	3,053,608	751,327
Offshore and international trading companies	287,592	99,999	0
Total	**1,409,974**	**3,446,710**	**959,926**
No. of companies	**68**	**87**	**64**

Source: Central Bank of Malta, Malta Financial Services Centre

Chart 3.3
SOURCES OF NON-RESIDENT PAID-UP CAPITAL



[1] Includes offshore and international trading companies.
Source: Central Bank of Malta

Chart 3.4
EXCHANGE RATE MOVEMENTS OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES
(index of end-of-month rates, end-1997 = 100)

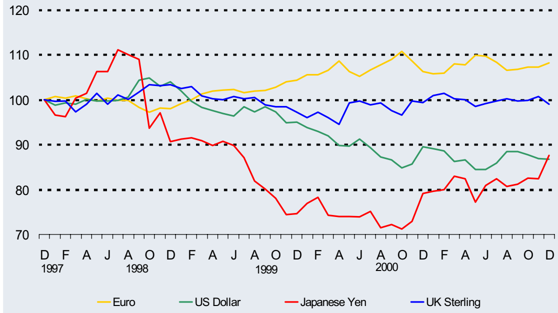


Chart 3.3 shows that Europe remained by far the largest source of new equity investment in Malta during 2001, accounting for 95% of the total.

Meanwhile, direct investment outflows were down by some Lm10 million from the previous year's level when such outflows were substantially boosted by the purchase of hotels abroad by Maltese investors.

At the same time, the surplus on short-term capital flows declined to Lm106.5 million, from Lm221.4 million a year ago. This was wholly attributable to a Lm254.2 million contraction in net inflows of other short-term investments in products mainly offered by the international banks operating from Malta. The effect of the latter was, however, dampened by a decline in portfolio investment outflows, as the monetary sector reduced its holdings of foreign debt securities. Furthermore, trade credit granted to foreign buyers declined, while that given by foreign suppliers to local importers increased, generating a Lm13.5 million rise in short-term financial inflows.

3.2.2 Movements in external reserves

As a result of these developments, the reserve assets of the Monetary Authorities – essentially the Central Bank's external reserves– rose by Lm108.7 million (net of revaluation adjustments) during the year. At the end of the year, the reserves covered 6.2 months of imports of goods and services, up from 4.4 months of imports at the end of 2000. This means that the import coverage was back to its 1999 levels, confirming that the reserve loss during 2000 was caused by the exceptional developments that took place during that year.

The Maltese Lira and External Competitiveness

3.3 The Maltese Lira

Movements in the Maltese lira exchange rate during 2001 reflected the international foreign exchange market developments outlined in Chapter 1 of this Report. In fact, the depreciation of the euro against the dollar during the first seven months of the year initially caused the lira to strengthen against the European unit, as Chart 3.4 shows. Subsequently, however, most of these gains were lost as the euro recovered some of the lost ground. As a result, the Maltese lira remained relatively stable against the euro over the year. This can be seen from Table 3.6, which shows that the lira, on average, appreciated by only 0.3% against the euro. On the other hand the domestic currency continued to lose ground against the dollar, falling on average by 2.8% in the course of the year. At the same time the lira strengthened by an average of 2.3% against sterling and to a larger extent against the Japanese yen.

3.4 External Competitiveness

Movements in the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) indices of the Maltese lira are important indicators of changes in the external price competitiveness of the economy. A rise in these indices indicates a loss,

Table 3.6
EXCHANGE RATES OF THE MALTESE LIRA AGAINST SELECTED MAJOR CURRENCIES FOR 2001

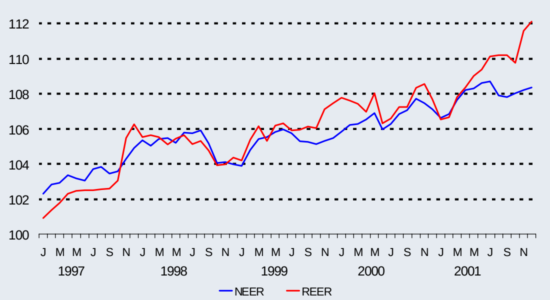
	US$	Stg	Yen	Euro[1]
Monthly Averages:				
January	2.2897	1.5494	267.6	2.4403
February	2.2602	1.5547	262.6	2.4522
March	2.2435	1.5510	272.0	2.4639
April	2.2166	1.5446	274.5	2.4830
May	2.1904	1.5355	266.7	2.5048
June	2.1557	1.5373	263.6	2.5244
July	2.1680	1.5332	270.1	2.5198
August	2.2276	1.5500	270.5	2.4732
September	2.2493	1.5376	267.4	2.4699
October	2.2400	1.5432	271.6	2.4714
November	2.2119	1.5391	270.7	2.4896
December	2.2181	1.5406	282.5	2.4850
Average for 2001	2.2226	1.5430	270.0	2.4815
Average for 2000	2.2855	1.5080	246.3	2.4741
% change 2001/2000	-2.8	2.3	9.6	0.3
Closing rate on 31.12.2001	2.2121	1.5258	290.4	2.4989
Closing rate on 31.12.2000	2.2843	1.5305	262.3	2.4559
% change 2001/2000	-3.2	0.3	10.7	1.8
High for the year	2.3248	1.5642	290.8	2.5498
	(Jan. 08)	(Mar. 1)	(Dec. 28)	(July 6)
Low for the year	2.1316	1.5168	255.3	2.4257
	(June 12)	(June 01)	(June 01)	(Jan. 08)

[1] The Euro replaced the ECU as from January 1, 1999.
Source: Central Bank of Malta

while a fall reflects a gain in competitiveness.

Following the 1.3% increase in the NEER index during 2000, the index continued to move on an upward trend, gaining another 1.6% during 2001. As Chart 3.5 shows, this trend was most pronounced during the first seven months of the year, reflecting the appreciation of the Maltese lira against the euro referred to earlier.

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



Meanwhile, as the Chart also shows, the REER index, which apart from exchange rate movements takes account of relative inflation rates, rose steadily throughout the year, going up by 5.2%, compared with 1.4% in 2000. Apart from the rise in the NEER index, this upswing was almost wholly attributable to Malta's persistently higher relative inflation rate. In fact, while inflation in Malta's main competitors eased during the year, the domestic inflation rate edged persistently upwards.

4. Government Finance

The fiscal deficit for 2001 has been provisionally estimated at Lm85.3 million, slightly above the projections published in November of that year and similar to the deficit recorded in 2000. This overrun of Lm2.8 million was the result of a shortfall in ordinary revenue – as a result of a smaller increase in tax receipts – that was only partly offset by lower recurrent and capital expenditure. The fiscal deficit/GDP ratio for the year is, however, still expected to fall to around 5%. A further improvement to 4.5% is foreseen for 2002, so that the objective of bringing the deficit down to 3-4% of GDP by 2004 appears to be within reach.

4.1 Fiscal Performance in 2001[1]

Both revenue and expenditure rose sharply during the year. The latter was boosted by a number of special factors, particularly the public sector wage award and the inclusion in the Consolidated Fund for the first time of items previously recorded in the Treasury Clearance Fund. At the same time, revenue reflected growth in nominal incomes and increased efficiency in tax collection.

Ordinary revenue fell short of recurrent expenditure during the year, leaving a negative current balance of Lm0.2 million, as against a Lm13.4 million surplus in 2000. This deterioration in the current balance, however, resulted entirely from the decision to classify as recurrent expenditure certain items, such as subsidies to public entities, formerly recorded as capital expenditure but which added nothing to the economy's productive potential.

4.1.1 Ordinary revenue

Ordinary revenue rose by Lm51.2 million, reflecting higher receipts from both direct and indirect taxation, as Table 4.1 shows. Increased inflows from income tax and social security contributions of Lm17.9 million and Lm10 million, respectively, resulted primarily from growth in nominal incomes and the progressive nature of income taxation.

Indirect taxes yielded Lm25.2 million more, of which Lm11.9 million in the form of higher VAT receipts. A substantial increase was also recorded in revenue from customs and excise duties and from licences, taxes and fines. Thus, revenue from the former rose by Lm7.4 million, in part due to the higher excise duty on cigarettes, while licences, taxes and fines contributed an additional Lm5.9 million, reflecting a substantial rise in receipts from duty on documents.

By contrast, revenue from non-tax sources was down by Lm1.9 million from the previous year's level, to Lm74.6 million, partly due to lower Central Bank profits. The latter, together with a drop in grant receipts following the expiry of the fourth financial protocol with Italy, more than offset higher yields from lotteries, rents and fees of office.

4.1.2 Expenditure

Recurrent expenditure rose by Lm64.8 million to Lm615.1 million during the year, with expenditure on personal emoluments accounting for more than a third of the increase. Expenditure on programmes and initiatives also rose substantially, reflecting both higher pensions and a greater number of pensioners.

Contributions to Government entities amounted to Lm51.8 million, up by Lm21.8 million from the previous year's level. Although additional funds were channelled to the University of Malta and the Junior College, the increase resulted mainly from the decision to carry out, as from 2001, certain changes in expenditure classification. In particular, some Lm17 million in subsidies to public entities that had previously been listed under capital expenditure were included under this heading, as were part of the debt-

[1] The analysis in the remainder of this chapter is based on data from the Financial Estimates 2002 published in November 2001. These data do not correspond with the latest information referred to in the opening paragraph of this chapter.

Table 4.1
GOVERNMENT BUDGETARY OPERATIONS[1]

Lm millions

	2000	2001	2002	Change 2001	Change 2002
ORDINARY REVENUE	**563.7**	**614.9**	**670.9**	**51.2**	**56.0**
Direct tax	**257.5**	**285.4**	**315.2**	**27.9**	**29.8**
Income tax	149.5	167.4	186.1	17.9	18.7
Social security[2]	108.0	118.0	129.1	10.0	11.1
Indirect tax	**229.7**	**254.9**	**280.4**	**25.2**	**25.5**
Consumption tax	104.1	116.0	126.5	11.9	10.5
Customs and excise duties	55.1	62.5	67.8	7.4	5.3
Licenses, taxes and fines	70.5	76.4	86.1	5.9	9.7
Total non-tax revenue	**76.5**	**74.6**	**75.2**	**-1.9**	**0.6**
Central Bank profits	27.1	26.0	26.3	-1.1	0.3
Other revenue[3]	49.4	48.6	48.9	-0.8	0.3
TOTAL EXPENDITURE	**648.9**	**697.4**	**748.6**	**48.5**	**51.2**
Recurrent expenditure	**550.3**	**615.1**	**653.2**	**64.8**	**38.1**
Personal emoluments	170.8	195.3	197.6	24.5	2.3
Operational and maintenance	50.0	45.8	45.2	-4.2	-0.6
Programmes and initiatives [2]	244.4	262.8	277.4	18.4	14.6
Contributions to Government entities	30.0	51.8	72.4	21.8	20.6
Interest payments	54.4	58.6	59.8	4.2	1.2
Other	0.7	0.8	0.7	0.1	-0.1
CURRENT BALANCE [4]	**13.4**	**-0.2**	**17.7**	**-13.6**	**17.9**
Capital expenditure	**98.6**	**82.3**	**95.4**	**-16.3**	**13.1**
PRIMARY BALANCE [5]	**-30.8**	**-23.9**	**-17.9**	**6.9**	**6.0**
FISCAL BALANCE	**-85.2**	**-82.5**	**-77.7**	**2.7**	**4.8**

[1] Data for 2001 and 2002 are revised estimates and estimates, respectively, as shown in the Financial Estimates 2002 published in November 2001.
[2] Government contributions to the social security account are excluded from both revenue and expenditure.
[3] Excludes proceeds from sale of public assets but includes grants.
[4] Ordinary revenue less recurrent expenditure.
[5] Ordinary revenue less total expenditure excluding interest payments.

Source: Ministry of Finance

servicing costs of Malta Freeport, previously financed through the Treasury Clearance Fund.

Operational and maintenance expenses, on the other hand, were down by Lm4.2 million. This reflected a decline in the cost of materials and supplies, mainly pharmaceutical products, and lower transport costs due to the change in status of former imprest drivers who were absorbed into the civil service. This change also contributed to the increase in expenditure on personal emoluments.

Interest payments totalled Lm58.6 million during 2001, up by Lm4.2 million over the preceding year, and equivalent to 9.5% of recurrent expenditure. Higher interest costs were incurred in respect of Treasury bills, as the Government made greater use of this short-term debt instrument to meet its financing needs.

Meanwhile, a Lm16.3 million drop in capital expenditure resulted entirely from the expenditure reclassification exercise referred to earlier. In fact, if the Government had not changed its accounting practices, capital expenditure would have remained practically unchanged from the previous year's level, as increases in outlays on such projects as the new hospital were offset by lower expenditure on other items.

4.2 Projected Fiscal Performance in 2002

Revenue from income tax and social security contributions is projected to rise by Lm18.7 million and Lm11.1 million, respectively during 2002. These increases should result mainly from growth in nominal incomes and increased efficiency in tax collection.

Revenue from VAT should rise by a further Lm10.5 million, and an additional Lm5.3 million should be collected from customs and excise duties. The yield from licences, taxes and fines is expected to increase by Lm9.7 million, primarily as a result of the shifting to this revenue component of receipts from lotteries, previously included under non-tax revenue. Meanwhile, fees payable under the foreign investment registration scheme announced in the latest Budget and higher receipts by way of EU pre-accession grants should ensure a higher yield from non-tax sources.

On the expenditure side, outlays on personal emoluments are expected to be contained after the wage increases awarded in 2001. Expenditure on programmes and initiatives, however, is set to reach Lm277.4 million, up by Lm14.6 million, as a result of higher outlays on pensions, increased spending on the National Programme for the Adoption of the *Acquis* and the projected cost of the agriculture support scheme announced in the Budget. Meanwhile, the incorporation of advances to the

Table 4.2

GOVERNMENT DEBT AND FINANCING OPERATIONS [1]

Lm millions

	2000	2001
FISCAL BALANCE	**-85.2**	**-82.5**
Financed by:[2]		
Increase in MGS outstanding	0.5	100.1
Increase in foreign loans	-5.2	1.1
Proceeds from sale of assets	12.0	0.0
Contributions to sinking funds	-12.2	-12.3
Sinking funds of converted loans	12.7	21.5
Increase in Treasury bills outstanding	89.7	-13.5
Decrease in Government deposits	41.5	-12.0
Net cash movements and other funds [3]	-53.8	-2.4
GROSS GOVERNMENT DEBT	**925.0**	**1,012.7**
Malta Government stocks	712.7	812.8
Treasury bills	173.0	159.5
Foreign loans	39.3	40.4

[1] Based on data from the Financial Estimates 2002 published in November 2001.

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

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

Source: Malta Stock Exchange, The Treasury and Central Bank of Malta

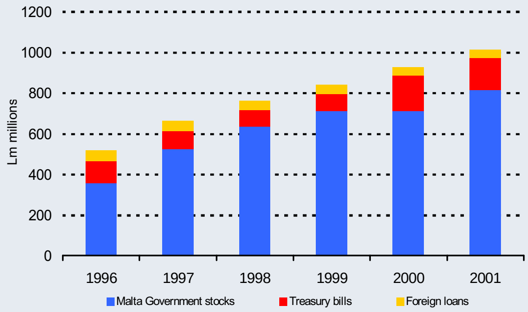
Drydocks and additional Malta Freeport debt-servicing costs into the Consolidated Fund should lead to a Lm20.6 million increase in contributions to Government entities.

Interest payments are also expected to rise slightly in 2002 before declining in subsequent years, as the proceeds from the Government's privatisation programme lead to a reduction of outstanding public debt. At the same time, the allocation of additional funds to the new hospital project is expected to lead to a steep rise in capital expenditure.

4.3 Government Debt and Financing Operations

During 2001 the fiscal deficit was largely financed through the issue of additional Malta Government stocks, as Table 4.2 shows. Transfers from sinking funds of converted stocks amounted to Lm21.5 million, but the Government also contributed Lm12.3 million to sinking funds earmarked to repay outstanding stocks. Meanwhile, Government deposits with the banking system rose by Lm12 million. This was in sharp contrast to the preceding year when Government financed a substantial part of the deficit by running down deposits. No public assets were sold during the year.

Chart 4.1
COMPOSITION OF GROSS GOVERNMENT DEBT



Source: Malta Stock Exchange, The Treasury

At the end of 2001 the Gross Government Debt totalled Lm1,012.7 million, up by Lm87.7 million from the end-2000 level. As can be seen from Chart 4.1, the increase in Malta Government stocks was only partly offset by a fall in the value of Treasury bills outstanding. At the same time, the outstanding balance of external debt rose marginally, by Lm1.1 million.

5. Monetary and Financial Developments

Despite a slowdown in domestic credit expansion, the annual rate of growth of broad money more than doubled during 2001, driven by rapid growth in the net foreign assets of the banking system. The faster monetary expansion also reflected a reversal of the portfolio switch in favour of collective investment schemes and foreign investments that had dampened monetary growth in 2000, with households again favouring fixed-interest assets such as bank deposits and bonds.

In the second half of the year, the Central Bank eased its monetary policy stance and this had an impact on money market rates and bank retail interest rates. In the capital market, however, Government bond yields generally ended the year slightly above the previous year's levels, as the Government issued additional long-term debt securities to finance its operations. Meanwhile, a steep fall in equity prices may have contributed to the shift into more traditional financial instruments.

5.1 The Monetary Base

The monetary base, M0, is a measure of the Central Bank's monetary liabilities and consists of currency in issue and banks' deposits with it, excluding term deposits. During 2001, M0 continued to decelerate, adding just Lm3.1 million, or 0.6%, to Lm567.6 million. In fact, during 1999 and 2000, M0 had increased by 7.3% and 3.9%, respectively. As Table 5.1 shows, currency in issue accounted for the entire increase in the monetary base during the year as banks ran down their deposits with the Central Bank.

