Central Bank of Malta

THIRTY-THIRD ANNUAL REPORT

AND

STATEMENT OF ACCOUNTS

2000

Enquiries relating to this Report should be addressed to:
The Manager
Information Services Department
Central Bank of Malta
Castille Place
Valletta CMR01
Malta

Telephone: (356) 247480
Fax: (356) 243051

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

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(As at 31st December 2000)

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Deputy Governor

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Mr Alfred F Lupi	Director
Prof Edward Scicluna	Director

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(As at 31st December 2000)

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Chairman

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Banking Supervision and Audit
Mr Herbert Zammit Laferla

Deputy General Manager
Finance and Banking
Mr Godfrey Huber

Deputy General Manager
Financial Markets
Mr Rene G Saliba

Deputy General Manager
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Mr Alfred Demarco

Deputy General Manager
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Mr John Agius

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(As at 31st December 2000)

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Mr Saviour Falzon

Director
Mr Alfred F Lupi

Director
Prof Edward Scicluna

Deputy General Manager
Banking Supervision and Audit
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Financial Markets
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Deputy General Manager
Research Management
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Finance and Banking
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Deputy General Manager
Financial Markets
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Economics Department
Mr Anton Caruana Galizia

Manager
Investments & Reserves
Mr Saviour Briffa

THE BOARD OF DIRECTORS

(As at 31st December 2000)

Left to right:

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

Organisation Chart of the Central Bank of Malta

- Governor
  Mr Michael C Bonello
  - Deputy Governor
    Mr David A Pullicino
    - Deputy General Manager
      Banking Supervision and Audit
      Mr Herbert Zammit Laferla
      - Banking Supervision
      - Financial Stability Office
      - Compliance
      - Audit
      - Risk Management
    - Deputy General Manager
      Finance and Banking
      Mr Godfrey Huber
      - Financial Control
        - *Payments & Reconciliation*
        - *Settlements & Communications*
      - Banking Office
        - *Operations*
        - *Payments & Services*
      - Issues
    - Deputy General Manager
      Financial Markets
      Mr Rene G Saliba
      - Money & Capital Markets
      - Open Market Operations
      - Investments
    - Deputy General Manager
      Research Management
      Mr Alfred Demarco
      - Balance of Payments
        - *Capital Flows*
        - *Data Compilation*
      - Economics
        - *Research & Analysis*
        - *Statistics*
      - Information Services
        - *Records Management Services*
        - *Library*
        - *External Relations Office*
    - Deputy General Manager
      Resource Management
      Mr John Agius
      - Human Resources
      - Information Technology
      - Administration
      - Security
    - Correspondent Banking
    - Legal Unit

December 2000

LETTER OF TRANSMITTAL

CENTRAL BANK OF MALTA
VALLETTA

30th March 2001

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 2000, and a report on the Bank's operations during that year.

Yours sincerely
Michael C Bonello
Governor

Contents

Governor's Statement

The year 2000 was characterised by divergent trends in the country's internal and external accounts and signs of an upturn in some areas of economic activity. On the one hand, the Government's macroeconomic stabilisation programme produced generally positive results. The fiscal deficit, the reduction of which is the primary objective of the programme, narrowed further to end the year at just over 6% of GDP. Despite this fiscal tightening and the adverse effects of higher oil prices, a steady pace of economic activity was maintained and the growth rate is estimated by the Central Bank to have been around 4%. This reflected a good performance in the export sector, where growth in manufacturing output more than compensated for a roughly unchanged level of tourism activity, as well as some incipient signs of recovery in domestic demand. While the year's outturn was broadly satisfactory, there remains considerable potential for higher output growth given that Malta's per capita PPP output stands at 52% of the EU average.

Additional evidence of a favourable macroeconomic environment in 2000 is to be found in price and employment indicators. Retail price inflation declined to around 2.4%, while underlying inflation was estimated at just over 1%. This compares well with trends in imported inflation, though domestic inflation remained somewhat higher than the latter, reflecting the persistence of a budget deficit as well as a lower level of productivity compared to Malta's main trading partners. At the same time, the unemployment rate eased further during the year to 4.5%, largely under the impact of rapid job creation by the private sector. The labour market nevertheless remains conditioned by underemployment in the public sector, a relatively low female participation rate and mismatches of skills between labour demand and supply.