Apart from the components of M0, the Table also shows the counterparts to it, movements in which are the sources of changes in the monetary base. This shows that during 2001 the Central Bank's foreign assets, which rose by Lm116.2 million, were the main driving force behind the increase in M0. However, the Bank's "fixed and other assets" contracted by Lm73.1 million as the value of repos outstanding dropped sharply, partly offsetting the rise in the

Table 5.1
THE MONETARY BASE AND ITS SOURCES

Lm millions

	2000	2001	Change
Currency in issue	423.2	441.8	18.6
Banks' deposits with the Central Bank[1]	141.3	125.8	-15.5
Monetary base (M0)	**564.5**	**567.6**	**3.1**
Central Bank assets			
Foreign assets	644.2	760.4	116.2
Claims on Government	9.2	5.8	-3.4
Fixed and other assets	134.2	61.1	-73.1
Less:			
Remaining liabilities			
Private sector deposits	4.0	1.2	-2.7
Government deposits	56.2	69.1	12.9
SDR allocations	6.4	6.4	0.0
Foreign liabilities	3.7	0.0	-3.7
Other liabilities	63.8	87.9	24.1
Capital and reserves	89.1	95.1	6.0

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

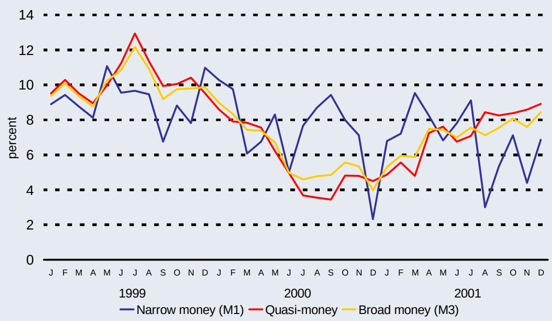
external reserves. Moreover, towards the end of the year the Central Bank also absorbed liquidity from the banking system through term deposits, adding to the Bank's "other liabilities", thus dampening growth in M0.

5.2 Monetary Aggregates

The annual rate of growth of broad money, M3, which consists of currency in circulation and residents' deposits with the banking system, more than doubled during 2001 to 8.4%. In fact, after having risen by Lm97.1 million during the previous year, M3 expanded by Lm214 million to Lm2,752.9 million during the year under review. The steady recovery in broad money growth following the deceleration registered during 2000 is illustrated in Chart 5.1.

Residents' deposits denominated in Maltese liri accounted for three-fifths of the increase in broad money during the year. However, the foreign currency component of broad money expanded more rapidly. Foreign currency deposits added Lm60.7 million, or 27.1%, as Table 5.2 shows, compared with single-digit growth rates in the previous two years, stimulated by the further easing of exchange control restrictions on such deposits at the beginning of the year.

Chart 5.1
MONETARY GROWTH RATES
(percentage changes on year earlier)



Following a moderate increase in 2000, narrow money, M1, expanded at a faster pace during 2001, but without returning to the growth rate recorded in 1999. M1 added Lm40.8 million to Lm635.5 million during the year under review, and the annual rate of growth trebled to 6.9%. However, as Chart 5.1 shows, narrow money growth was uneven during the year, peaking at 9.5% in March, dropping as low as 3% in August, and recovering by the end of the year. In absolute terms, M1 dropped in August and November, which coincided with primary market issues of Malta Government stocks.

Currency in circulation accounted for over half the increase in narrow money during the year, registering

Table 5.2
MONETARY AGGREGATES

Lm millions

	1999		2000		2001	
	Amount	% Change	Amount	% Change	Amount	% Change
Broad money (M3)	**2,441.8**	**9.9**	**2,538.9**	**4.0**	**2,752.9**	**8.4**
of which:						
Narrow money (M1)	**581.1**	**11.0**	**594.7**	**2.3**	**635.5**	**6.9**
Currency in circulation	384.6	4.1	396.3	3.0	418.9	5.7
Demand deposits	196.6	27.5	198.4	0.9	216.6	9.2
Quasi-money	**1,860.7**	**9.5**	**1,944.2**	**4.5**	**2,117.4**	**8.9**
Savings deposits	637.4	8.9	629.4	-1.3	671.4	6.7
Time deposits	1,223.3	9.8	1,314.8	7.5	1,446.0	10.0
Foreign currency deposits	**206.6**	**7.5**	**224.8**	**8.8**	**285.5**	**27.1**
Demand	10.4	17.0	9.5	-9.5	14.2	50.7
Savings	122.6	14.3	123.1	0.4	153.2	24.5
Time	73.5	-3.3	92.2	25.4	118.1	28.1

its largest annual rise in ten years. In fact, cash held outside the banking system increased by Lm22.6 million in 2001, with its annual rate of growth accelerating to 5.7%, from 3% in 2000: it contracted during the first quarter, in line with the seasonal decline in consumer spending, before rebounding in the second quarter and growing more moderately during the second half of the year.

Fluctuations in narrow money in the course of the year were highly correlated with movements in demand deposits. The latter added Lm18.2 million, or 9.2%, during 2001, which was in sharp contrast with the previous year when they had barely risen. This rise, however, masked wide swings, with the annual growth rate reaching a peak in March and dropping sharply in August and November. Personal deposits, which expanded by Lm15.9 million, accounted for almost the entire increase, as balances in corporate current accounts rose moderately and demand deposits belonging to public sector enterprises contracted[1].

Quasi-money continued to drive growth in broad money during the year as savings and, especially, time deposits found favour with investors. In absolute terms, quasi-money recorded its largest rise in ten years, expanding by Lm173.2 million to Lm2,117.4 million. Consequently, the annual rate of quasi-money growth nearly doubled to 8.9% in 2001.

The trend decline in the annual rate of growth of time deposits was halted in 2001. In fact, this deposit category, which put on Lm131.2 million, was the largest single contributor to broad money growth during the year. As a result, the annual growth rate of time deposits rose to 10% in December 2001 from 7.5% twelve months earlier. Households added Lm133.6 million to such deposits during the year, while corporate holdings rose more moderately and those of public sector firms contracted. One-year time deposits proved to be especially popular, rising by Lm112.5 million, or 14.1%. In contrast with the previous year, when they rose by over a third, short-term deposits increased by only 8.9% in 2001.

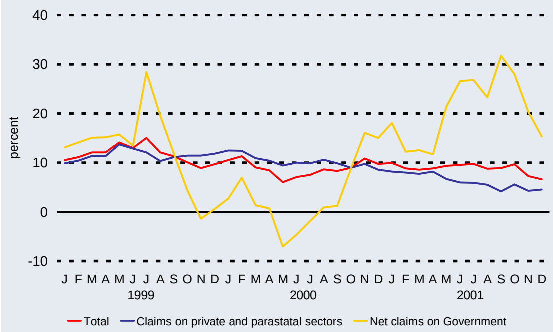
After having contracted in 2000, savings deposits recovered during the year under review, expanding by Lm42.1 million, or 6.7%. The rise was almost evenly split between the personal and corporate categories, which gained Lm21.7 million and Lm23.8 million, respectively. The relaxation of exchange controls appears to have had a significant impact on foreign currency savings deposits, which rose by nearly a quarter during the year, as can be seen from Table 5.2, making up nearly three-quarters of the overall increase in this deposit category.

5.3 Counterparts to Monetary Growth

Monetary expansion during 2001 was matched by growth in domestic credit and in the net foreign assets of the banking system, while being held back by an increase in "other items (net)". As can be seen in Table 5.3, however, although domestic credit remained the most important counterpart to monetary expansion, accounting for more than half the annual increase in broad money, vigorous growth in the net foreign assets of the banking system also contributed substantially. Moreover, "other items (net)" rose less rapidly and thus exerted less of a dampening effect on monetary expansion.

In absolute terms, domestic credit registered the smallest increase since the mid-1990s, expanding by Lm144.1 million to Lm2,328.3 million. As a result, the annual rate of credit growth dropped fairly steadily throughout the year, as Chart 5.2 shows, falling to 6.6% in December 2001 from 9.7% a year earlier. Claims on the private and parastatal sectors and net claims

Chart 5.2
DOMESTIC CREDIT
(percentage changes on year earlier)



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

Table 5.3
BROAD MONEY AND ITS COUNTERPARTS

Lm millions

	1999	2000	2001
Broad money (M3)	**2,441.8**	**2,538.9**	**2,752.9**
Domestic credit	**1,991.0**	**2,184.2**	**2,328.3**
Net claims on Government	358.1	411.8	475.1
Claims on private and parastatal sectors	1,632.9	1,772.4	1,853.2
Net foreign assets	**969.1**	**970.8**	**1,088.9**
Central Bank	740.3	640.5	760.4
Banks	228.8	330.3	328.4
Less:			
Other items (net)	**518.4**	**616.1**	**664.2**
COUNTERPARTS TO MONETARY GROWTH[1]			
Domestic credit	**7.9**	**7.9**	**5.7**
Net claims on Government	0.1	2.2	2.5
Claims on private and parastatal sectors	7.8	5.7	3.2
Net foreign assets	**4.1**	**0.1**	**4.7**
Central Bank	4.5	-4.1	4.7
Banks	-0.4	4.2	-0.1
Less:			
Other items (net)	**2.1**	**4.0**	**1.9**
Broad money (M3)	**9.9**	**4.0**	**8.4**

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

on Government both contributed to domestic credit expansion, with the former accounting for just over half the overall increase.

The Government continued to finance its operations by issuing securities that were taken up to a significant extent by the banking system. Hence, net claims on Government continued to expand rapidly, rising by Lm63.3 million during 2001, as an increase in banks' holdings of Government stocks outweighed a rise in the Government's deposits with the Central Bank. Net claims on Government rose fairly steadily during the first three quarters of the year before contracting in the final quarter, when a stock issue proved popular with the non-bank private sector and the fiscal deficit contracted. The annual rate of growth of net claims on Government, which is shown in Chart 5.2, mirrored these developments, climbing from 15% at the end of 2000 to a peak of 31.8% in September, before dropping to 15.4% at the end of the year.

Although claims on the private and parastatal sectors continued to expand, accounting for the greater part of the increase in domestic credit, they did so at a markedly slower pace than in 2000. In fact, they put on around half the increase recorded during the previous year, adding Lm80.7 million to Lm1,853.2 million. Consequently, their annual rate of growth continued to decelerate steadily, dropping from 8.5% in 2000 to 4.6% in 2001, which is the lowest annual growth rate recorded since the mid-1970s. Despite falling nominal and real bank lending rates, the demand for credit fell, possibly because of weaker economic growth. Coupled with a more prudent lending stance on the part of the banks, this reduced the rate of credit expansion.

Loans and advances, including discounted bills, accounted for around 95% of bank claims on the private and parastatal sectors, with the remainder consisting of the banks' holdings of corporate debt

Table 5.4

CLAIMS ON PRIVATE AND PARASTATAL SECTORS [1]

Lm millions

	2000			2001		
	Amount	Annual Growth (%)		Amount	Annual Growth (%)	
Claims on the private sector	1,524.4	11.5		1,587.1	4.1	
Claims on the parastatal sector	248.0	-6.4		266.1	7.3	
TOTAL	**1,772.4**	**8.5**		**1,853.2**	**4.6**	
LOANS AND ADVANCES	Amount	Annual Growth (%)	Share of Total (%)	Amount	Annual Growth (%)	Share of Total (%)
Energy and water	101.1	-7.2	6.0	95.2	-5.8	5.4
Agriculture and fisheries	19.0	76.7	1.1	10.4	-45.5	0.6
Manufacturing, shiprepair/building	212.9	3.9	12.7	204.3	-4.0	11.6
Building and construction	98.6	1.7	5.8	85.2	-13.5	4.8
Hotel, restaurant and tourist trades	239.3	7.8	14.2	245.7	2.7	13.9
Wholesale and retail	292.2	6.0	17.3	300.0	2.7	17.0
Personal	393.3	14.8	23.3	462.5	17.6	26.2
Transport, storage and communications	98.7	21.8	5.8	107.5	8.9	6.1
Other services	66.2	-18.9	3.9	75.9	14.7	4.3
All other	166.2	20.2	9.9	180.7	8.7	10.2
TOTAL LOANS AND ADVANCES [2]	**1,687.5**	**8.0**	**100.0**	**1,767.4**	**4.7**	**100.0**

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

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

and equity. During 2001 bank loans and advances expanded by Lm79.9 million, or 4.7%, compared with 8% in 2000. This slowdown in credit growth was broadly based: lending to all categories of borrower, except households and "other services", either expanded at a slower pace or contracted. Meanwhile, bank holdings of corporate securities, which had risen by around a fifth during 2000, expanded marginally during the year reviewed.

Claims on the private sector rose by just 4.1% during the year, whereas they had grown about three times as fast during the previous two years. In contrast, after having contracted during 2000, claims on public sector enterprises expanded by 7.3% during the year under review. However, this swing may have resulted from a reclassification of loan facilities away from the private sector.

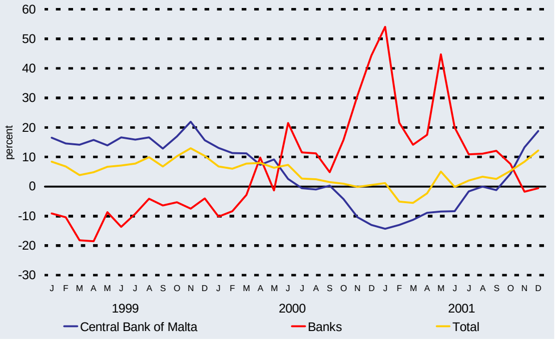
In fact, a reclassification exercise undertaken by one reporting bank in the course of the year also means that the breakdown of credit by the various categories of borrower, which is shown in Table 5.4, has to be analysed cautiously. However, the information available suggests that personal credit, which rose by Lm69.2 million-driven mainly by housing finance-accounted for almost the entire increase in bank lending during the year. Indeed, the annual rate of growth of credit to the personal sector accelerated to 17.6%.

At the same time, credit to the "other services" sector, which had contracted sharply in 2000 as a result of the above mentioned reclassification exercise, expanded by Lm9.7 million, or 14.7%. Loans and advances to the transport, storage and communications sector also rose rapidly, going up by 8.9%, driven by robust demand from communications firms early in the year. Lending to the tourism industry, to the wholesale and retail trades and to borrowers in the "all other" category continued to expand, albeit at a slower pace. In contrast, as the Table shows, there were significant drops in lending to the construction, manufacturing and agriculture and fisheries sectors, as well as to the energy and water sector. Reclassifications accounted for the sharp reduction in credit to agriculture and fisheries, which nearly halved, while increased borrowing from banks abroad explains most of the decline in credit to the energy and water sector.

After a lull during 2000 when they were virtually unchanged, the net foreign assets of the banking system resumed rapid growth during the year reviewed. As noted elsewhere in this Report, the balance of payments position improved substantially during 2001, with the deficit on the current account contracting, while falling international interest rates led to a wider premium on short-term Maltese lira interest rates, boosting demand for the lira in the domestic foreign exchange market. Together, these factors drove the recovery in the net foreign assets of the banking system, which expanded by Lm118.1 million to Lm1,088.9 million. Hence, after dropping to a low of –5.6% in March, the annual growth rate rose steadily, as can be seen in Chart 5.3, reaching 12.2% in December.

As the Chart also indicates, the recovery came about largely in the second half of the year, as a result of vigorous growth in the Central Bank's external reserves. The Central Bank was in fact a heavy net buyer of foreign exchange from the rest of the banking

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



system during the year. Consequently, the Central Bank's net foreign assets expanded by Lm119.9 million, or 18.7%, to Lm760.4 million. Thus, the sharp fall recorded during 2000 was completely reversed and, as Table 5.3 shows, the Bank's net foreign assets at the end of the year exceeded the end-1999 level.

The increase in the Central Bank's net foreign assets was partly offset by a slight drop in those of the remainder of the banking system[2], which ended the year at Lm328.4 million, or Lm1.8 million lower. Thus, as Chart 5.3 shows, their annual rate of growth plunged from 44.3% in December 2000 to –0.6% a year later. During the first half of the year, the net foreign assets of the rest of the banking system fluctuated widely as losses suffered by a number of international banks in February were reversed in May. The banks' net foreign assets fell in the second half of the year, as the domestic banks sold foreign exchange to the Central Bank, while those of the international banks increased. As a result, over the year, the net foreign assets of the domestic banks dropped by Lm19.9 million, shedding part of the gains registered during 2000, while those of the international banks expanded by Lm18 million.

"Other items (net)" consists of the banking system's non-monetary liabilities – including capital and reserves, provisions and debentures issued – less its other assets, such as premises, equipment and interest receivable. During 2001 these items continued to expand, as can be inferred from Table 5.3, rising by Lm48.1 million, mainly because the banks added to their capital and reserves, though their annual rate of growth decelerated from 18.9% in 2000 to 7.8% in 2001. This slowdown implies that other items (net) had a smaller negative impact on monetary growth during the year reviewed compared with the previous year.

5.4 The Money Market

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

[2] For the purposes of this analysis domestic banks include the deposit money banks' international banking subsidiaries, which are not included with the international banks.

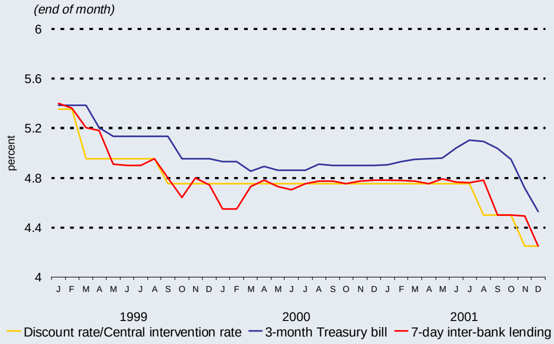
market operations are described elsewhere in this Report.

The Central Bank's decisions to ease its monetary policy stance by lowering official interest rates and by reducing reserve requirements led to a drop in money market interest rates during 2001. After leaving official interest rates unchanged during 2000, the Central Bank cut both the central intervention rate and the discount rate by 25 basis points on two occasions during 2001: at the end of August and again in November. This brought both rates down to 4.25% by the end of the year. Moreover, with effect from October, the Bank reduced the required reserve ratio, releasing liquidity into the banking system, and exerting further downward pressure on short-term interest rates.

As a result, the interest rate charged on seven-day interbank lending fell from 4.78% in December 2000 to 4.25% a year later, as Chart 5.4 shows. However, the interbank market remained thin and trading continued to decline, with the value of interbank loans dropping by nearly a third to Lm207.6 million during the year. Interbank transactions with a term to maturity of one week or less accounted for more than four-fifths of the total. The drop in interbank trading may reflect the small number of participants in the market, as well as a preference for trading with the Central Bank in its weekly open market operations.

The Treasury continued to resort regularly to the money market to finance its operations, issuing bills with terms to maturity ranging between one month and one year. During 2001, Lm477.7 million worth of such bills were issued, up from Lm431.5 million during the previous year. Issues of three-month Treasury bills predominated, accounting for nearly two-thirds of the total. Banks subscribed to two-thirds of the bills issued, with other investors – including Malta Government Sinking Funds – taking up the remainder. Although other money market rates remained stable during the first half of the year, the primary market yield on three-month Treasury bills rose, reflecting the Treasury's demand for short-term funds and the limited number of investors in the primary market. Towards the end of the year, however, the Treasury

Chart 5.4
MONEY MARKET INTEREST RATES
(end of month)



conducted fixed-rate auctions of bills, taking advantage of the drop in official interest rates and excess liquidity in the banking system to reduce its short-term borrowing costs. Consequently, the primary market three-month Treasury bill yield, which had risen to 5.1% in July, dropped to 4.53% at the end of December.

After having contracted sharply during 2000, secondary market trading in Treasury bills recovered during the year reviewed, with turnover rising by Lm78.9 million to Lm154 million. Trading was almost equally split between transactions that involved the Central Bank and those that did not. The latter, which consisted mainly of deals between banks and Malta Government Sinking Funds, totalled Lm76.3 million. Secondary market yields on Treasury bills fell during the year, with that on the three-month bill, for example, shedding 38 basis points to 4.55%.

5.5 The Capital Market

The Government raised long-term finance four times in the capital market during the year, issuing a total of Lm153.9 million worth of stocks. As Lm53.8 million worth of stocks matured in the course of the year, however, net issues of long-term Government debt securities amounted to Lm100.1 million. Stocks were issued in March, May, August and November, with terms to maturity of between eight and fifteen years. The coupon rates offered ranged from 5.9% on the eight-year bond issued in November to 6.65% on the fifteen-year bond issued in March. Whereas retail investors subscribed to bonds issued at par, larger investors bid for bonds at auction. Households took up 43.9% of the total amount issued, while banks

Table 5.5

ISSUES OF LONG-TERM DEBT SECURITIES [1]

Lm millions

	1999	2000	2001
Government			
Total issues	125.6	87.0	153.9 [2]
Redemptions	46.8	86.5	53.8
Net issues	78.8	0.5	100.1
Corporate			
Total issues	17.0	65.3	4.5
Redemptions	3.0	-	30.0
Net issues	14.0	65.3	-25.5
Total net issues	**92.8**	**65.8**	**74.6**

[1] Includes public issues of debt securities by residents in Maltese liri and foreign currencies. Banks and State-owned enterprises are included with corporate issuers. Long-term securities are those with an original term to maturity exceeding one year.

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

Sources: Central Bank of Malta, The Treasury

subscribed to 38.5%, with other investors, including non-bank financial institutions, buying the remainder.

In contrast with the previous year when net issues of corporate bonds had risen considerably, only two new debt securities were issued by the private sector during 2001, and one bond issued by a credit institution was redeemed. As Table 5.5 shows, corporate issuers tapped the bond market to a limited extent during the year. One private firm launched an issue of Lm3 million worth of secured notes in March, while in September another issued Lm1.5 million worth of bonds, which were later listed on the Malta Stock Exchange.

Heightened primary market activity and falling equity prices probably prompted investors to focus on the bond market during the year. Hence, secondary market trading in Government stocks continued to expand, with turnover more than doubling to Lm133.5 million. As Table 5.6 shows, Central Bank involvement in the secondary market for Government stocks declined further, accounting for less than a fifth of the total market activity. Trading was spread across a broad spectrum of securities, with the value of transactions in the 7% MGS 2003 and the 7.8% MGS 2018 reaching Lm14.5 million and Lm13.6 million, respectively. Turnover in the market for listed corporate bonds, including preference shares, also continued to rise, going up by Lm10.4 million to Lm15.1 million, with bank debt in particular being traded actively.

Government bond yields were stable or rising for most

Table 5.6

SECONDARY MARKET TRADING IN GOVERNMENT STOCKS

Lm millions

	1999	2000	2001
Central Bank purchases	3.8	7.7	10.3
Central Bank sales	16.9	4.2	8.8
Other deals[1]	30.1	51.2	114.4
Total	**50.7**	**63.1**	**133.5**

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

Sources: Central Bank of Malta, Malta Stock Exchange

Chart 5.5
GOVERNMENT BOND YIELDS
(end of month)

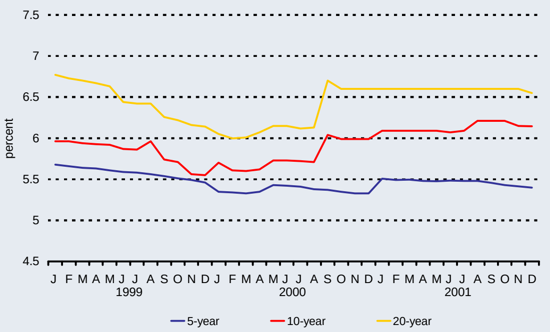
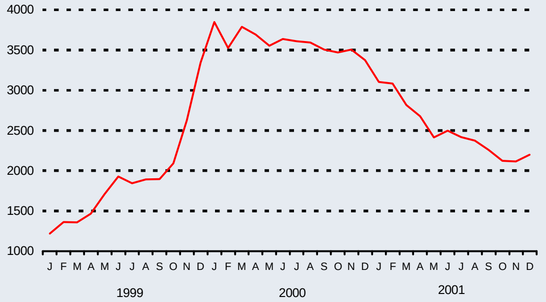


Chart 5.6
MALTA STOCK EXCHANGE SHARE INDEX
(end of month)



Source: Malta Stock Exchange

of the year. Although they dipped slightly in the final quarter, as Chart 5.5 shows, they generally ended the year above their end-2000 levels. For example, the yield on ten-year Government bonds rose from 5.99% in December 2000 to 6.21% in October 2001, before ending the year at 6.15%. In the corporate bond market, whereas yields on bonds issued by deposit money banks fell, those on other corporate issues generally rose.

Two companies, Globe Financial Management plc and First International Merchant Bank plc, raised capital through public offerings of shares during the year. Both companies were admitted to the official list of the Malta Stock Exchange, where their shares began trading. Trading in equities on the Exchange nevertheless fell further, with turnover dropping in both volume and value terms. In fact, the value of traded equities shrank to Lm20.7 million during 2001 from Lm81.1 million the year before[3]. Maltacom plc and the two major banks continued to dominate market activity, accounting for more than two-thirds of the total turnover between them.

With investors turning away from the equity market, the decline in share prices that had set in at the beginning of 2000, following the sharp rise recorded during 1999, gathered momentum, although there were signs of a small recovery at the end of the year, as Chart 5.6 shows. During 2001 the Malta Stock Exchange Share Index dropped by 34.8% to end the year on 2,200.

[3] This excludes shares listed on the Alternative Companies List.

6. The Banking System

The year 2001 was characterised by some notable institutional changes in the Maltese banking system. The main development was the restructuring exercise undertaken by the two major deposit money banks designed to streamline banking services. Bank of Valletta plc absorbed the operations of its international banking subsidiary Bank of Valletta International Limited (BOVI) and closed down its subsidiary Valletta Investment Bank Limited, as the parent bank took over its business activities. The other major deposit money bank, HSBC Malta plc, likewise assumed the financial services provided by its subsidiary, HSBC Finance (Malta) Limited. Consequently, both Valletta Investment Bank Limited and HSBC Finance (Malta) Limited terminated their activities and surrendered their operating licences to the Competent Authority.

During the year three Turkish international banks carrying out banking activities from Malta terminated their operations following the financial crisis in Turkey at the end of the previous year. At the same time, two other international banks commenced their activities in Malta after having been given a licence to operate by the Competent Authority.

The institutional changes effected by the major deposit money banks necessitated a reclassification of banking institutions by the Central Bank for statistical purposes. Thus, from the beginning of 2001, a subsidiary of HSBC, HSBC Home Loans (Malta) Limited, previously included with "Other Banking Institutions", was reclassified under the "Deposit Money Banks" category. Furthermore, Britannia Financial Services, a small financial institution, which was also classified under the "Other Banking Institutions" category, was redesignated a financial intermediary. As a result, there are now only two categories of banking institutions for statistical reporting purposes: "Deposit Money Banks" and "International Banking Institutions". The "Other Banking Institutions" category no longer exists.

These institutional developments, together with a renewed preference for bank deposits as against other, more risky financial products, led to a marked expansion in the deposit money banks' aggregate balance sheet. At the same time, a more prudent approach to lending resulted in increased bank holdings of domestic securities and foreign assets. The Bank of Valletta's absorption of BOVI meanwhile led to a marked increase in its foreign liabilities and a corresponding drop in subsidiaries' deposits.

Profits before tax fell during 2001 compared with 2000. This mainly reflected a fall in non-interest income arising from that year's one-off transfer of past profits by a subsidiary to its parent bank. This, together with higher operating expenses, outweighed an increase in net interest income. Nevertheless, the banks consolidated their capital base and recorded a further improvement in their liquidity position.

6.1 Deposit Money Banks' Balance Sheet

6.1.1 Liabilities

Following the sharp slowdown in deposit growth recorded in 2000, lower expected returns on alternative financial products led to a surge in bank deposits during the year under review. Thus, funds placed with the deposit money banks grew by Lm200 million to Lm2.3 billion during the year, as Chart 6.1 shows.

Chart 6.1
ANNUAL CHANGES IN DEPOSIT MONEY BANKS' DEPOSITS

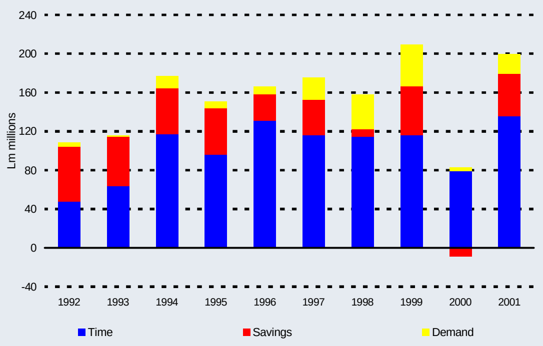


Table 6.1
DEPOSIT MONEY BANKS' BALANCE SHEET

Lm millions

	2000	2001	Change
ASSETS			
Cash and deposits with the Central Bank of Malta	153	180	27
Foreign assets	730	792	62
Loans and advances	1,608	1,866	258
Local investments	601	663	62
Fixed and other assets	151	169	18
LIABILITIES			
Capital and reserves	159	191	32
Foreign liabilities	405	600	195
Other domestic liabilities	567	567	0
Deposits	2,113	2,313	200
Time	1,297	1,432	135
Savings	624	667	43
Demand	192	213	21
AGGREGATE BALANCE SHEET	**3,243**	**3,670**	**427**

The acceleration in growth was evident across all deposit categories, as can be seen from Table 6.1. Thus, time deposits rose by 10.5% to Lm1.4 billion, with the increase being almost entirely in deposits with a maturity of one year or less, as Chart 6.2 shows, while demand deposits were up by 10.9% to Lm213 million. Even savings deposits, which had contracted by Lm8.9 million in 2000, moved up by Lm43 million, or 7%, to Lm667 million during the year under review.

The Lm195 million rise in the banks' foreign liabilities resulted largely from Bank of Valletta's absorption of BOVI's operations, as non-resident deposits previously appearing on the latter's books were transferred to the parent bank's accounts. Since BOVI's assets consisted mainly of deposits with its parent bank, this led to the deterioration in the net foreign asset position of the deposit money banks portrayed in Chart 6.3.

The banks' other domestic liabilities, at Lm567 million, were unchanged from the previous year's level. Initially, the incorporation of HSBC Home Loans Bank in the deposit money banks sector led to a rise in other interbank deposits, debentures in issue and subordinated loan capital. Later, however, as a result of BOVI's merger with its parent bank, this was offset by a fall in deposits due to subsidiaries. Domestic securities sold under repurchase agreements also declined.

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

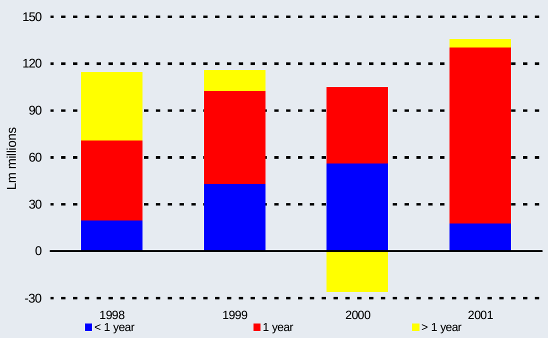
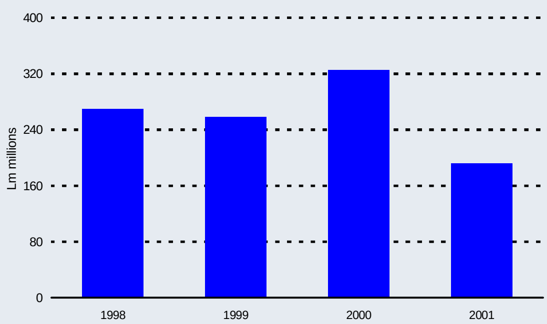


Chart 6.3
NET FOREIGN ASSETS OF DEPOSIT MONEY BANKS



At the same time, the banks' combined capital and reserves increased by Lm32 million. This mainly reflected the addition of retained profits to reserve funds, though Lombard Bank's decision to grant its shareholders the option of receiving dividends in the form of new shares also contributed.

6.1.2 Assets

The incorporation of HSBC Home Loans Bank in the deposit money banks sector contributed to a Lm258 million expansion in the banks' portfolio of loans and advances, including discounted bills, during the year. Excluding this, however, credit growth decelerated to 7%, from 9.8% a year earlier, in spite of a rise in interbank lending. As at the end of the year, loans and advances accounted for half the value of the banks' assets.

The deposit money banks' foreign assets increased by Lm62 million to Lm792 million. In particular, the banks invested an additional Lm55.3 million in non-Government foreign securities and expanded their portfolio of loans to non-residents. Money at call abroad and claims on overseas banks also increased, although the banks reduced their holdings of foreign Government securities by some Lm21 million.

The banks' domestic securities portfolio grew by Lm62 million, representing a year-on-year increase of 10.3%. In fact, a surge in their holdings of Malta Government stocks and Treasury bills was only partly offset by a drop in investments in corporate bonds that matured in April.

The banks' fixed and other assets rose by Lm18 million over the previous year, partly reflecting an increase in the value of their premises and equipment. Meanwhile, their reserve assets expanded by Lm27 million, as a rise in deposits with the Central Bank more than compensated for a decline in cash holdings.

6.2 Deposit Money Banks' Performance

6.2.1 Profitability

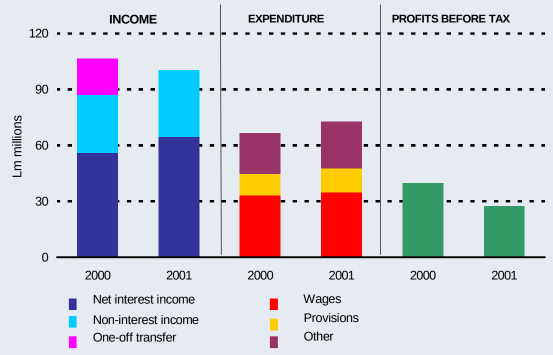
The deposit money banks reported aggregate profits before tax of Lm27.5 million during 2001, down by Lm12.3 million on the year. The drop mainly reflected the previous year's one-off transfer of past profits from an international subsidiary to its local parent bank, as can be seen from Table 6.2 and Chart 6.4. This transfer led to a decline in non-interest income that was only partly offset by higher net interest income, while an increase in operating expenses and provision charges also contributed to lower profits.

Table 6.2
DEPOSIT MONEY BANKS' INCOME AND EXPENDITURE

Lm millions

	2000	2001	Change
Interest income	185.8	201.1	15.3
Interest expenses	129.9	136.5	6.6
Net interest income	**55.9**	**64.6**	**8.7**
Fees and commissions	12.2	11.9	-0.3
Foreign exchange gains	9.0	12.7	3.7
Other non-interest income	29.3	10.1	-19.2
Non-interest income	**50.5**	**35.6**	**-14.9**
GROSS INCOME	**106.4**	**100.2**	**-6.2**
Wages	33.2	34.7	1.5
Other expenses	21.8	25.0	3.2
Operating expenses	**55.0**	**59.7**	**4.7**
Provisions	**11.6**	**13.0**	**1.4**
PROFITS BEFORE TAX	**39.8**	**27.5**	**-12.3**

Chart 6.4
DEPOSIT MONEY BANKS' PERFORMANCE



The deposit money banks earned an additional Lm15.3 million in interest income during the year. This largely reflected higher interest on loans and investment securities which, coupled with a more moderate increase in interest expenditure, translated into an Lm8.7 million rise in the banks' net interest income. The latter was, however, completely offset by a Lm14.9 million drop in non-interest income, reflecting the previous year's one-off transfer of past profits from an international banking subsidiary to its parent bank. Meanwhile, the banks' operating expenses rose by Lm4.7 million, reflecting both a higher wage bill and an increase in fees and commissions payable. At the same time, provision charges, at Lm13 million, were Lm1.4 million higher than in the previous year.

6.2.2 Interest rates

During 2001 the Central Bank's Monetary Policy Council lowered the central intervention rate by 50 basis points through two equal reductions: one at the end of August and the other in November. As can be seen in Chart 6.5, this led to a 74 basis point fall in the weighted-average lending rate on loans to residents, which stood at 6.5% as at end-December. The

Chart 6.5
INTEREST RATES ON LOANS AND DEPOSITS

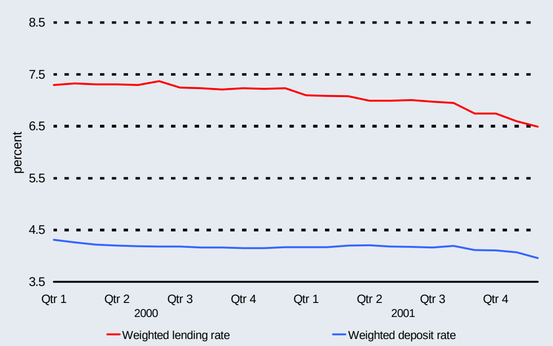
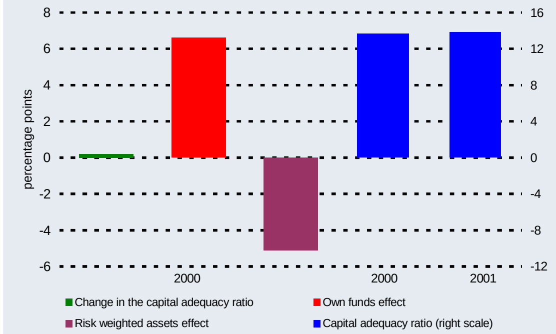


Chart 6.6
BREAKDOWN OF THE CHANGE IN THE CAPITAL ADEQUACY RATIO



weighted-average rate on deposits declined less steeply, from 4.2% in January to just under 4% at the end of the year, as interest rates on time deposits adjust more slowly to changes in official rates. Consequently, the interest rate spread narrowed from 3.1% to around 2.5%, with the greater part of the contraction taking place in the second half of the year.