Developments in the balance of payments during 2000, on the other hand, deserve close attention. The current account deficit experienced a marked deterioration while the capital and financial account surplus narrowed significantly. Admittedly, the existence of special factors contributed to both the exceptional surge in import payments during the year and the heavy net outflows on the investment income account, but the fact remains that the current account is structurally in deficit. This inevitably clouds the economy's medium-term prospects, particularly since capital is increasingly mobile and, therefore, more sensitive to domestic economic conditions.

Concerns regarding the balance of payments invariably lead to questions about the exchange rate. This is a key issue for the Central Bank, as the main operational objective of its monetary policy is to maintain the lira exchange rate pegged to a basket of currencies reflecting the direction of Malta's external trade. The first question concerns the suitability of the pegging arrangement. While a market-determined exchange rate should eventually result in balance of payments equilibrium, the associated fluctuations and uncertainty in pricing could be detrimental to the development of a small, open economy such as Malta's. Indeed, the exchange rate peg has proved to be one of the main sources of macroeconomic stability since its adoption almost thirty years ago. There is, therefore, no compelling reason for a change in policy at this time.

The second question relates to the level at which the lira is pegged. A reduction in the external value of a currency could improve the balance of payments position by enhancing the price competitiveness of exports. This presupposes that sufficient slack exists in the economy to meet an eventual increase in export demand, and that the export price competitiveness thus engendered is not subsequently lost through higher domestically-induced costs, particularly wages, arising in response to an increase in inflation. Experience has shown, however, that the benefits of a devaluation in an economy like Malta's tend to be short lived. Furthermore, a devaluation would imply a reduction in the wealth of the economy and undermine the country's reputation for exchange rate stability with both existing and potential investors.

A more effective approach to addressing a balance of payments imbalance in the long run would be based on prudent macroeconomic policies, the creation of new, export-oriented productive capacity and an enhancement of productivity. The determined pursuit of such policies should obviate the need for a potentially destabilising adjustment in the external value of the currency.

The Central Bank, therefore, believes that a preferable and more lasting solution to the underlying balance of payments problem at this juncture does not lie exclusively in macroeconomic adjustment but also in microeconomic reform. The latter would be aimed at producing a larger volume of output at a lower cost, and thus a higher real national income. For this to happen, it is essential that a more investment-friendly business climate be fostered, reinforced by a more efficient use of the available resources. International experience shows that this is more likely to be achieved through economic policies that allow prices to fully reflect the production costs of goods and services, and that reward the resources employed accordingly. In this way, efficient enterprises receive suitable incentives while uncompetitive activities are discouraged.

A number of specific microeconomic reforms towards this end suggest themselves. In the labour market, for example, it is vital that in every sector of economic activity people produce the value added for which they are remunerated. Significant responsibility lies with entrepreneurs in identifying and exploiting opportunities for the creation of productive jobs, in developing human capital to effectively meet market requirements and, in conjunction with the trade unions, in promoting a culture of safeguarding jobs through efficient work practices. The educational system also has a role to play in this respect. Apart from often failing to provide students with the technical knowledge and skills most in demand in a modern economy, the educational system has conditioned at least two generations of students to expect universal State handouts.

Another vital requirement of a properly functioning labour market is for wages to closely reflect productivity. The current practice of applying a uniform cost-of-living adjustment to all wages could lead to a loss of competitiveness and rising unemployment if it is not balanced by an increase in productivity. This is because the remuneration of insufficiently productive jobs is a cost borne by the rest of the economy. This cost cannot be sustained without threatening the viability of the export-oriented industries that subsidise the less productive activities. Similarly, an excessive absorption of human resources by the public sector not only imposes a tax burden on other sectors, but it also restricts the availability of labour elsewhere in the economy and increases its cost.