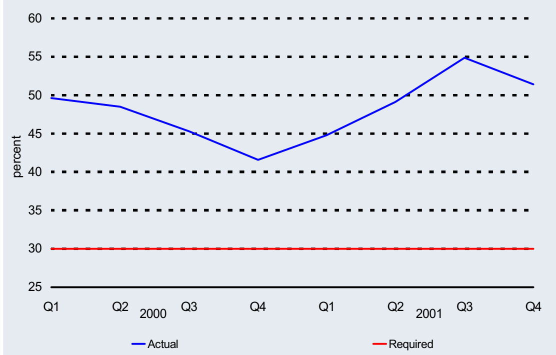
6.2.3 Capital adequacy

The deposit money banks' capital base strengthened further during the year under review, with the aggregate capital adequacy ratio reaching 13.8%, for a year-on-year rise of 20 basis points. As can be seen from Chart 6.6, the strengthening of the capital base resulted from a 6.6% rise in the banks' own funds, largely reflecting higher retained earnings, which more than compensated for the negative effect of a simultaneous 5.1% increase in the value of risk-weighted assets. The banks' capital adequacy ratio remained consistently above the mandatory 8% minimum throughout the year.

6.2.4 Liquidity

During 2001 the deposit money banks' net short-term

Chart 6.7
DEPOSIT MONEY BANKS' LIQUIDITY RATIO



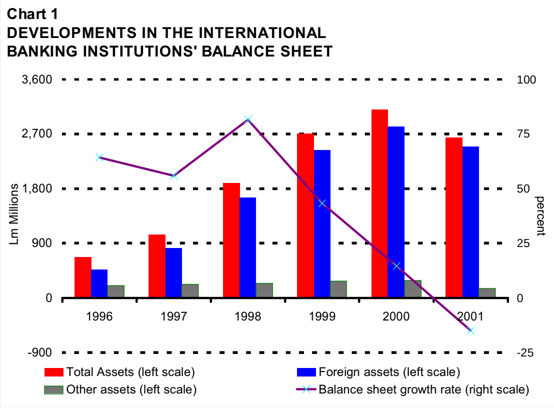
liabilities[1] increased by Lm110.6 million, while their holdings of liquid assets rose by Lm 218.5 million. The latter largely took the form of marketable long-term debt securities, although increases in interbank deposits, holdings of Treasury bills and deposits with the Central Bank also contributed. As Chart 6.7 shows, this led to a marked improvement in the banks' liquidity ratio, which rose to 51.4%, up by 9.8 percentage points when compared to the previous year and well above the mandatory 30%.

[1] These consist of all short-term liabilities to banks and customers net of loans received under repurchase agreements against liquid assets, deposits pledged as security and half of items in course of collection.

Box 1:

International Banking Institutions

The aggregate balance sheet of the international banking sector in 2001 was significantly influenced by the merger of Bank of Valletta International (BOVI) with its parent bank, the termination of operations of three Turkish institutions and a marked contraction in the balance sheets of two other banks. The effects of these developments were only partly offset by the commencement of operations in Malta by two other banks, Akbank T.A.S. and Sparkasse Bank Malta plc. As a result, the aggregate balance sheet of the sector contracted for the first time since 1996, as Chart 1 shows. Meanwhile, a drop in interest income led to a fall in profits.



Assets

In general, international banks can only carry out banking business with non-residents and in currencies other than the Maltese lira. Hence, as Table 1 shows, foreign assets and foreign liabilities constitute the greater part of their balance sheet. At the end of 2001, their foreign assets stood at Lm2.5 billion, down by Lm335 million from the end-2000 level. The banks' portfolio of foreign securities expanded by Lm75 million, as a rise in the Treasury bill holdings of a particular bank was only partly offset by a drop in its investments in non-Government securities, while a small increase was also reported in holdings of long-term Government debt instruments. At the same time, the banks' loans and advances to non-residents increased by Lm245 million to nearly Lm1.2 billion, largely on account of the inclusion for the first time of

Table 1
INTERNATIONAL BANKING INSTITUTIONS' BALANCE SHEET

Lm millions

	2000	2001	Change
ASSETS			
Cash and money at call	2	1	-1
Foreign assets	**2,819**	**2,484**	**-335**
Foreign securities	932	1,007	75
Loans and advances to non-residents	951	1,196	245
Other foreign assets	936	281	-655
Loans to residents	6	6	0
Local investments	268	137	-131
Other domestic assets	11	13	2
LIABILITIES			
Capital and reserves	194	257	63
Foreign liabilities	**2,821**	**2,348**	**-473**
Balances due to other banks abroad	877	858	-19
Non-resident deposits	1,032	692	-340
Other foreign liabilities	912	798	-114
Other domestic liabilities	59	4	-55
Resident deposits	32	33	1
AGGREGATE BALANCE SHEET	3,106	2,641	-464

one of the two banks that had been granted a licence towards the end of 2000.

However, other foreign assets, primarily claims by local branches on their overseas head offices, declined by Lm655 million, reflecting the contraction in the balance sheet value of one particular bank and the withdrawal of three institutions from the Maltese banking scene. Meanwhile, the international banks' domestic investments at the end of December stood at Lm137 million, down by Lm131 million from the previous year's level, as BOVI ceased to exist as a separate entity and, thus, no longer held deposits with its parent bank.

Liabilities

At the end of 2001, the foreign liabilities of the international banks amounted to Lm2.3 billion, Lm473 million less than a year earlier. Non-resident deposits shed Lm340 million, as deposits with BOVI were passed on to its parent bank. In addition, a particular bank also reported a shift in the composition of its foreign liabilities from non-resident deposits to other foreign liabilities. Despite this, the sector's other foreign liabilities still declined by Lm114 million, reflecting a sharp drop in such liabilities reported by another bank. Meanwhile, movements in balances owed to other banks abroad by individual institutions more or less offset each other, such that the aggregate balance at the end of the year was only Lm19 million less than a year earlier.

The international banks' other domestic liabilities fell by Lm55 million, reflecting the transfer of past profits to the banks' reserve funds, as well as BOVI's merger with its parent. The former, coupled with the addition of the capital of a bank that started operating in 2000, contributed to a Lm63 million rise in the sector's capital and reserve funds.

Profitability[1]

As Table 2 shows, the international banks reported an aggregate profit before tax of Lm18 million during 2001, down by Lm4.5 million from the previous year's level. The decline in profits was to a large extent attributable to a fall in the sector's net interest income. In fact, a Lm38.1 million drop in interest receivable, primarily on balances due from banks, was only partly offset by a fall in interest expenditure.

The international banks' non-interest income rose by Lm16.2 million, reflecting gains on foreign exchange instruments by a particular institution. At the same time, a fall in non-interest expenses arising from the reversal of the previous year's losses on investment securities also helped to dampen the effect of the decline in net interest income on the banks' profits. Meanwhile, provision charges, largely in the form of general provisions on bad and doubtful debts, increased by Lm0.5 million.

Table 2

INTERNATIONAL BANKING INSTITUTIONS' INCOME AND EXPENDITURE[1]

Lm millions

	2000	2001	Change
Interest income	265.3	227.2	-38.1
Interest expenses	205.0	195.2	-9.8
Net interest income	**60.3**	**32.0**	**-28.3**
Non-interest income	**7.4**	**23.6**	**16.2**
Non-interest expense	**44.9**	**36.8**	**-8.1**
Provisions	**0.3**	**0.8**	**0.5**
PROFITS BEFORE TAX	**22.5**	**18.0**	**-4.5**

[1] Excludes banks registered under the Malta Financial Services Centre Act, 1988.

[1] The following profitability assessment does not cover international banks that are licensed in terms of the Malta Financial Services Centre Act, 1988.

Part II

CENTRAL BANK POLICIES,

OPERATIONS AND ACTIVITIES

1. Monetary and Exchange Rate Policy

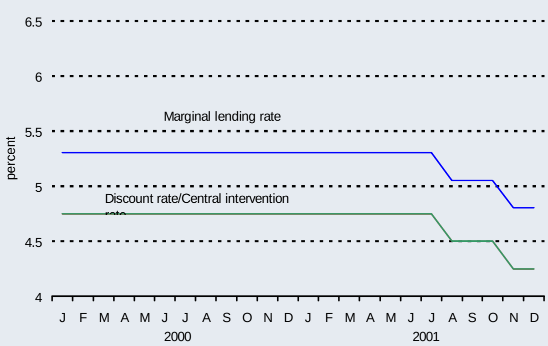
1.1 Policy Overview

The Central Bank is responsible for the conduct of monetary policy in Malta. It also plays an important role in the formulation of exchange rate policy, which is the joint responsibility of the Bank and the Government. The Bank interprets this responsibility as a mandate to pursue price stability, which in the longer term is a necessary prerequisite for balanced economic growth and sustainable increases in employment and incomes. To achieve this policy objective, the Bank keeps the exchange rate of the Maltese lira pegged to a basket of three low-inflation currencies - the euro, the US dollar and sterling - with shares that broadly reflect Malta's external trading patterns. The exchange rate peg, in turn, acts as a nominal anchor for domestic inflation, restraining domestic price and wage increases, and limits imported inflation, which is an important concern in a small, open economy.

The Bank's Monetary Policy Council sets the stance of monetary policy. The Council, which is chaired by the Governor and is made up of the other members of the Board and three senior Bank officials, met twelve times during the year under review.

After having kept interest rates unchanged during 2000, the Council lowered official interest rates twice during 2001, cutting both the discount rate and the central intervention rate by a total of 50 basis points, to 4.25%, by the end of the year. As Chart 1.1 indicates, the Council cut both official interest rates by 25 basis points in August and again in November. Moreover, in September, it also eased the monetary policy stance by lowering the reserve ratio imposed on banks by one percentage point to 4% of their deposit liabilities. The Council's decisions to relax monetary policy reflected economic and financial developments in Malta and abroad. A key factor was the deterioration in global economic conditions and the response of the world's major central banks, which cut interest rates several times. This resulted in a marked widening of the interest rate premium on the Maltese lira, which in turn made domestic financial investments relatively more attractive and thus contributed to a steady recovery in the official external reserves. Domestic economic conditions, which were characterised by sluggish demand and weak output growth, were also compatible with an easing of the monetary policy stance.

Chart 1.1
TRENDS IN OFFICIAL INTEREST RATES



1.2 The Implementation of Monetary Policy

The Central Bank uses a number of tools to maintain the exchange rate peg. First, the Bank supports the peg indirectly by buying or selling foreign exchange in response to market requirements. Second, the Bank adjusts official interest rates in line with its monetary policy stance. Changes in official interest rates influence money market rates, capital market yields and retail bank deposit and lending rates. Higher interest rates generally dampen domestic demand and make Maltese financial assets more attractive. In contrast, lower interest rates stimulate demand and make foreign assets more attractive. Given the progressive relaxation of exchange controls, domestic interest rates must increasingly move with those abroad.

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

To limit the effects of fluctuations in banks' liquidity on interest rates, the Bank also offers lending and deposit facilities to the banks. Finally, banks are obliged to hold reserves with the Central Bank in proportion to their deposit liabilities. Reserve requirements generate a shortage of liquidity in the banking system and limit the potential for credit expansion in the economy.

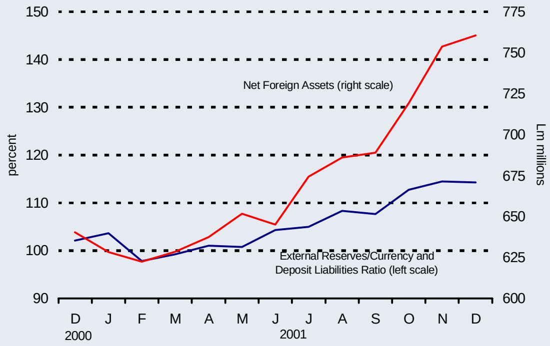
1.2.1 External reserves management

To support the exchange rate peg, the Central Bank is legally obliged to keep an adequate stock of external reserves in proportion to its currency and deposit liabilities. This proportion, which the Minister of Finance set at 60% in 1994, remained unchanged during 2001.

In line with this legal obligation and its objective of supporting the exchange rate peg, the Bank manages a portfolio of foreign assets. The parameters governing the management of this portfolio are set by the Bank's Investments Policy Committee. The Committee is chaired by the Governor and includes the Deputy Governor and other senior Bank officials. The Committee reviews the performance of the Bank's portfolio, discusses investment policy and lays down guidelines for the Bank's foreign exchange dealers.

The Bank's foreign asset portfolio mainly consists of deposits with banks abroad and listed foreign debt securities. It also includes claims on the International Monetary Fund and a small quantity of gold. Part of the portfolio is invested in liquid assets, which the

Chart 1.2
THE CENTRAL BANK'S FOREIGN ASSETS



Bank holds to be able to meet demand for foreign exchange from the Government, the banking system and other customers. The remainder is invested to earn income, while keeping risks low. The portfolio is structured to limit exposure to currency risk and is monitored regularly to limit the risks that may arise as a result of dealings with foreign financial institutions. From time to time the Bank also advises the Government and public sector entities on the management of external debt.

The Bank publishes opening exchange rates daily and quotes real-time exchange rates throughout the day on Reuters. It operates in the spot foreign exchange market, dealing with banks and financial institutions in euros, US dollars and pounds sterling, generally in amounts exceeding Lm150,000. The Bank also operates in the forward foreign exchange market and trades in gold, apart from selling gold grain to local goldsmiths[1].

During 2001, as Malta's balance of payments position improved, the Bank was a net buyer of foreign currency, adding to its external reserves in the process. In contrast, during 2000 the Bank had been a net seller of foreign exchange. During the year reviewed, the Bank bought Lm135.6 million worth of foreign exchange from banks and financial institutions in the spot market and sold Lm48.4 million worth to them. The Bank also made net purchases of Lm46.5 million worth of foreign exchange as forward contracts matured. These transactions outweighed net payments carried out on behalf of the Government

[1] During 2001 the Bank sold 1,365 kilograms of gold grain worth Lm5.4 million on the local market.

and other customers. In addition, the Bank entered into two swap transactions in which it sold foreign currency in the spot market and entered into a concurrent obligation to buy foreign exchange at a later date.

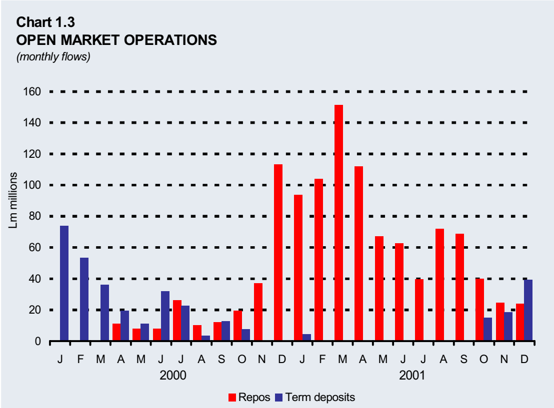
Reflecting these large net purchases of foreign exchange, the Bank's net foreign assets, which had contracted by Lm99.8 million during 2000, expanded by Lm119.9 million, to Lm760.4 million, during 2001. As a result, the statutory ratio between the Bank's external reserves and its currency and deposit liabilities rose by twelve percentage points to 114.3%, as Chart 1.2 shows.

The Bank monitors developments in the local foreign exchange market to detect any incipient trends. To this end, banks and financial institutions are required to report on the value and economic purpose of foreign exchange transactions above a Lm10,000 threshold. The value of transactions in the foreign exchange market, excluding interbank deals and deals involving the Central Bank, amounted to Lm1,975 million, compared with Lm1,989 million in 2000[2]. Activity in the interbank foreign exchange market was limited, with turnover edging up to Lm14.4 million from Lm13.2 million in 2000.

1.2.2 Open market operations

In line with the reduction in official rates, interest rates applied in the Bank's open market operations declined during the year. The repo rate dropped from 4.8% at the end of 2000 to 4.29% a year later, while the rate offered on fourteen-day term deposits fell by half a percentage point to 4.22% at end-December 2001.

The manner in which the Bank conducted its open market operations was modified during the year. Whereas until October 5 the Bank conducted repo auctions at a fixed rate equal to the upper limit of the band around the central intervention rate, repo auctions after that date were held at a variable rate. In a variable rate auction, the banks submit bids indicating the interest rates they are willing to pay to obtain



liquidity. In contrast, term deposit auctions were held at variable rates throughout the year. Pursuant to its objective of aligning its collateral management framework to international best practice, in October the Central Bank began to apply an initial margin of 1% on the amount injected as a risk control measure. As a result, the market value of the underlying securities offered by each credit institution as collateral in repo operations has to be 1% higher than the amount of liquidity provided by the Bank.

In contrast with previous years, when the Central Bank used open market operations mainly to absorb liquidity from the banking system, during most of 2001 the Bank used them to inject liquidity. Thus, the value of term deposits accepted shrank from Lm271.6 million in 2000 to Lm77.2 million during 2001. Conversely, the value of repos expanded from Lm244.9 million to Lm859 million. As can be seen in Chart 1.3, the banking system was short of liquidity for most of the year, with the Central Bank injecting funds through repos in response. In the final quarter, the liquidity shortage in the banking system eased and the Bank absorbed liquidity by offering term deposits instead.

1.2.3 Other standing facilities

In terms of the Central Bank of Malta Act, 1967, the Bank may also discount Treasury bills and other eligible securities to provide liquidity to the banking system. As in the previous year, however, this facility was not used during 2001, in line with the Bank's

[2] Data for 2000 do not include transactions carried out by financial institutions. During 2001 these totalled Lm131 million.

policy not to resort to the discount window to provide liquidity. On the other hand, the Bank continued to offer a marginal lending facility, whereby it provides overnight loans secured by pledges of collateral. Banks did make use of this facility during the year, borrowing Lm8.6 million. The interest rate charged on these loans remained set at 55 basis points above the Bank's central intervention rate. Therefore, as official interest rates moved lower during the year, the marginal lending rate eased from 5.3% to 4.8%.

The Bank also provides banks with an overnight deposit facility. Amounts placed with the Bank rose from an aggregate of Lm97.7 million during 2000 to Lm120.2 million during the year reviewed. The Bank paid interest on these deposits at a rate 295 basis points below its central intervention rate.

1.2.4 Reserve requirements

In terms of the Central Bank of Malta Act, the Bank may require banks to maintain reserve deposits with it. Reserve requirements were introduced in October 1990 when banks were obliged to keep deposits with the Central Bank equivalent to 5% of their deposit liabilities. In September 2001, as part of a series of moves aimed at easing the monetary policy stance, the Bank lowered the required reserve ratio by one percentage point to 4% of the banks' deposit liabilities. This reduction in the required reserve ratio, which entered into effect on October 15, led to an increase in the liquidity available to the banks and was reflected in lower money market interest rates.

As in the past, banks met their reserve requirements on an averaging basis. This means that they are allowed to go below the required amount at times, provided that the requirement is met on average during each maintenance period. The reserve requirement is calculated monthly, with the maintenance period running from the fifteenth day of each month to the fourteenth day of the following month. The Bank continued to pay interest at 2.7% per annum on reserve requirements.

1.2.5 Exchange controls

The Central Bank continued to administer exchange controls as the agent of the Minister of Finance in terms of the Exchange Control Act, 1972. In line with the Government's liberalisation programme aimed at removing most controls by 2003, a number of measures came into effect in January 2001.

Quantitative limits on certain current payments were relaxed further. These mainly included travel allowances and cash gifts. As for capital account transactions, residents' annual investment allowances were increased, while collective investment schemes denominated in Maltese liri were permitted to invest a limited proportion of their portfolios in foreign currency assets. Rules governing the operation of foreign currency accounts were relaxed further, and lending between residents and non-residents for maturity periods of one year or more was completely liberalised. Meanwhile, restrictions in respect of dowry payments and transfers of assets by emigrants were completely lifted.

In terms of the Exchange Control Act, the Central Bank continued to monitor transactions between residents and non-residents on the basis of information supplied by authorised foreign exchange dealers. The latter are obliged to provide statistical returns on a range of transactions between residents and non-residents. Table 1.1 summarises the information gathered from authorised dealers, which supplements other information on the balance of payments. As the Table shows, portfolio investment outflows declined during the year, while borrowing by resident companies from overseas increased, largely reflecting domestic banks' borrowings from the international market.

The November Budget Statement contained another round of liberalisation measures that were to take effect in January 2002. The measures included increased travel and portfolio investment allowances, the removal of quantitative restrictions on investment in real estate, and a further easing of restrictions on the operation of foreign currency accounts. In addition,

Table 1.1

TRANSACTIONS UNDERTAKEN IN TERMS OF THE EXCHANGE CONTROL ACT

Lm millions

	2000	2001
Cash gifts	7.1	8.0
Portfolio investments in foreign currency	46.0	35.8
Borrowing by local companies owned by non-residents		
From domestic banks	16.2	11.1
From foreign shareholders	0.9	0.8
Borrowing by resident companies from overseas lenders	8.0	86.5
Borrowing by resident persons from overseas lenders	0.1	0.5
Borrowing by non-residents from domestic banks	1.4	2.4

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

locally registered companies were to be permitted to seek a listing for certain securities on recognised international markets.

1.3 Money and Capital Markets

In line with the established policy, the Central Bank refrained from participating in the primary markets for Treasury bills and Malta Government stocks during 2001. However, the Bank acted as market maker in the secondary markets for Malta Government securities, helping to ensure the liquidity of the market and thereby enhance investor confidence.

In the secondary Treasury bill market, the Bank regularly quoted selling and buying rates both for retail and wholesale amounts. In establishing these prices the Bank took into consideration the level of primary market yields and official interest rates besides secondary market developments. Total transactions involving the Bank more than doubled, to Lm77.7 million, and accounted for around half of the secondary market turnover. The extent of the Bank's net purchases in the market increased. In fact, whereas during 2000 the Bank bought Lm19.7 million worth of bills and sold Lm11.8 million, during 2001 it made purchases and sales worth Lm60.5 million and Lm17.2 million, respectively. In particular, the Bank bought significant amounts of bills during the second quarter, mainly from the banking system.

The Bank also continued to trade in Malta Government stocks on the Malta Stock Exchange and quoted buying and selling rates for listed stocks. Trading involving the Bank recovered, increasing from Lm11.9 million in 2000 to Lm19.2 million during 2001. As in the previous year, purchases exceeded sales, with the Bank buying and selling Lm10.3 million and Lm8.8 million worth of stocks, respectively. In addition, the Bank's broker also traded in a nominal Lm19.1 million worth of stocks on behalf of Malta Government Sinking Funds, the Maltese Episcopal Conference and the Malta Stock Exchange.

The Financial Markets Committee – which is composed of representatives of the Central Bank and the domestic credit institutions – continued to meet regularly throughout 2001. The Committee provides a forum for the regular exchange of views and information between the banks in connection with market-related issues and contributes to higher levels of efficiency in the financial market. The Committee also consulted regularly with the Treasury in connection with matters relating to the issuance of Government paper.

During the year the Committee agreed on a thorough updating of the Interbank Agreement on Value Dating and Compensation Charges. The revised Agreement, which incorporates the interbank guidelines promulgated by the European Banking Federation in April 2001, governs the procedures to be followed in respect of interbank payments sent in error and late delivery of funds.

Another area examined by the Committee was the interest rate day count convention currently applicable for Malta Government bonds in respect of the computation of accrued/rebate interest. The Committee held consultations with the major interested parties to align the method used with international best practice.

1.4 Economic Information and Statistics

In order to enable the Central Bank to carry out its functions effectively, the Bank continuously monitors economic and financial developments both in Malta and abroad. Furthermore, during 2001, the Bank continued toexpand and enhance its statistical database so as to meet international standards.

The task of compiling, analysing and diffusing economic information is carried out in the Bank's Economic Research Department. In fact, the Department regularly provides the Bank's Monetary Policy Council and its Investment Policy Committee with comprehensive statistical tables and analytical reports prior to their respective monthly meetings. Additionally, the Department conducts research on specific topics for the Bank's senior management.

Furthermore, the Central Bank regularly provides the National Statistics Office (NSO), and the Government's Economics Policy Division with monetary and exchange rate data. Similar statistical information is also supplied regularly to the International Monetary Fund (IMF), the World Bank and the EU statistical agency Eurostat, as well as to international credit-rating agencies.

The Central Bank also keeps the general public informed on economic and financial developments through its regular publications – namely, its **Quarterly Review**, its **Annual Report** and the monthly **Statistical Release on Monetary Aggregates and their Determinants**. These publications are also regularly posted on the Bank's website.

During 2001 the Bank continued to compile statistics on government finance and the public debt, and to report on these to the IMF and the World Bank. Moreover, the Bank continued to meet the standard set by the IMF's General Data Dissemination System (GDDS) and to provide data to Eurostat on a regular basis. The Bank also compiled metadata[3] relating to monetary and banking statistics for the European Central Bank (ECB). These were subsequently published, alongside similar contributions by the other EU accession countries, in a methodological manual. The Bank also provided other information and data to the ECB. These included a list of monetary and financial institutions operating in Malta and data on bond markets and long-term interest rates. For the first time, the Bank also submitted financial statistics on a test basis to the ECB. To assist the Bank in its statistical reporting tasks, an IMF mission team and two experts from the Central Bank of Ireland visited Malta during the year.

Meanwhile, the Bank continued to work on the re-designing of the statistical returns for banks licensed to operate in Malta so as to enable it to meet the future ECB reporting requirements. Discussions with the banks continued to be held through the Technical Committee on Financial Statistics that had been set up the previous year. Similarly, the Bank together with the NSO was directly involved in the preparatory work being undertaken to establish a new direct reporting data collection system for the balance of payments and the international investment position in line with EU and IMF requirements. This system is expected to replace the current cash and accruals based reporting systems. In this regard the Bank also contributed to the preparation of the related questionnaires and guidelines for various economic categories of respondents.

[3] That is information about the data and how they are collected.

To supplement the information on its database, the Bank continued to make use of the services of a private marketing agency to conduct a quarterly survey of business perceptions on its behalf. An analysis of the survey results was published regularly in the Bank's **Quarterly Review**. At the same time, the Bank continued to update and refine its econometric models of the Maltese economy.

During the year the Bank took part in a number of forums dealing with economic analysis and data compilation, both in Malta and abroad. Bank staff sat on various technical committees together with Government and public sector officials. During the year the Bank and the NSO continued to hold monthly meetings in order to discuss topics of common interest, including the methodologies to be used in the compilation of statistics and ways of enhancing co-operation and co-ordination between the two organisations.

2. Regulatory and Supervisory Activities

The Central Bank is responsible, in terms of the Central Bank of Malta Act, for promoting a sound financial structure and fostering an orderly capital market in Malta. Under the Malta Stock Exchange Act, it is also responsible for supervising the Exchange so as to protect investors and promote a sound securities market. Furthermore, up to the end of 2001 the Bank was the Competent Authority in terms of the Banking Act, 1994 and the Financial Institutions Act, 1994, and in this capacity licensed, regulated and supervised banks and financial institutions.

The Joint Banking Committee, which is set up in terms of the Banking Act, is the body responsible for formulating banking regulatory and supervisory policy and monitoring the soundness of the banking system. During 2001 the Committee was chaired by the Governor and included four other officials of the Bank, two representing the Bank as the Competent Authority and two in connection with the Bank's responsibilities under the Central Bank of Malta Act. The Committee met seven times during the year to discuss and approve policy amendments to the Banking and Financial Institutions Directives.

At the same time, within the Regulatory Co-ordination Forum, the Central Bank of Malta, the Malta Financial Services Centre (MFSC) and the Malta Stock Exchange (MSE) continued to discuss matters of mutual interest.

On December 27, 2001, through Legal Notices 324 and 325, the Minister of Finance announced the transfer of responsibility for the supervision and regulation of credit and financial institutions from the Central Bank to the MFSC. This changeover was to enter into effect from January 1, 2002. During 2001, therefore, the Bank remained the Competent Authority and its supervisory and regulatory arms continued with their normal working schedule.

During the year, due to the presence of several Turkish banks in Malta, officials from the Turkish regulatory authority visited the Central Bank under a reciprocal supervisory arrangement. In collaboration with the Bank's officials, the Turkish officials reviewed the activities of the branches of the Turkish banks licensed to operate from Malta. Other matters of mutual interest, such as the progress reached on the Memorandum of Understanding between the two supervisory and regulatory authorities, were also discussed. In this regard, it should be mentioned that considerable progress was also made on the Memorandum of Understanding between the Central Bank of Malta and the Austrian regulatory authority. In view of the impending changes in supervisory responsibilities both in Malta and Austria, however, the finalisation of this agreement was postponed to 2002.

2.1 Policy Developments

In order to ensure full compliance with international standards, and following approval by the Joint Banking Committee, the Bank amended the Banking Directives on large exposures, own funds and statutory financial information. The Bank also finalised the replacement of the Banking Notice on Provisioning with a new Notice on Credit Risk Management and a new Banking Directive on Credit and Country Risk Provisioning. Furthermore, the work on the Directive on Consolidated Supervision, begun in 2000, was also completed during the year under review.

As part of its ongoing work to set up a deposit protection scheme in Malta, the Bank set up a working group comprising a number of its own officials and representatives from credit institutions. The aim of this group was to identify the legislation that would have to be enacted for this scheme to become operative. A first draft of the legislation was completed by the end of the year. The draft is expected to be finalised by the new banking regulator and enacted into law during 2002.

Another major project finalised during the year was the self-evaluation exercise on the level of compliance with the Banking Core Principles through the methodology document of the Basle Committee on

Banking Supervision. The self-evaluation was updated after consultation with technical experts from the International Monetary Fund (IMF). The Bank was also involved in providing the information relating to Malta for the database on the regulatory and supervisory structures which the IMF is developing with the co-operation of a selected group of countries. Following this exercise, information about Malta's supervisory and regulatory framework became accessible to all IMF member countries contributing to this database.

2.2 Financial Stability

Towards the end of 2000 the Bank had created a Financial Stability Office whose function is to carry out research and analysis on the overall stability of the domestic financial system. This work gathered momentum during 2001, with particular emphasis on the identification of data sources for the construction of stability indicators. Furthermore, in conjunction with the MFSC and the MSE, the office co-ordinated a self-assessment exercise on the level of adherence of the Maltese financial sector to international standards

Box 2:
Banks and Financial Institutions Licensed to Operate in Malta *

Credit Institutions Licensed under the Banking Act (1994)

Akbank T.A.S.[2,3]
APS Bank Ltd[1]
Bank of Valletta plc[1]
Disbank Malta Ltd[2,5]
Finansbank Malta Ltd[2,5]
First International Merchant Bank Ltd[6]
HSBC Bank Malta plc[1,7]
HSBC Home Loans (Malta) Bank Ltd[7,1]
Investkredit International Bank Malta Ltd[2,5]
Izola Bank Ltd[2,6]
Lombard Bank Malta plc[1]
Raiffeisen Malta Bank plc[2,5]
Sparkasse Bank Malta plc[2,5]
Tekstil Bankasi AS[2,3]
Turkiye Garanti Bankasi AS[2,3]

Financial Institutions Licensed under the Financial Institutions Act (1994)

All Financial Services Ltd[4]
Britannia Financial Services Ltd
ChangeMart Financial Services Ltd[4]
Collins Exchange Bureau Ltd[4]
Cremona Exchange Bureau Ltd[4]
Direct Foreign Exchange Services Ltd[4]
Euro Change Company Ltd[4]
Fexco (Malta) Ltd[4]
LB Factors Ltd
Medarea Forex Services Ltd[4]
PDK Financial Services Ltd[4]
Travelex Financial Services Malta Ltd[4]
W&J Coppini & Co[4]

Representative Offices

Barclays Bank plc

Offshore Banking Institutions Licensed under the Malta Financial Services Centre Act (Cap. 330)

Erste Bank (Malta) Ltd[2,5]
HSBC Overseas Bank (Malta) Ltd[2,7]
Volksbank Malta Ltd[2,5]

* As at December 31, 2001
1 Deposit money bank
2 Licensed to operate with non-residents only
3 Licensed to operate as a branch
4 Licensed to provide foreign exchange services
5 Established as subsidiary of foreign bank
6 Foreign-owned bank established and incorporated in Malta
7 Member of HSBC Group

within the Financial Sector Assessment Programme (FSAP) of the IMF and the World Bank. Malta is expected to undergo an FSAP towards the end of 2002 as part of the IMF Article IV consultations.

2.3 Licensing of Credit and Financial Institutions

In the course of the year the Bank did not issue any new banking licenses under the Banking Act. In December, however, the Bank accepted the voluntary surrender of the licenses of EGS Bank AS and Demirbank TAS. On the other hand, following the revocation of the license of Iktisat Bankasi AS by the Turkish regulatory authorities in November, the Central Bank of Malta requested the same bank to cease operations from its branch in Malta.

The Bank licensed three new financial institutions in terms of the Financial Institutions Act during 2001. In March it issued a licence to LB Factors Ltd. to conduct debt-factoring operations from Malta, and another to Medarea Forex Services Ltd. to administer means of payment and trade in foreign exchange. In October it issued a similar licence to that of Medarea Forex Services Ltd to Direct Foreign Exchange Services Ltd. In January, the Valletta Investment Bank Ltd. voluntarily surrendered its licence and merged with its parent company. Similarly, HSBC Finance (Malta) Ltd voluntarily surrendered its licence following the winding up of this institution as from December 31, 2000. Furthermore, the licences of three financial institutions were amended to enable them to carry out wider cross-border payments and money transmission services, while the licence of another institution was modified following a change in its name. A list of credit and financial institutions that held licences to operate in Malta at the end of the year under review is given in Box 2.

2.4 Supervision of Credit and Financial Institutions

During the year under review supervision was carried out through a combination of on-site inspections and off-site monitoring. As part of the supervisory process, the Bank continued to meet licensed institutions' external auditors in order to evaluate their annual management letters and any other relevant documentation.

In carrying out its programme of on-site supervision, the Bank's inspectors covered a range of issues including credit risk and asset quality, adherence to the Prevention of Money Laundering Regulations, 1994, treasury operations and other internal audit functions. Local subsidiaries and branches of foreign-owned institutions were also included in the supervisors' inspection schedule.

As regards the off-site counterpart of the supervisory programme, the Bank continued to examine the statutory returns that it received regularly from credit and financial institutions. Apart from the structure of the institutions' balance sheets, the inspectors focused on market risk, profitability and the entities' managerial and organisational structure. During the year, the Bank carried out surveys on a number of issues, including operational risks and corporate governance, as part of its overall assessment of the licensed institutions' risk management capabilities. Furthermore, the Bank continued to monitor the returns on foreign currency positions introduced in 2000 in terms of the Central Bank of Malta Act.

2.5 Combating Money Laundering

As part of its central role in combating money laundering, the Central Bank continued to chair the Joint Committee on the Prevention of Money Laundering, which includes representatives from the Attorney General's Office, the Malta Police, the banks and other regulators. Under the auspices of this committee, the Bank co-ordinated a working group to amalgamate the Guidance Notes to the financial sector on the prevention of money laundering that had been issued separately by the MFSC, the MSE and the Bank itself. The final document is expected to be published during 2002. During the year the Bank also continued to participate in the process of refinement of the laws and regulations on the prevention of money laundering and on the establishment of a Financial Intelligence Unit in Malta.

Furthermore, as in 2000, a senior Bank official represented the Bank on specialist delegations that undertook country evaluations on the prevention of money laundering under the auspices of the Council of Europe Select Committee of Experts on the Evaluation of Money Laundering Measures (PC-R-EV), of which Malta currently holds the chair.

Following the September 11 attacks, the Bank immediately took steps to ensure that the local banking system was not being used to finance terrorism. The Bank requested all banks and financial institutions to examine transactions and accounts that could be linked to the financing of terrorism consistent with relevant lists of names issued internationally. No such links were traced or identified.

2.6 Other Activities

As in previous years, developments on the Malta Stock Exchange were monitored, in liaison with the Exchange itself, in terms of the Malta Stock Exchange Act. In this regard, the Bank participated in a number of meetings with the Exchange on matters of mutual concern, while also commenting on the principles on corporate governance issued by the Exchange.

The Bank also continued to contribute to the negotiations for Malta's accession to the EU. This focused mainly on Chapters 3 and 4 of the *acquis communautaire*, dealing with the free movement of capital and services between member states.

In anticipation of the scheduled transfer of the banking regulatory and supervisory functions from the Central Bank to the MFSC, the Bank formulated a plan aimed at rendering the changeover as smooth as possible.

3. Banking and Currency Operations

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

3.1 Banker to the Public Sector

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

During 2001 the Central Bank cashed 2.0 million cheques drawn on it by Government departments. This was 14.2% less than in the preceding year, and the total value of such cheques fell to Lm434.1 million from Lm460.0 million in 2000. This decrease mainly reflected the previous year's cheque payment to each household as compensation for the removal of bread subsidies, which was not repeated in 2001, as well as the growing use being made of the direct credit system.