An efficient allocation of resources in the capital market is equally important for sustained economic development and the restoration of equilibrium in the external account. A prime factor in this respect is the removal of the main sources of uncertainty in the economy. Foremost among these are the doubts about Malta’s commitment to EU membership, which are adversely affecting prospects for increased inflows of foreign direct investment. With regard to portfolio investment, it is essential that individual investors have access to unbiased advice and adequate information about the potential gains and risks involved. Banks, moreover, must properly evaluate the feasibility of borrowers’ proposals and encourage the latter to commit an appropriate level of own funds to their projects. More expeditious bankruptcy procedures would also be conducive to the re-deployment of capital resources to more productive uses.

Another important resource in the Maltese economy is land. Past policies, including controls on rents, have contributed to artificially inflate the price of this scarce resource. This is diverting resources away from more productive investment. Price mechanisms that would allow rents to reflect property values more fairly could mitigate these undesirable effects.

The provision of public goods and services by the State is another area where significant efficiency gains could be reaped. It is estimated that these activities absorb around one-fifth of the economy's output and contribute increasingly to the fiscal deficit. As these goods and services are mostly provided free of charge, users do not appreciate their real cost, while the provider may be unaware of existing inefficiencies. Devising mechanisms whereby society would be made aware of the costs involved, while safeguarding the dimension of social protection inherent in the provision of such goods and services, could free up valuable resources. Similar arguments may be applied to subsidies given to public sector enterprises.

Reforms to the welfare system also carry the potential for achieving a more efficient allocation of resources. In particular, the present pay-as-you-go pension system disconnects the payment of contributions from the receipt of benefits. This creates incentives for abuse, apart from the often-voiced concerns regarding the long-term sustainability of the system. Funded pension schemes which directly link benefits to contributions paid would be more sustainable and conducive to expand saving and investment in the economy.

The principal dividend of enhanced efficiency in the provision of public goods, in the operation of the welfare system and in the granting of subsidies would be a lower tax burden on the economy, thereby releasing resources for investment in productive activities.

Microeconomic reform in the goods and services markets is another necessary step towards enhancing the efficiency and export capability of the economy. Monopolistic practices enable suppliers to restrain output and keep prices high, thereby contributing to inflation and denting international competitiveness. A notable example in this respect is the transport sector, and the associated high levels of inland freight costs. The creation of a more competitive environment would alleviate such problems.

As for the economy's short-term prospects, the macroeconomic stabilisation policies currently in place should contribute to a further improvement in 2001. Thus a strong manufacturing export performance and the commencement of work on a number of development projects are expected to raise the economic growth rate to within a 4%-4.5% range. Inflation should further moderate to between 1.5%-2%, as imported inflation remains low while domestically-generated pressures are likely to remain subdued.

Indeed, domestic demand expansion should be contained during 2001 in the light of an expected further reduction in the fiscal deficit. The recent wage award in the civil service will, however, inhibit a faster consolidation of the fiscal position. The external current account deficit will persist, although it should narrow as the exceptional factors observed last year are unlikely to be repeated.

Expectations that the deterioration in the current account would be reversed in 2001 were an important factor behind the Central Bank's decision not to raise official interest rates during 2000 in spite of a drop in external reserves. The Bank, however, remains fully committed to defend the exchange rate peg by resorting to monetary policy measures to prevent excessive, and possibly destabilising, balance of payments outflows.

Looking further ahead, however, it should be clear that while prudent fiscal and monetary policies do help to foster conditions conducive to economic expansion, growth and prosperity ultimately depend on how well the economy's productive base works. In Malta's case, therefore, macroeconomic policy must be complemented by appropriate microeconomic reforms. This is not an easy task given the complex origins of the problem. It arises from an inevitable clash between rising expectations and limited resource availabilities, compounded by the persistence of outdated and inefficient economic structures and work practices, and adverse demographic trends. The domestic political environment further complicates the search for an effective, lasting solution.

With the economy's competitiveness increasingly under threat, however, such a solution must be found. The potential efficiency gains cannot be fully exploited unless the restructuring process currently underway is extended across a broader front. Faced with similar circumstances, other countries have successfully injected a new dynamism into their economies on the strength of a broad consensus on reform measures among the political and social forces. Considerable long-term benefits could likewise accrue to the Maltese economy if a common effort were made to devise ways how: to relate the provision of welfare payments and free medical, social and tertiary education services more closely to needs; to create a smaller, but more professional and accountable public service; and to introduce greater competition into monopoly situations, particularly in key economic sectors.

Central Bank Operations

In the light of the need to adapt to a rapidly changing external environment, the Bank reviewed its core functions and objectives during the past year. As the revised Mission Statement, which is reproduced in this Report, clearly states, the Bank focuses on maintaining the domestic and external value of the currency, using the exchange rate as the intermediate target of monetary policy. The emphasis on price stability as the primary objective of monetary policy is also a key feature of the amendments to the Central Bank of Malta Act that are to be brought before Parliament later this year.

The process of interest rate liberalisation in the banking sector, which began in the mid-1990s, was completed this past year. In April the Bank removed the last restriction on bank lending rates, which was related to housing finance, in a move that generated a positive market response. Controls on capital movements were eased further.

The Bank is also legally responsible for promoting a sound financial structure and an orderly capital market in Malta. During the year the Bank formally set up an office to detect and limit risks to the overall stability of the financial system. A stable financial system is vital for sustained economic development and is also a necessary element in the conduct of a monetary policy aimed at price stability.

In terms of the Malta Stock Exchange Act, the Bank monitors the Exchange in its efforts to promote a sound securities market. Moreover, as the Competent Authority appointed in terms of the Banking Act, 1994 and the Financial Institutions Act, 1994, it also has the duty to license, regulate and supervise banks and financial institutions. In this regard, the Bank licensed three new banks during 2000. In the course of the year the Bank also began work on new banking directives on provisioning and consolidated supervision, and was involved in preparatory work leading to the establishment of a deposit protection scheme. The Bank meanwhile continued to ensure that banks and financial institutions complied with the relevant statutory requirements.

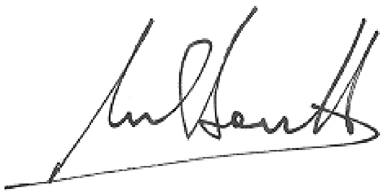
The Bank supports the market for Government securities by standing ready to buy and sell them on the secondary market. During 2000, however, the Bank again refrained from participating in the primary market for Treasury bills, and for the first time did not participate in the primary market for Government stocks either. This is an important manifestation of the Bank's independence, a status that should soon be enshrined in law through a number of amendments to the Central Bank of Malta Act.

During 2000 the Bank also strengthened its relations with the European Central Bank, as well as with national central banks of European Union member countries and those of several accession countries. It continued to play an important role in the harmonisation of legislation governing the domestic financial system with the "*acquis communautaire*", and began work leading to the eventual integration of the Maltese payments system with the European TARGET system.

The Bank continued to upgrade its resources during the past year through both staff recruitment and training and further investment in information technology. The millennium changeover passed without incident, both within the Bank and throughout the banking system.

During 2000 the Bank made net profits of Lm26 million, compared with Lm23 million in 1999.

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



Michael C Bonello

Part I

FINANCIAL AND ECONOMIC DEVELOPMENTS

1. The International Environment

1.1 The World Economy

World economic and financial conditions improved notably during 2000. In fact, global growth was expected to rise to 4.8%, from 3.4% in 1999. This positive performance was mainly generated by an above-potential growth in the US as well as economic recovery in several other countries. The main risks to this scenario stemmed from unrealistically high equity prices, the misalignments of several key currencies and rising oil prices. In the later months of the year, global growth moderated considerably, undermined by a significant slowdown in the US.

In the United States, growth continued at a vigorous pace until around mid-year, mainly on the back of strong consumer spending and robust business investment. On the negative side, personal savings continued to drop while the US trade deficit widened to record levels, as imports continued to outpace exports. In the second half of the year, however, the US economy slowed down markedly as firms scaled back their inventory building and moderated their spending on new equipment. Household consumption and residential construction also fell, mainly in response to higher interest rates, the retreat of equity prices from their peaks and rising energy prices. On the other hand, productivity, meaning output per hour of workers outside the farm sector, rose by 4.3% during the year, the strongest growth rate since 1983. Thus, although US labour-market conditions remained tight, with unemployment falling to 4% in December, unit-labour costs remained subdued.