During the year, in fact, the Bank continued to promote the use of the more cost-efficient direct credit system when effecting Government payments. The number of direct credits transacted during the year thus rose from 0.4 million to 0.5 million and their value increased by 27.9% to Lm124.1 million. These increases reflected the growing willingness on the part of public sector employees, social security beneficiaries and holders of Malta Government stocks to receive payment by credit to their bank accounts.

The foreign exchange services provided by the Bank include transactions supported by documentary letters of credit, inward and outward bills for collection, inward transfers, guarantees, and the sale of foreign exchange and travellers' cheques. Other foreign exchange transactions are carried out through SWIFT and bank drafts. During the year, the value of foreign exchange receipts processed on behalf of the Government and public corporations amounted to Lm75.1 million, while foreign exchange payments totalled Lm114.6 million.

The Central Bank also effects the payments related to the servicing of the Government's external debt. During 2001 capital repayments amounted to Lm5.6 million, whereas interest payments on outstanding foreign loans declined marginally, to Lm1.4 million. Meanwhile, Lm3.5 million were transferred to sinking funds earmarked for foreign debt servicing.

The Bank continued to administer the Foreign Pension Subsidy Scheme on behalf of Government. Under this scheme, Maltese nationals (including persons holding dual citizenship) who receive a pension in foreign currency from Australia, Canada, the United Kingdom and the United States are entitled to a means-tested subsidy when they suffer losses due to unfavourable exchange rate movements. The amount paid under the scheme dropped to Lm24,105 in 2001 from Lm27,004 in the previous year.

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

3.2 Banker to the Banking System

As banker to the rest of the banking system the Central Bank also offers local and foreign currency deposit facilities to domestic credit institutions[1]. The latter maintain balances at the Bank to comply with statutory reserve requirements, to settle interbank transactions and to carry out daily operations in the domestic financial market. The Bank also maintains settlement accounts for the Malta Stock Exchange to enable brokers to settle trades in securities that are listed on the Exchange.

3.2.1 Payment system

The Bank plays a central role in the management of the local payment and settlements system. Thus besides continuing to offer the credit institutions payment system services it also implemented measures in order to develop further the payment system in Malta. It continued to accept payment instructions from credit institutions mostly via SWIFT and introduced an automated system for the processing of interbank transfers. Thus, using the Straight Through Processing methodology, the banks are able to effect automated payments which are settled in real time through settlement accounts held with the Bank. In addition, a SWIFT compliant standard for the exchange of low-value payments was introduced. The number of interbank transfers during the year rose to 21,294, up by 24.2% when compared to the previous year, and their value grew by around Lm150 million to Lm3,650 million.

The Bank continued to participate in the Payments System User Group (PSUG) which was established in the previous year with the aim of achieving further standardisation and the dematerialization of financial transactions. As an outcome of the work undertaken by the PSUG in 2001, further functionality was added to the Bank's Real Time Gross Settlement System (RTGS). In addition, an Executive Payments System Task Force, with representatives from the Central Bank and the private banking sector, was set up to formulate the rules and regulations governing payment systems in Malta. During the year, this task force prepared a preliminary draft of these rules and regulations.

The Central Bank also manages the Malta Clearing House, through which cheques are settled. The number of cheques cleared fell from 7.4 million in 2000 to 7.3 million in 2001, and over the same period their value declined by 7.4% to Lm2.5 billion. This resulted entirely from a drop in the number of cheques issued by the Government and drawn on the Central Bank (for the reasons mentioned earlier), and notwithstanding a rise in the number of cheques drawn on the deposit money banks.

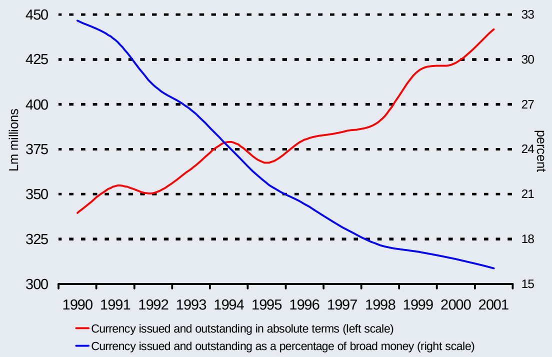
Domestic banks are also eligible for short-term credit from the Central Bank, either through the discount window or through the marginal lending facility. The operation of these facilities is discussed in Chapter 1 of Part II of this Report.

3.3 Currency Operations

At the end of 2001 the stock of currency notes and coins issued and outstanding amounted to Lm441.8 million, up by 4.4% from the end of the previous year. As Chart 3.1 shows, the increase in the amount of currency in issue in absolute terms was greater than in 2000. However, the share of currency in broad money continued to decline, ending the year at just over 16%.

As Table 3.1 shows, movements in the amount of currency in circulation continued to follow the usual seasonal trend. Thus, the Lm10.4 million drop in January resulted from the running down of excess cash holdings accumulated during the festive season. As in previous years, the rise in private consumer spending associated with the Christmas period

Chart 3.1
CURRENCY ISSUED AND OUTSTANDING



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

Table 3.1

CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE CENTRAL BANK OF MALTA IN 2001

Lm thousands

	Issued	Notes and Coins Paid-In	Net Issue	Issued and Outstanding[1]
January	10,525	20,964	-10,439	412,749
February	13,501	12,386	1,115	413,863
March	15,999	14,601	1,398	415,262
April	21,264	14,770	6,494	421,757
May	20,618	16,173	4,445	426,201
June	20,235	16,710	3,525	429,727
July	23,028	18,381	4,647	434,373
August	18,210	19,705	-1,495	432,878
September	16,259	19,708	-3,449	429,428
October	21,385	15,738	5,647	435,076
November	14,613	19,607	-4,994	430,082
December	23,359	11,612	11,747	441,829
2001	**218,996**	**200,355**	**18,641**	**441,829**
2000	176,676	171,974	4,702	423,188

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

translated into a significant increase in the demand for notes and coins in December.

At the end of December 2001, the value of notes in issue amounted to Lm423.8 million, 4.5% more than at the end of the previous year. However, their composition remained relatively unaltered. Thus, as Chart 3.2 shows, the Lm10 note remained the most widely used currency note, accounting for over 66% of the value of all notes in issue. At the same time, although the share of the Lm20 note in the total fell to 25.7%, from 27% in the previous year, it retained its status as the second most popular currency note.

Meanwhile, the value of the outstanding stock of coins totalled Lm18 million, up by 2.9% from the previous year's level, but the distribution of the various coin denominations in the total remained broadly unchanged. The share of the 25c coin rose by nearly two percentage points to 15.1 %, as shown in Chart 3.3. In contrast, the share of the Lm1 coin, at 30%, was down by slightly more than one percentage point from the end-2000 level.

Chart 3.2
COMPOSITION OF CURRENCY NOTES ISSUED AND OUTSTANDING AS AT END-2001

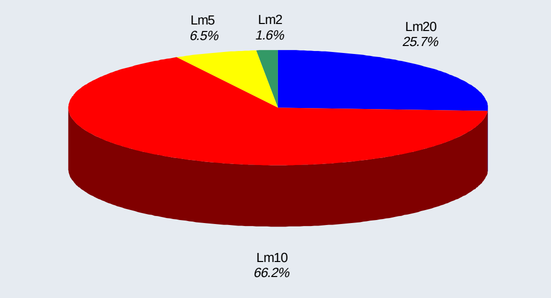
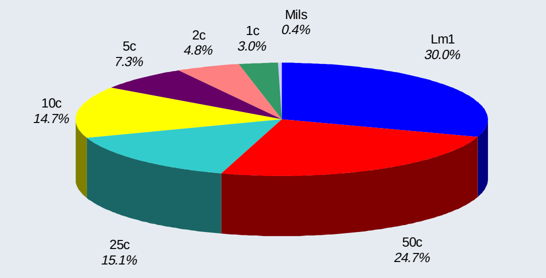


Chart 3.3
COMPOSITION OF COINS ISSUED AND OUTSTANDING AS AT END-2001



3.4 Commemorative Coins

In September 2001 the Central Bank of Malta issued the first coin in a series commemorating Maltese personalities who had distinguished themselves in a variety of fields of national importance, including professional, cultural, artistic and social life. The reverse side of the coin shows the name and portrait of Enrico Mizzi, Malta's second post-war prime minister, with the dates of his birth and death (1885-1950) above, and the legend "Prim Ministru 1950" (Prime Minister 1950) at the bottom right of the coin. The obverse side of the coin shows the coat of arms of the Republic of Malta and the year of issue. The coin, which is in proof condition, was designed by the Maltese artist Noel Galea Bason and was struck at the Royal Mint in the UK. It has a finesse of 0.925 silver, weighs 28.28gms and has a diameter of 38.61mm. The coin has a legal tender value of Lm5 and is subject to a minting limit of 2,000.

3.5 Anti-Counterfeit Measures

During 2001 the Central Bank continued to monitor closely all incidents of counterfeit currency. The Bank also pursued its policy of raising public awareness of the security features of genuine banknotes. In particular, informative brochures were extensively distributed and officials of the Bank participated in a number of educational programmes on the local media. In December the Bank also issued a press release alerting the public to watch out for counterfeit notes that may have been circulated during the festive season.

4. Internal Management

4.1 Administration

4.1.1 The Board of Directors

At the end of 2001 the Board of Directors of the Central Bank of Malta was composed of Mr M C Bonello, Governor and Chairman of the Board, together with Mr D A Pullicino, Deputy Governor, and Mr S Falzon, Mr A F Lupi and Professor E Scicluna as non-executive directors. Mr H Zammit LaFerla was Secretary to the Board. During the year the Board held 11 scheduled meetings and 12 ad hoc meetings, the latter to ratify decisions taken by the Monetary Policy Council.

On June 12, the Governor, Mr M C Bonello, was re-appointed for a further two years with effect from October 1, 2001. During the year, Mr A F Lupi was re-appointed for a further year with effect from January 21, 2001 while the appointments of Professor E Scicluna, and Mr S Falzon, were renewed for a period of one year and two years respectively, with effect from November 15, 2001.

4.1.2 Management

The Executive Management Committee is the body responsible for most decisions related to the Bank's internal management and administration. The Committee, which is composed of the Governor (as Chairman), the Deputy Governor, and the five Deputy General Managers held 46 meetings during the year.

In February 2001 the Board approved a management restructuring plan which places the Bank in a stronger position to perform its tasks and responsibilities in the years ahead. A new management tier, that of senior managers, was established to assume the effective management of related groups of offices and to deputize for the management officials responsible for the various divisions of the Bank.

With effect from January 1, 2002, responsibility for banking supervision and regulation was transferred from the Central Bank to the Malta Financial Services Centre (MFSC). To bring this decision into force, the Minister of Finance, on December 27, 2001, issued Legal Notices Nos 324 and 325, which appointed the MFSC as the Competent Authority under the Financial Institutions Act, 1994 and the Banking Act, 1994.

In March 2001 the Bank revised its Mission Statement. The revised statement included a supporting document containing a detailed explanation of the Bank's corporate objectives. The task of reviewing the Statement had been launched in 2000 during a workshop for senior and middle management. It was completed early in 2001 after an internal consultation process.

4.1.3 Official representation overseas

During April the Governor accompanied the Minister of Finance to the EU Economic and Finance Ministers (ECOFIN) Council Meeting, which was held in Malmo, Sweden. This was the first time that delegates from EU accession countries were invited to an ECOFIN meeting. Prior to the meeting the Governor and the Minister attended the G13 meeting in Copenhagen. The G13 was set up by the finance ministers of the EU accession countries to discuss common strategies on macroeconomic and financial issues as their countries prepare for EU membership. Later that month the Governor attended the Spring Meetings of the International Monetary Fund (IMF) and the World Bank in Washington DC. The Deputy Governor attended the Annual Meeting of the European Bank for Reconstruction and Development (EBRD), which was held in London in April.

In June the Governor attended the Conference for Commonwealth Central Bank Governors and the Central Bank Governors' Symposium organised by the Bank of England, as well as the Annual General Meeting of the Bank for International Settlements (BIS) in Basle.

During August the Governor visited the European

Central Bank (ECB), where he had discussions on a range of issues, including technical assistance and training facilities. The Governor also visited the European Commission in Brussels where he held talks with the Director General of the Directorate General for Economic and Financial Affairs.

In early December the Governor accompanied the Minister of Finance to Brussels to attend a meeting of the G13. This was followed by an informal meeting with the EU's ECOFIN Council to which Ministers of Finance from EU Accession countries were invited for the second time. The Governor also participated in the Berlin Seminar on the Accession Process hosted by the Deutsche Bundesbank and the European Central Bank. This was the third high-level seminar organised by the European Central Bank for accession countries and was attended by the governors of the central banks of accession countries besides high ranking officials of the central banks of EU member countries. The main topics discussed at the seminar included the financial sector structure in accession countries and the impact of capital account liberalisation on macroeconomic policies in these countries.

4.2 Human Resources

The full-time staff complement at the Central Bank at the end of 2001 stood at 305. In addition, 17 staff members were employed on a part-time basis. During the year the Bank recruited two trainee economic officers, a legal officer and ten clerks. One staff member retired upon reaching the pensionable age, while two others retired on medical grounds. A total of six employees terminated their employment.

The Bank also offered temporary employment to five university students during the summer months. In addition, the Bank continued to participate in the Extended Skills Training Scheme organised by the Employment and Training Corporation (ETC).

The Employee Assistance Programme launched with the help of Caritas - Malta in 1999 was once more renewed during 2001. Several awareness sessions were organised by Caritas coordinators with the aim of making participants sensitive to personal problems they might encounter at their place of work.

4.2.1 Training and development

As in previous years, the Bank continued to provide its staff with extensive training opportunities both through in-house programmes and external courses organised by local and foreign institutions. Further details are given in the table below.

Type of Training Courses	NUMBER OF EMPLOYEES PARTICIPATING	NUMBER OF COURSES
Overseas courses	37	35
In-house courses	724	45
Local external courses	107	53

The international exchange programme for clerks introduced in 2000 was continued during the year under review. Under this programme bank clerks are sent on short-term attachments with other European central banks. Two staff members participated in this programme during 2001, with attachments at the Bank of Slovenia and the National Bank of Slovakia. Under the same scheme, the Bank also received officials from the Central Bank of Cyprus, the Bank of Slovenia and the National Bank of Slovakia on one-week assignments in Malta.

The in-house training courses organised by the Bank focused on various work-related topics, in particular management and supervisory development, information technology and risk-based auditing. More specialised in-house courses covered such areas as the Bank's policies and procedures, the functions and responsibilities of the European Central Bank, and the design features of the new euro banknotes. In view of its growing international commitments the Bank also continued to organise French and German language courses for its staff.

As the table shows, a large number of staff attended training programmes organised by local and foreign institutions. Local training courses were mainly in the field of information technology, management and industrial relations. External programmes, which in the majority were organised by European central banks, tended to focus more specifically on subjects related to a central bank's core functions and operations. The areas covered included monetary and economic policies, treasury management, banking supervision, financial stability, statistics, financial reporting, central bank legislation and payment and settlement systems.

4.2.2 Academic and professional courses

An increasing number of employees made use of the Bank's Study Scheme while pursuing self-development opportunities during 2001. A number of them successfully completed their programmes. Details of the type of programmes offered and the number of staff pursuing them are shown in the tables below. Specialised areas of study included business administration, European studies, financial services, accountancy, law and information technology.

Type of Programme	NUMBER OF EMPLOYEES WHO SUCCESSFULLY COMPLETED PROGRAMMES
Postgraduate courses	3
Honours first degree courses	5
General first degree courses	3
Diploma courses	2
Certificate courses	5

Type of Programme	NUMBER OF EMPLOYEES PURSUING QUALIFICATIONS
Full-time degree courses	2
Postgraduate courses (part-time)	11
First degree courses (part-time)	29
Diploma courses (part-time)	8
Certificate courses (part-time)	2

4.2.3 Gender equality

The Bank continued to give due importance to gender equality. In the course of the year members of the internal committee that monitors this issue attended various meetings convened by the Department for Women in Society to keep abreast of developments in this area.

During the year, the proportion of female staff members in the Bank's full-time staff complement rose slightly, to 33%. Furthermore, 38% of staff members pursuing self-development programmes on a part-time basis were females. Female staff members also continued to play an important role in lecturing duties within the Bank and accounted for 27% of the total.

4.3 Premises

Works related to the restoration of the Bank's facade and the pavement in front of the Central Bank's main building were completed during 2001. An extensive refurbishing of the main premises and significant structural modifications to the bridge connecting the two parts of the Bank were also undertaken.

4.4 Information Technology

During the year the Bank upgraded its underlying database, which involved changes in Flexcube, its core operating system. As a result, users are now benefiting from greater functionality and, above all, improved performance. The installation of Flexcube's Straight Through Processing (STP) functions was completed, so that the Bank can now automatically process all incoming SWIFT payments and has the basic requirements for operating a Real Time Gross Settlements System (RTGS).

During the year the Bank also upgraded the Reuters information service to Reuters Xtra and to Dealing 3000. These upgrades give users more information and improved graphical presentation of foreign exchange markets. SWIFT was also upgraded to the most recent release, and during the final quarter of the year the Closed User Group for the Domestic Real Time Gross Settlement system was in place.

A number of software applications tailored to the specific requirements of particular offices and departments were also developed. In particular, one such application should enable the Bank to notify the Treasury of transactions made on its account on a daily basis for reconciliation purposes. At the organisational level, a number of databases in Lotus Notes were developed in order to automate further the Bank's internal operations and to make better use of existing technologies to improve communication between staff at all levels.

In order to meet the ever-increasing demand for rapid transmission of data and information and the storage of such data, the Bank installed a Storage Area Network with which all the existing servers were integrated. All networked computers at the Bank's main building are now running on Ethernet. Meanwhile, the cabling infrastructure in the Annex was upgraded to the latest available standards and additional network connection points were installed.

4.5 Risk Management and Audit

During 2001 the name of the Risk Management Unit was changed to Risk Assessment Office, reflecting the new focus of the office. One of the main tasks undertaken in the course of the year was the further restructuring of the Bank's Standing Instructions, which have now been collected into a new Policies and Procedures Manual. This exercise involved an examination of all the business processes of the Bank and a review of the risks involved, so as to ensure that comprehensive internal controls existed over all operational procedures. The new manual was installed on a Lotus database and successfully launched in August.

Staff from the Risk Assessment Office also formed part of an internal committee established by the Bank to draw up information security codes of conduct. These codes are to be implemented throughout the Bank in the first quarter of 2002.