Meanwhile, in the euro area, GDP growth was forecast to rise to 3.5% in 2000, from 2.5% in 1999, reflecting a broadly-based recovery generated by buoyant domestic demand and robust exports. A sustained decline in unemployment boosted consumer confidence, while industrial confidence hit a record high in June. During the later months of the year, however, the rise in oil prices and less supportive

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		
	1998	1999	2000[1]	1998	1999	2000[1]	1998	1999	2000[1]
United States	4.4	4.2	5.0	1.6	2.2	3.2	-217	-332	-433
European Union	2.7	2.4	3.4	1.7	1.2	N/A	86	21	-15
Euro Area	2.8	2.5	3.5	2.7	3.8	6.3	81	30	-1
United Kingdom	2.6	2.2	3.0	3.4	1.6	2.0	-	-18	-22
Japan	-2.5	0.2	1.9	0.6	-0.3	-0.7	121	107	128
Advanced countries	2.4	3.2	4.2	1.5	1.4	2.3	51	-134	-176
Developing countries	3.5	3.8	5.6	10.1	6.6	6.2	-94	-24	21
Countries in transition[2]	-0.8	2.4	4.9	21.8	43.8	18.3	-26	-4	7

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

Source: IMF, World Economic Outlook (September 2000)
OECD, Economic Outlook (December 2000)
Euro Statistics (December 2000)

monetary conditions contributed to a moderate deceleration in the pace of euro-zone economic growth. Furthermore, on the negative side, the euro area's current-account deficit rose substantially. This mainly reflected a narrowing of the area's merchandise-trade surplus as a result of rising oil prices.

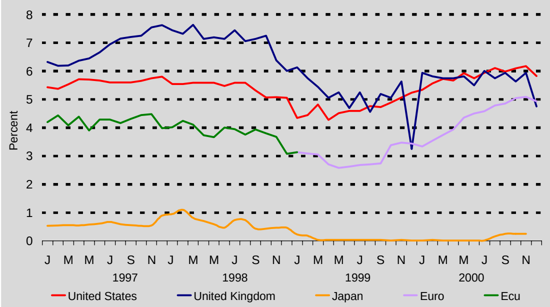
Economic activity in the United Kingdom tended to moderate during the year, reflecting a broad decline in industrial output as manufacturing firms were hit hardly by the strength of the pound and a drop in consumer confidence. The slowdown in Britain's GDP growth became more pronounced in the last quarter of the year, as the expansion of the services sector eased while industrial production contracted. Moreover, in December house prices registered their largest decline in more than six years, as potential buyers were priced out of the market or dissuaded by higher interest rates and property taxes. Nevertheless, the labour market continued to tighten, with unemployment falling to very low levels by historical standards.

In the first half of 2000, the Japanese economy began to show signs of recovery, largely generated by a pick-up in investment and robust exports. Business profits rose notably as firms implemented cost-cutting measures while the demand for information-technology products rose strongly. Subsequently, however, the Japanese economy returned to uncertain conditions, as consumption remained sluggish, undermined by households' concern in view of business restructuring and record high unemployment. Moreover, the number of bankruptcies continued to grow, in part because Japanese banks became more rigorous in their lending practices.

1.2 Interest Rates and Exchange Rates

Short-term interest rates during 2000 fluctuated in line with inflation expectations and underlying economic conditions. Hence, in both the US and the euro area, money-market rates rose in response to the monetary-policy tightening stance adopted by the Federal Reserve Bank and the ECB, respectively. In the UK, rates remained largely unchanged in the early months of the year but followed a modest downtrend thereafter

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



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

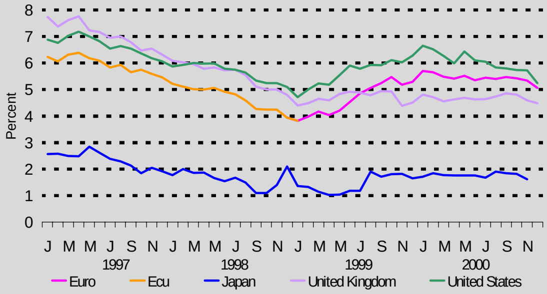
on indications of a slowdown in growth and a subdued inflation climate. Meanwhile, Japan's money-market rates stood at just above 0% until around mid-August, when they rose to 0.25% and remained at that level till the end of the year.

In the United States, money-market rates tended to rise until around mid-May as the Federal Reserve raised its target for the Federal Funds rate three times by way of a pre-emptive measure against inflation. Subsequently, however, the Fed kept the Federal Funds rate unchanged against a background of strong growth in labour productivity. Short-term money-market rates tended to stay slightly below the Federal Funds rate throughout the year.

In the euro area, money-market rates rose almost continuously during the year, reflecting the ECB's monetary-policy tightening stance. In fact, against the background of rising inflation expectations in the euro zone, the ECB raised its main refinancing rate six times between February 3 and October 1. Subsequently, however, the ECB kept official interest rates unchanged. Short-term money-market rates tended to stay above the ECB's refinancing rate throughout the year.

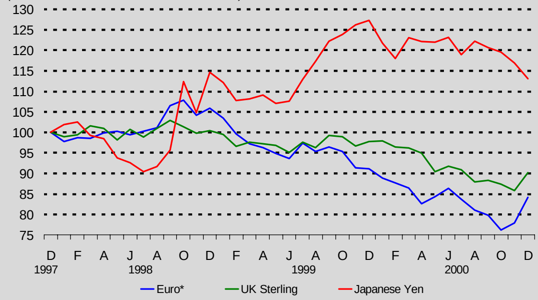
In the United Kingdom, money-market rates remained largely stable in early 2000. Later, however, UK rates eased slightly amid marked fluctuations. Against the background of a strong average-earnings growth rate and a notable rise in house prices, the Bank of England raised its repo rate on both January 13 and February 10. Subsequently, however, the Bank kept its monetary policy unchanged within the context of a

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

subdued inflation environment. Short-term money-market interest rates stood at or below the repo rate throughout the year.

Meanwhile, Japanese money-market rates fluctuated thinly above 0% until after mid-year, reflecting the Bank of Japan's zero interest-rate policy within the context of persisting deflationary pressures. On August 11, however, the Bank of Japan raised its overnight-call-rate target to 0.25%. Consequently, Japanese short-term interest rates rose to that level, remaining there until the end of the year.

Long-term interest rates in the major economies fluctuated according to inflation expectations and, in the case of the US, developments in short-term rates. Accordingly, long-term interest rates tended to fall even below short-term rates in the US, as investors expected the economy to slow down to more sustainable levels in the longer term. In contrast, long-term rates tended to rise in the euro area on prospects of stronger economic growth. Meanwhile, British long-term rates tended to rise until around October. Later, however, UK long-term rates followed a downward trend on indications of a slowdown in growth. In contrast, Japan's long-term rates remained largely unchanged throughout the year.

Through most of 2000, the foreign-exchange markets were characterised by the US dollar's appreciation against both the euro and sterling, reflecting the robust economic performance of the US and favourable interest-rate differentials. During the later months of the year, however, the dollar was undermined by expectations that growth in the euro area was about to outpace that of the US. Against the Japanese yen, meanwhile, the dollar fluctuated rather widely until early September, when the yen fell across the board on increasing uncertainty about the outlook for the Japanese economy.

In the early months of 2000, the US dollar continued to strengthen against the other major currencies, particularly the euro, which was depressed by relatively weak economic fundamentals and structural rigidities in the euro zone. Direct-investment funds flowing out of the euro area into the US also supported the dollar and depressed the euro. The US currency also appreciated against the yen, which was undermined by fear of yen sales by the Bank of Japan and concern regarding Japan's mounting fiscal deficit.

After mid-May, however, the dollar fell across the board, mainly on account of technical factors. Conversely, the euro strengthened broadly, benefiting from expectations of market intervention by central banks on its behalf and indications of higher euro-zone interest rates. Sterling also firmed, mainly benefiting from the euro's appreciation. By mid-June, however, the dollar rebounded against the euro, which was undermined by rumours of mergers and acquisitions favouring sterling, heavy selling of euros for yen and negative market sentiment. Subsequently, the dollar also firmed against the pound, following comments by Federal Reserve Chairman Greenspan to the effect that US productivity had remained strong.