In performing its mandate, the Bank's Audit Office endeavoured to ensure that the Bank's operations and internal controls were in line with the Standing Instructions and/or the Policies and Procedures Manual. Furthermore, as part of its continuing efforts to ensure high standards of accountability, the Office carried out regular audit examinations. These were designed to evaluate and improve the effectiveness of the risk management and control processes and efficiency in the use of the Bank's resources.

In the course of the year the Audit Office also laid the basis for the introduction of risk-based auditing. A report was drawn up, in collaboration with the Risk Assessment Office, to pave the way for the construction of a risk matrix. In this regard, a definition of broad risk and what should constitute significant financial loss for the Bank was established. Furthermore, a Risk Matrix Committee was established to evaluate the broad risks.

4.6 Legal Issues

During the year the Bank's Legal Office continued to draft amendments to the laws falling under the Central Bank of Malta's competence in order to update them in the light of industry and international developments, including the EU *acquis*. Specifically the Bank was involved in drafting the amendments to the Central Bank of Malta Act, 1967, the Banking Act, 1994 and the Financial Institutions Act, 1994. The proposed amendments were finalized and forwarded to the Ministry of Finance and to the Attorney General's Office by the end of the year and they are expected to be adopted by Parliament in the early part of 2002. The Office was also involved in the discussion on the proposed amendments to other laws, notably those on insolvency, collateral and payment systems.

During the final quarter of the year, the Office reviewed the contracts and prepared the necessary documentation in connection with the global loan extended to Bank of Valletta plc by the European Investment Bank, for which the Central Bank acted as a guarantor. The Office was also actively involved in the preparatory work leading to the establishment of the Investment Registration Scheme that was announced in the Budget Speech for 2002.

4.7 Information Services

4.7.1 Awareness campaigns

During the year the Bank brought a number of issues to the attention of the public through the media. A major activity, carried out in conjunction with the Malta Bankers' Association, was the launching of an extensive awareness campaign on the introduction of euro notes and coins in the euro area. This included the publication of two information leaflets: the first, published in September, provided practical guidelines on the possible implications at the local level; while the second, published in December, focused on the new banknotes and highlighted their security features.

In addition, various seminars and presentations on the introduction of euro notes and coins were held for bank employees, exchange bureau officials, constituted bodies and the general public.

4.7.2 Publications

As in past years the Bank continued to keep the public informed about economic and financial developments in Malta and abroad through its **Quarterly Review**.

In March the Bank published its **Annual Report**, which included an account of the Bank's policies, operations and activities and its audited financial statements for the year ending 31 December 2000. As usual, the **Report** also included an extensive analysis of economic and financial developments during that year.

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

The above-mentioned publications, as well as various others which the Bank issued during the year, were regularly posted on the Central Bank's own website, www.centralbankmalta.com

During 2001 the Bank's website was modified to include a statistics section for the first time. This section contains data on monetary and financial aggregates, as well as domestic, fiscal and public debt indicators.

4.7.3 Library

Being one of the main sources of information on economic and financial matters in Malta, the Central Bank's Library is extensively used by the Bank's staff, by employees of other public and private sector bodies and by the general public, particularly students, engaged in research work.

During 2001 the Bank further upgraded the Library's collection with acquisitions of books, periodicals, specialized publications related to its functions and operations, and databases on CD-ROM. The newspaper clippings service was expanded.

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

4.8 Social, Cultural and Educational Activities

As in past years, the Central Bank during 2001 continued to organise activities of a social, cultural and educational nature. The annual concert of classical music was held at the Mediterranean Conference Centre in April as part of the festivities commemorating the Bank's anniversary. The Bank also organised several educational visits for local and foreign visitors, which were given an overview of the Bank's functions and its role in the Maltese economy.

The Bank also continued to give financial assistance to a number of organisations working in the educational and social fields. It provided support to its Staff Social Club, which on its part organised various social, cultural and philanthropic activities. Through the Staff Contributions Fund, the Bank also provided assistance to staff members in need and to charitable institutions.

5. Relations with International Institutions

During the year the Central Bank remained actively involved in maintaining Malta's relations with a number of international organisations. These include the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD) or World Bank, the Multilateral Investment Guarantee Agency (MIGA) – an affiliate of the World Bank Group – and the European Bank for Reconstruction and Development (EBRD). Malta is a member of all these institutions and the Minister of Finance is the Governor for Malta on the Board of the IBRD, the MIGA and the EBRD, while the Governor of the Central Bank is the Governor for Malta on the Board of the IMF. He is also the Alternate Governor on the Board of the EBRD.

The Central Bank's close relationship with the Bank for International Settlements (BIS) was developed further, particularly on matters relating to banking supervision and financial stability. Although the Bank is not a member of the BIS, the Governor, as in previous years, was invited to attend its Annual General Meeting as an observer. In addition, the Bank was involved in matters related to Malta's commitments to the World Trade Organisation (WTO), particularly in the area of financial services. In this regard the Bank participated in a working group on WTO issues established by the Ministry of Foreign Affairs and worked closely with the Malta Financial Services Centre (MFSC) and the EU Directorate in order to assess these commitments in view of Malta's EU membership negotiations.

5.1 International Monetary Fund (IMF)

As the institution representing Malta at the IMF, the Central Bank voted, in consultation with the Minister of Finance, on a number of resolutions proposed by the Fund's Executive Board in the course of the year. The Bank also co-operated with the Fund in matters related to its operational budget, though it was not requested to effect any payments during the year. As a result, the Fund's holdings of Maltese currency remained unchanged from the level of SDR 61.75 million (around Lm30.8 million) reported at the end of 2000. Malta's reserve position in the Fund similarly remained unchanged at SDR 40.25 million (Lm22.9 million). The Bank also participated in the operations of the Fund's SDR Department and effected a number of transactions that resulted in net receipts of Lm 1 million (SDR 1.9 million). As a result, Malta's total SDR holdings at the end of 2001 stood at around Lm 15 million (SDR 26.4 million).

In April an IMF Consultation Mission visited Malta for bilateral discussions in terms of Article IV of the Fund's Articles of Agreement. Under this Article, the IMF carries out regular surveillance exercises of its members' economic situation and policies. In the case of Malta such discussions are held every two years. The Mission team held meetings with senior officials from the Ministry of Finance and the Ministry for Economic Services, the Central Bank, the National Statistics Office and the Malta Financial Services Centre, as well as with representatives of the private and parastatal sectors. At the conclusion of the consultation exercise the IMF mission prepared a report which was published in August.

Following the tragic events of September 11, the Annual Meetings of the IMF and the World Bank, due to be held in Washington DC towards the end of that month, were cancelled. The business that would have been transacted during the meetings was nevertheless successfully completed through direct correspondence between the Fund and its members. In the second week of October, Dr P. Padoan, the Executive Director for Malta on the Executive Board of the IMF, came to Malta for a familiarisation visit. He had meetings with senior officials from the Central Bank and the Ministry of Finance.

During the year the Bank continued to co-operate with the Fund on statistical matters related to the Fund's General Data Dissemination System (GDDS).

In fact, a technical mission from the IMF's Statistics Department visited Malta to advise the Bank on the classification and methodology to be used in the compilation of monetary statistics. Subsequently, the Bank started to publish updated monetary, fiscal and public debt indicators on its website, as required under the GDDS. The Bank also requested the Fund to send a mission to Malta under the Fund's Financial Sector Assessment Programme (FSAP) to assess the health of the financial sector in Malta. It is expected that a mission team will visit Malta for this purpose towards the end of 2002.

5.2 World Bank (IBRD)

The Bank continued to monitor World Bank issues on a regular basis and advised the Ministry of Finance on matters related to Malta's membership of this institution. The Bank also participated in a World Bank questionnaire on banking regulation and supervisory arrangements for credit and financial institutions. It also held consultations with various officials from the World Bank on matters related to the development of the financial sector in Malta, particularly insofar as the evolution of the domestic capital market is concerned.

5.3 European Bank for Reconstruction and Development (EBRD)

During 2001 the Central Bank continued to collaborate with the Ministry of Finance on issues related to Malta's membership of the EBRD. In this context, the Central Bank provided the Ministry with background information on proposals put forward by the Board of Directors of the EBRD that required the approval of the Governors of member countries.

In March the Central Bank, on behalf of the Government, effected the fourth annual payment, amounting to euro 28,750 (about Lm12,400), in respect of Malta's contribution to the general capital increase of the EBRD.

In April the Minister of Finance, accompanied by the Deputy Governor of the Central Bank, attended the tenth Annual General Meeting of the EBRD, which was held in London.

5.4 European Union (EU)

As in 2000, the Bank continued to prepare reports in connection with some of the chapters related to Malta's EU membership negotiations. These included the areas of free movement of capital, free movement of services, statistics and economic and monetary union (EMU). The Bank also collaborated with the European Central Bank (ECB) on matters of common interest and monitored closely all relevant developments in the field. The Bank also participated in discussions with a delegation from the EU Commission that visited Malta to assess progress in the EU accession process.

The Central Bank during the year continued to consolidate its relations with the ECB, EU central banks and the European Commission. As noted in another section of this Report, the Governor accompanied the Minister of Finance to the meeting of the Council of Economic and Finance Ministers (the ECOFIN Council) which was held in Malmo, Sweden in April.

The Bank continued to make use of technical assistance from EU central banks, particularly in matters related to the Economic and Monetary Union (EMU) process, since it is expected to have certain structures and reporting procedures in place at the time of Malta's accession to the European Union. In this connection an expert from the Bank of England visited the Central Bank to review the procedures followed by the Monetary Policy Council (MPC). Technical experts from the Central Bank of Ireland and De Nederlandsche Bank also visited the Bank to advise on statistical reporting in the area of monetary and banking data and the balance of payments. At the same time the Bank collaborated with the ECB on a number of issues related to the payment system and central bank legislation.

Apart from briefing representatives of the banking sector on matters related to the accession process, the Central Bank closely monitored developments relating to the introduction of euro banknotes and coins in the euro area countries. A sub-committee composed of Central Bank and commercial bank officials was set up to formulate a strategy to inform the public in general and operators in the tourism and commercial sectors in particular about the euro changeover.

During the year the Central Bank collaborated with the Ministry of Finance in drawing up the first report that Malta submitted as part of its Pre-accession Economic Programme (PEP). The report included a review of recent economic developments, a detailed macroeconomic framework, medium-term economic forecasts, and an outline of public finance and structural reform policies. Later in the year, senior officials from the Bank and the Ministry of Finance participated in the meetings that the European Commission held with accession countries in Brussels to discuss these reports.

Part III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2001

Directors' report

The Directors present their report and the audited financial statements of the Bank for the year ended 31 December 2001.

Principal activities and review of operations

The Central Bank's Mission and Objectives are set out on page 3. The Governor's Statement on pages 12 to 17 and the Bank's Policies, Operations and Activities on pages 63 to 86 give a detailed account of the Bank's activities and operations during 2001.

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 2001, 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 compliance with International Accounting Standards issued by the International Accounting Standards Board in so far as these standards are appropriate to a central bank and applicable in terms of the Central Bank of Malta Act, 1967.

Financial results

The Bank's financial statements for the year ended 31 December 2001 are set out on pages 92 to113 and disclose an operating profit of Lm26.1 million (2000: Lm25.9 million). The amount payable to Government is Lm25.7 million (2000: Lm25.9 million).

Directors' report – continued

Board of Directors

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

Mr Michael C Bonello - Governor (reappointed on 1 October 2001)
Mr David A Pullicino - Deputy Governor
Mr Alfred F Lupi (reappointed on 21 January 2001 and on 21 January 2002)
Mr Saviour Falzon (reappointed on 15 November 2001)
Prof Edward Scicluna (reappointed on 15 November 2001)

Mr Herbert Zammit LaFerla is the Secretary to the Board.

Auditors

MSD & Co 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

5 March 2002

Statement of Directors' responsibilities in respect of the financial statements

The Central Bank of Malta is governed by the provisions of the Central Bank of Malta Act, 1967. The Bank has also chosen to comply with International Accounting 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 2001, and of the profit, changes in equity and cash flows for the year to that date. The Board of Directors is also responsible for ensuring that the financial statements are drawn up in accordance with the requirements of the Central Bank of Malta Act, 1967.

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

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

Report of the auditors

We have audited the financial statements set out on pages 92 to 113. As described in the statement of Directors' responsibilities on page 90, these financial statements are the responsibility of the Bank's Board of Directors. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements give a true and fair view of the financial position of the Bank at 31 December 2001 and its profit, its changes in equity and its cash flows for the year then ended, in accordance with the basis of preparation set out in Note 1(a) on page 96, and comply with the Central Bank of Malta Act, 1967.

MSD & Co
Malta

5 March 2002

PRICEWATERHOUSECOOPERS
Malta

5 March 2002

Profit and loss account

	Note	**2001** **Lm'000**	2000 Lm'000
Profit for the financial year	3	**26,054**	25,902
Payable to the Government of Malta in terms of Section 24(4) of the Central Bank of Malta Act, 1967		**25,682**	25,902

The amount of profit payable to the Government of Malta consists of the profit for the financial year as modified by the transitional adjustment attributable to the remeasurement of derivative financial instruments to fair value on adoption of International Accounting Standard IAS 39 Financial Instruments: Recognition and Measurement on 1 January 2001.

Balance sheet

	Notes	**2001 Lm'000**	2000 Lm'000
Assets			
Cash and balances with banks	4	**17,885**	4,598
Gold balances		**629**	453
Placements with banks	5	**511,367**	411,271
Available-for-sale investment securities	6	**189,359**	189,225
Claims on the International Monetary Fund	7	**37,863**	36,940
Other foreign currency assets	8	**3,325**	1,657
Total external assets		**760,428**	644,144
Available-for-sale local assets:			
Treasury bills	9	**969**	2,726
Domestic debt securities	10	**4,804**	16,452
Derivative financial instruments	11	**1,616**	228
Other assets	12	**44,000**	103,736
Tangible fixed assets	13	**4,843**	4,807
Prepayments and accrued income		**10,681**	15,594
Total assets		**827,341**	787,687
Liabilities and equity			
Liabilities			
Notes and coins in circulation	14	**441,829**	423,188
Deposits by:			
Banks	15	**146,789**	141,270
Government	16	**69,080**	56,161
Others	17	**7,644**	10,393
Profits payable to Government		**25,682**	25,902
Foreign liabilities	18	**-**	3,655
Other liabilities	19	**37,478**	37,437
Accruals		**3,770**	631
		732,272	698,637
Capital and reserves			
Capital	20	**5,000**	5,000
General reserve fund	21	**23,000**	23,000
Special reserve fund	21	**13,000**	13,000
Reserves for risks and contingencies	22	**48,050**	48,050
Fair value reserve	23	**6,019**	-
		95,069	89,050
Total liabilities and equity		**827,341**	787,687

The financial statements on pages 92 to 113 were approved for issue by the Board of Directors on 5 March 2002 and were signed on its behalf by:

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

Statement of changes in equity

	Capital Lm'000	General reserve fund Lm'000	Special reserve fund Lm'000	Reserves for risks and contingencies Lm'000	Fair value reserve Lm'000	Retained earnings Lm'000	Total Lm'000
Balance at 1 January 2000	5,000	23,000	13,000	48,050	-	-	89,050
Profit for the financial year	-	-	-	-	-	25,902	25,902
Transfer to profits payable to Government	-	-	-	-	-	(25,902)	(25,902)
Balance at 31 December 2000	5,000	23,000	13,000	48,050	-	-	89,050
Balance at 1 January 2001 - as previously reported	5,000	23,000	13,000	48,050	-	-	89,050
Effect of adopting IAS 39 - derivative instruments not qualifying as hedges remeasured at fair value	-	-	-	-	-	(372)	(372)
- available-for-sale assets remeasured at fair value	-	-	-	-	5,707	-	5,707
- as restated	5,000	23,000	13,000	48,050	5,707	(372)	94,385
Arising in the financial period: - net gains from changes in fair value of available-for-sale assets	-	-	-	-	1,176	-	1,176
Transfers: - net gains transferred to net profit on disposal of available-for-sale assets	-	-	-	-	(864)	-	(864)
Net gains not recognised in the profit and loss account	-	-	-	-	312	-	312
Profit for the financial year	-	-	-	-	-	26,054	26,054
Total recognised gains	-	-	-	-	312	26,054	26,366
Transfer to profits payable to Government	-	-	-	-	-	(25,682)	(25,682)
Balance at 31 December 2001	**5,000**	**23,000**	**13,000**	**48,050**	**6,019**	**-**	**95,069**

On the adoption of IAS 39 at 1 January 2001, all assets classified as available-for-sale and all derivative instruments were remeasured to fair value. The difference between their original carrying amount and their fair value at 1 January 2001 was credited to retained earnings in accordance with the requirements of IAS 39. On the same date the Directors have resolved to transfer the amount of the transitional adjustment attributable to the remeasurement of available-for-sale assets to the fair value reserve. Further information is disclosed in Note 23 to the financial statements.

Cash flow statement

	Notes	2001 Lm'000	2000 Lm'000
Cash flows from operating activities			
Profit for the financial year		**26,054**	25,902
Decrease/(increase) in interest receivable		**4,913**	(2,620)
Increase/(decrease) in interest payable and accrued expenses		**3,139**	(405)
Depreciation	13	**434**	352
Amortisation of premiums and discounts on investments		**(290)**	(360)
Profit on sale of investments		**(864)**	(167)
Cash flows from operating profits before changes in operating assets and liabilities		**33,386**	22,702
Net changes in operating assets and liabilities:			
Placements with banks		**115,132**	(1,118)
Other foreign exchange assets		**(1,091)**	(1,158)
Treasury bills		**(76)**	135
Dealing securities		**1,667**	(757)
Derivative financial instruments		**(1,760)**	4,709
Other assets		**36**	28
Deposits		**(16,292)**	14,703
Other liabilities		**41**	(25)
Net cash from operating activities		**131,043**	39,219
Cash flows from investing activities			
Purchase of investment securities		**(61,571)**	(10,954)
Proceeds from sale and maturity of investment securities		**78,591**	39,896
Purchase of tangible fixed assets	13	**(470)**	(63)
Net cash from investing activities		**16,550**	28,879
Cash flows from financing activities			
Net movement in currency in issue		**18,641**	4,703
Payment to the Government under Section 24(4) of the Central Bank of Malta Act, 1967		**(25,902)**	(27,113)
Net cash used in financing activities		**(7,261)**	(22,410)
Movement in cash and cash equivalents		**140,332**	45,688
Cash and cash equivalents at 1 January		**117,821**	72,133
Cash and cash equivalents at 31 December	24	**258,153**	117,821

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 Accounting Standards issued by the International Accounting Standards Board in so far as they are appropriate to a central bank and applicable in terms of the Central Bank of Malta Act, 1967, as amplified below.

In exceptional circumstances, as part of its inherent responsibilities as a central bank, the Bank may intervene in the financial markets to help prevent a loss of confidence spreading through the financial system as a whole. Circumstances could arise where confidence can best be sustained if confidentiality is maintained with regard to the Bank's support, or the extent thereof. Accordingly, and as a matter of course, the Bank's financial statements disclose less detail of the constituent elements of the profit and loss account, particularly of interest income and expense and any provisions for bad and doubtful debts, than would be required under International Accounting 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 Accounting Standards.

In 2001 the Bank adopted IAS 39 Financial Instruments: Recognition and Measurement. The financial effects of adopting IAS 39 are reported in the statement of changes in equity on page 94. Further information is disclosed in the accounting policies for Investment securities, Government securities held for dealing purposes and Treasury bills and Derivative financial instruments, and in related Notes to the financial statements. IAS 39 has been applied prospectively in accordance with the requirements of this standard and therefore comparative financial information has not been restated.

(b) Investment securities, Government securities held for dealing purposes and Treasury bills

On adoption of IAS 39 at 1 January 2001, the Bank classified its foreign currency investment securities, Malta Government securities held for dealing purposes and Treasury bills as available-for-sale assets. 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.

1. Accounting policies - continued

(b) Investment securities, Government securities held for dealing purposes and Treasury bills - continued

In accordance with the requirements of IAS 39, 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. Securities and similar instruments with fixed maturity where management has both the intent and the ability to hold to maturity are classified as held-to-maturity. Securities 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. However, as at 1 January 2001 and during the financial year under review, the Bank did not hold any securities in these categories.

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

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

In 2000, prior to adoption of IAS 39, foreign currency debt securities intended for use on a continuing basis, and which were hence classified as investment securities, were stated at amortised cost less any provision for impairment. Malta Government securities held for dealing purposes were stated at the lower of cost and market value, and Treasury bills were stated at cost plus accrued discount.

Any difference between the initial amount and the maturity amount (premium or discount) arising on financial assets that have a fixed maturity is recognised using the effective interest rate method over the period to maturity in accordance with the requirements of IAS 39. Prior to adoption of IAS 39, in the case of securities and similar assets redeemable on or before a given date and not subject to abnormal risk of default (excluding Government securities held for dealing purposes which were measured as outlined above), the cost was adjusted for the amortisation of premiums and discounts on a straight-line basis. The financial effect of this change was not considered material to disclose for the purpose of giving a true and fair view.

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 fair value is calculated as the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the current market rate of interest for similar financial assets.

All regular way purchases and sales of all available-for-sale assets 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.

1. Accounting policies - continued

(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 for macro-hedging purposes so as to hedge foreign exchange risk on its net balance sheet exposure. Accordingly, the Bank's 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. 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.

Prior to adoption of IAS 39, the carrying amount of foreign exchange derivative contracts represented the unrealised gain or loss on revaluation of the contracts to year end rates of exchange. Gains and losses on derivative instruments used in dealing activities were included in the profit and loss account as they occurred. Gains and losses on other derivative financial instruments used for hedging purposes were deferred and recognised as income or expense on the same basis as the corresponding expense or income on the hedged position.

The Bank's criteria for a derivative instrument to be classified as a hedge prior to adoption of IAS 39 included the following factors:

(a) the transaction was reasonably expected to match or eliminate a significant portion of the risk inherent in the position being hedged, and

(b) there was adequate evidence of the interest to hedge at the outset of the transaction.

(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.

1. Accounting policies - continued

(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 SDR1.76024 to Lm1 as quoted by the Fund at the close of business on 31 December 2001.

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 2001. 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.

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.

1. Accounting policies - continued

(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.

(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 accrued discount and premium 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 90 days maturity from the date of acquisition including: cash and balances with banks, Treasury bills, placements with banks, other foreign currency assets, other 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 114.29% (2000: 102.08%). The minimum ratio established by the Minister of Finance on the recommendation of the Board of the Central Bank of Malta in accordance with Section 19(2) of the Central Bank of Malta Act, 1967 is 60%.

3. Profit for the financial year

The profit for the financial year is stated after charging:

	2001	2000
	Lm'000	Lm'000
Fees and salaries:		
Directors' remuneration	**50**	44
Staff costs	**2,598**	2,463
Depreciation	**434**	352
Auditors' remuneration	**14**	14

4. Cash and balances with banks

	2001	2000
	Lm'000	Lm'000
Cash in hand	**704**	213
Balances with banks – repayable on call and at short notice	**17,181**	4,385
	17,885	4,598

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

	2001	2000
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**59,952**	151,410
- Three months or less but over one month	**217,595**	122,241
- One month or less	**233,820**	137,620
	511,367	411,271

6. Available-for-sale investment securities

	2001 Lm'000 At fair value	2000 Lm'000 At amortised cost
By remaining maturity		
- Over five years	**75,450**	60,670
- Five years or less but over one year	**99,745**	113,125
- One year or less but over three months	**10,405**	14,555
- Three months or less	**3,759**	875
	189,359	189,225

The Bank's investment securities, Government securities held for dealing purposes (Note 10) and Treasury bills (Note 9) at 31 December 2000 have been reclassified as available-for-sale assets based on the intentions of the Bank's management at that date. On adoption of IAS 39, the Bank reclassified and remeasured all available-for-sale assets in accordance with the accounting policy outlined in Note 1(b) to the financial statements. The financial effect of adopting IAS 39 at 1 January 2001 on available-for-sale assets is reflected in the statement of changes in equity on page 94. The impact of adoption of IAS 39 on the financial results for the year ended 31 December 2001 and on the balance sheet position as at the year end with respect to these assets is disclosed in Note 23 to the financial statements.

The Bank's portfolio of investment securities is composed of listed foreign currency debt securities issued by foreign governments and international financial institutions . The market value of the Bank's investment securities as at 31 December 2000 amounted to Lm194,900,000. As at 31 December 2001, investment securities have been pledged as collateral against the provision of credit lines by a counterparty up to an amount of US$15 million (approximately Lm6.8 million). No amounts were borrowed under these facilities at the balance sheet date. At 31 December 2001, investment securities with a fair value of Lm5,469,000 (2000 : Lm2,775,000) were lent out under a securities lending programme with a counterparty.

7. Claims on the International Monetary Fund

	2001 Lm'000	2000 Lm'000
Reserve Tranche Position	**22,869**	22,962
Special Drawing Rights	**14,994**	13,978
	37,863	36,940

Malta's membership subscription to the International Monetary Fund amounts to SDR102,000,000 (2000: SDR102,000,000).

7. Claims on the International Monetary Fund - continued

The Bank's position with the International Monetary Fund at 31 December 2001 is reflected in the balance sheet as follows:

(a) Reserve Tranche Position included above is equivalent to SDR40,254,368. 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 SDR26,393,366. These represent the Special Drawing Rights allocated to Malta amounting to SDR11,288,000, to which a corresponding liability exists in the form of a restricted demand deposit of the Government of Malta included under "Other deposits" (see Note 17), together with other Special Drawing Rights acquired in accordance with International Monetary Fund requirements and procedures. Special Drawing Rights allocated to Malta cannot be withdrawn unless such advice is received from the Fund. Other Special Drawing Rights have no specified maturity.

(c) Currency Subscription included with "Other assets" (see Note 12) is stated at Lm35,077,963 and represents the balance of the quota paid in Maltese liri. A corresponding liability included with "Other liabilities" (see Note 19) exists in the form of Non-Interest Bearing Notes of Lm18,256,000 or SDR32,134,941 and IMF current accounts of Lm16,821,963 or SDR29,610,691.

8. Other foreign currency assets

	2001 **Lm'000**	2000 Lm'000
Amounts receivable under banking arrangements		
- Repayable within three months	**1,676**	-
Others	**1,649**	1,657
	3,325	1,657

9. Treasury bills

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

	2001 **Lm'000** **At fair value**	2000 Lm'000 At amortised cost
By remaining maturity		
- One year or less but over three months	**59**	326
- Three months or less but over one month	**162**	6
- One month or less	**748**	2,394
	969	2,726

The fair value of the Treasury bills as at 31 December 2000 approximated their carrying amount.

10. Domestic debt securities

	2001 Lm'000 At fair value	2000 Lm'000 At cost
Malta Government Stocks held for dealing purposes	**4,804**	6,452
Other securities held for investment purposes	**-**	10,000
	4,804	16,452

Malta Government Stocks are listed on the Malta Stock Exchange. The market value of the Malta Government securities as at 31 December 2000 amounted to Lm6,485,000. Other securities consisted of unlisted bonds guaranteed by the Government of Malta.

Amounts include:

	2001 Lm'000 At fair value	2000 Lm'000 At cost
By remaining maturity		
- Over five years	**1,387**	1,104
- Five years or less but over one year	**1,412**	2,598
- One year or less	**2,005**	12,750
	4,804	16,452

11. Derivative financial instruments

Following the adoption of IAS 39, the Bank remeasured all derivative contracts in accordance with the accounting policy described in Note 1(c) to the financial statements. The impact of adopting IAS 39 at 1 January 2001 on derivative instruments is disclosed in the statement of changes in equity at page 94. The financial effects of adoption of IAS 39 on the results for the financial year ended 31 December 2001 and on the financial position as at the balance sheet date relating to these instruments were not deemed to be material to disclose for the purpose of giving a true and fair view.

The contracted local currency amounts of the derivative financial instruments outstanding at 31 December 2001, consisting of forward foreign exchange contracts and currency swaps, amounted to Lm31,942,000 (2000: Lm81,902,000).

The Bank's derivative contracts mature within six months from the balance sheet date, with the exception of one contract having its fair value at Lm1,554,000 and its contracted local currency amount at Lm26,962,000, which expires in 2010. Settlement of this forward contract maturing in 2010 is guaranteed by the Government of Malta.

12. Other assets

	2001 Lm'000	2000 Lm'000
International Monetary Fund Currency Subscription	**35,078**	35,222
Amounts receivable under repurchase agreements	**5,000**	64,700
Others	**3,922**	3,814
	44,000	103,736

The Bank accepted listed Malta Government securities at fair value of Lm5,070,000 (2000: Malta Government securities and Treasury bills at fair value of Lm63,788,000) as collateral for amounts receivable under repurchase agreements as at 31 December 2001. These agreements mature within one month from the balance sheet date.

13. Tangible fixed assets

	Leasehold property Lm'000	Others Lm'000	Total Lm'000
Year ended 31 December 2001			
Opening net book amount	4,331	476	4,807
Additions	90	380	470
Depreciation charge for the year	(66)	(368)	(434)
Closing net book amount	**4,355**	**488**	**4,843**
At 31 December 2001			
Cost	4,486	1,862	6,348
Accumulated depreciation	(131)	(1,374)	(1,505)
Net book amount	4,355	488	4,843
At 31 December 2000			
Cost	4,396	1,482	5,878
Accumulated depreciation	(65)	(1,006)	(1,071)
Net book amount	4,331	476	4,807

14. Notes and coins in circulation

	2001 Lm'000	2000 Lm'000
Notes	**423,835**	405,713
Coins	**17,994**	17,475
	441,829	423,188

15. Bank deposits

	2001	2000
	Lm'000	Lm'000
Reserve deposits held in terms of Section 37 of the Central Bank of Malta Act, 1967	**125,789**	141,270
Liabilities arising from monetary policy instruments	**21,000**	-
	146,789	141,270

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

Amounts include:

	2001	2000
	Lm'000	Lm'000
By currency		
Maltese liri	**145,699**	140,256
Foreign	**1,090**	1,014
	146,789	141,270

16. Government deposits

Amounts include:

	2001	2000
	Lm'000	Lm'000
By currency		
Maltese liri	**53,756**	40,555
Foreign	**15,324**	15,606
	69,080	56,161
By remaining maturity		
- Repayable within three months	**583**	547
- Repayable on demand	**68,497**	55,614
	69,080	56,161

17. Other deposits

	2001	2000
	Lm'000	Lm'000
Public Sector Corporations and similar entities:		
- Repayable within three months	**2**	2
- Repayable on demand	**810**	3,678
	812	3,680
International Monetary Fund SDR allocation	**6,413**	6,439
Others:		
- Repayable on demand	**419**	274
	7,644	10,393

Amounts include:

	2001	2000
	Lm'000	Lm'000
By currency		
Maltese liri	**497**	2,846
Foreign	**7,147**	7,547
	7,644	10,393

18. Foreign liabilities

	2001	2000
	Lm'000	Lm'000
Amounts payable under banking arrangements		
- Repayable within three months	**-**	3,655

19. Other liabilities

	2001	2000
	Lm'000	Lm'000
International Monetary Fund Non-Interest Bearing Notes	**18,256**	18,549
International Monetary Fund current accounts	**16,822**	16,673
Others	**2,400**	2,215
	37,478	37,437

20. Capital

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

21. Reserve funds

Reserves are maintained in terms of Section 18(2) and (3) of the Central Bank of Malta Act, 1967. The General Reserve is held to strengthen the capital base of the Bank. The Special Reserve is available to fund certain investments contemplated by the Central Bank of Malta Act, 1967 or for any other similar purpose which may be approved by the Minister of Finance.

22. Reserves for risks and contingencies

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

23. Fair value reserve

Following the adoption of IAS 39 at 1 January 2001, all assets classified as available-for-sale and all derivative instruments were remeasured to fair value. The difference between their original carrying amount and their fair value at 1 January 2001 was credited to retained earnings in accordance with the transitional provisions of IAS 39. On the same date the Directors have resolved to transfer the amount of the transitional adjustment attributable to the remeasurement of available-for-sale assets to the fair value reserve.

Gains and losses arising from the change in the fair value of available-for-sale assets subsequent to 1 January 2001 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, including the amount of the adjustment on initial application of IAS 39, are transferred to the profit and loss account as gains and losses from available-for-sale assets.

	Available-for-sale investment securities Lm'000	Available-for-sale local assets Lm'000
On adoption of IAS 39 at 1 January 2001	5,675	32
Net gains/(losses) from changes in fair value	1,188	(12)
Net gains transferred to net profit on disposal	(815)	(49)
At end of year	6,048	(29)

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

24. Cash and cash equivalents

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

	2001	2000
	Lm'000	Lm'000
Cash and balances with banks (Note 4)	**17,885**	4,598
Treasury bills maturing within three months (Note 9)	**555**	2,388
Placements with banks maturing within three months (Note 5)	**314,286**	99,058
Other foreign currency assets maturing within three months (Note 8)	**1,676**	-
Other assets maturing within three months (Note 12)	**5,000**	64,700
Deposits maturing within three months (Notes 15, 16 and 17)	**(81,249)**	(49,268)
Foreign liabilities maturing within three months (Note 18)	**-**	(3,655)
	258,153	117,821

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

25. Financial instruments

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

Credit risk

The Bank has in place internal control structures to assess and monitor credit exposures and risk thresholds. The Bank places limits on the level of credit risk undertaken from the main categories of financial instruments, covering on and off-balance sheet exposures, in relation to individual financial institutions and groups of financial institutions classified by country of origin. These limits are approved by the Board of Directors and actual exposures are monitored against limits on a daily basis. Funds are placed with, and derivative instruments are entered with, financial institutions having a first class credit rating. The Bank invests only in first class quality paper and does not engage in derivative trading for speculative purposes. 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.

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.

25. Financial instruments - continued

Currency risk - continued

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:

	2001	2000
	%	%
USD	**25.99**	24.39
GBP	**22.72**	22.73
EURO	**51.07**	52.37
Others	**0.22**	0.51
	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 and 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 risk varies from that expected from banks and similar institutions under International Accounting 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.

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, 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 their fair value in view of the fact that deposits by banks mainly comprise reserve deposits and due to the nature or short-term maturity of the other instruments. Placements with banks mature mainly within a period of three months from the financial year end. All deposit liabilities, excluding reserve deposits and International Monetary Fund SDR allocation, are repayable within three months from the balance sheet date.

26. Contingent liabilities and commitments

	2001 Lm'000	2000 Lm'000
Contingent liabilities		
Guarantees and letters of credit	**24,391**	34,985
Commitments		
Repayment of foreign loans received by the Bank on behalf of the Government under Financial Conventions	**18,001**	20,182
Total	**42,392**	55,167

By remaining maturity:

Guarantees and letters of credit

	2001 Lm'000	2000 Lm'000
- Five years or less but over one year	**9,256**	14,384
- One year or less but over three months	**5,725**	3,878
- Three months or less	**9,410**	16,723
	24,391	34,985

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

	2001 Lm'000	2000 Lm'000
- Over five years	**7,014**	8,908
- Five years or less but over one year	**8,690**	9,007
- One year or less but over three months	**2,132**	2,105
- Three months or less	**165**	162
	18,001	20,182

The Bank has guaranteed the due performance of a local bank's financial obligations in respect of credit facilities granted by an international financial institution for an amount of Euro25 million (approximately Lm10 million). The Bank has 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. Under these arrangements, the Bank has accepted as collateral listed Malta Government securities at fair value of Lm10,547,000 at 31 December 2001 which have been pledged in its favour by the local bank.

27. Related parties

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

The main services are:-

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

28. General

(a) Demonetised currency notes

On 13 September 2000, in accordance with Section 42(4) of the Central Bank of Malta Act, 1967, notice was given in the Government Gazette that the Lm10 4th series currency note having a value of Lm5,754,190 was demonetised. The amount of the above mentioned demonetised currency note claimed by the public within one year from the date of demonetisation was Lm2,542,320.

Claims made after the expiry of one year following the end of the period established in the notice of demonetisation, but not later than ten years after the end of that period, are charged against profits of the Bank in the year such claims are made. During 2001, such claims amounted to Lm364,609 (2000: Lm216,681).

After the expiry of ten years from notice of demonetisation, demonetised currency notes are not redeemed by the Central Bank of Malta.

At 31 December 2001, the value of unpresented demonetised currency notes amounted to Lm5,202,389 (2000: Lm2,353,507).

(b) Average number of employees

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

	2001 Number	2000 Number
Governors and Deputy General Managers	**7**	7
Heads and Executives	**75**	65
Supervisory and clerical staff	**175**	182
Non-clerical staff	**48**	50
	305	304

28. General - continued

(c) Assets held in custody

At 31 December 2001, assets held in custody by the Bank in terms of the Insurance Business Act amounted to Lm30,382,000 (2000: Lm30,587,000).

(d) Comparative amounts

Particular comparative figures relating to available-for-sale assets and derivative financial instruments have been reclassified to conform with the current year's disclosure format for the sake of fairer presentation. Further information is disclosed in the related Notes to the financial statements.