In July, the dollar rose sharply against the yen, which was depressed by economic uncertainty in Japan. In the following month, however, the dollar lost most of these gains as, besides technical factors, the yen was

Table 1.2
AVERAGE EXCHANGE RATES OF THE EURO, STERLING AND THE YEN AGAINST THE US DOLLAR - 2000

	US$ per Euro	US$ per Stg	Yen per US$
January	1.0158	1.6411	105.2
February	0.9838	1.6025	109.4
March	0.9661	1.5802	106.7
April	0.9480	1.5833	105.4
May	0.9070	1.5096	108.2
June	0.9493	1.5081	106.2
July	0.9409	1.5092	107.9
August	0.9061	1.4893	108.0
September	0.8722	1.4347	106.8
October	0.8563	1.4531	108.4
November	0.8558	1.4267	108.9
December	0.8971	1.4628	112.2
Average for the year	0.9249	1.5167	107.8
Closing rate on 29.12.00	0.9289	1.4939	114.9
Closing rate on 30.12.99	1.0058	1.6193	102.1
High for the year	1.0369 (Jan. 06)	1.6550 (Jan. 21)	114.9 (Dec. 29)
Low for the year	0.8268 (Oct. 26)	1.3976 (Nov. 24)	102.6 (Jan. 04)
Percentage appreciation (+)/depreciation (-) of the currency vs the dollar from closing rate on 30.12.99 to closing rate on 29.12.00	-7.6	-7.7	-12.6

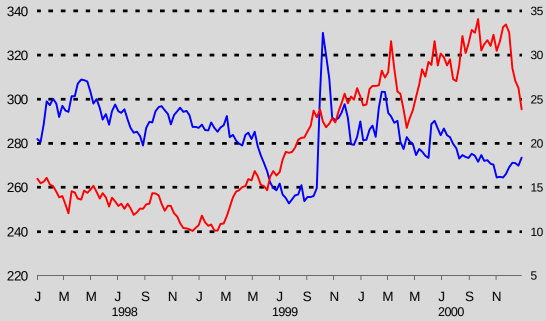
supported by renewed speculation that the Bank of Japan could soon end its near-zero interest-rate policy.

In the later months of the year, the dollar was undermined by the uncertainty surrounding the US presidential election and fears of a sharp economic slowdown. As a result, it weakened notably against both the euro and sterling. At this stage, moreover, the euro was supported by central-bank intervention as well as positive market sentiment, while, on its part, the pound benefited from indications that the UK economy was not going to slow down as much as expected earlier. But the dollar still tended to appreciate against the yen, as declining business confidence, rising bankruptcy debt and sharp declines in Japanese equity prices gave rise to renewed scepticism regarding Japan's economic recovery.

1.3 Commodities

The price of **oil** rose notably throughout most of 2000, mainly on account of supply shortages following the implementation of output reductions agreed by OPEC in 1999 and speculative buying. Moreover, fears of supply disruptions in the wake of escalating tensions in the Middle East pushed oil to a 10-year peak of

CHART 1.4
COMMODITY PRICES



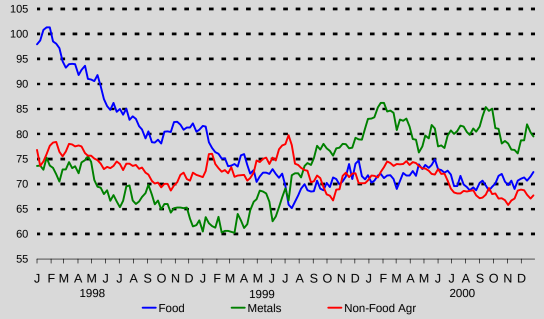
Source: The Economist

US$35.30 per barrel on October 12. Towards the end of the year, however, oil prices fell, mainly on the back of a recovery in US stockpiles, strong selling pressure from speculators and the resumption of Iraqi oil sales to Europe. Consequently, oil ended the year at US$23.85 per barrel, down from the US$25.28 that prevailed at the end of 1999.

Meanwhile, the prices of base metals fluctuated rather widely. In the early months of 2000, prices fell substantially owing to surplus stocks. In May, however, base-metal prices rebounded strongly on the back of both trade and speculative buying. Towards the end of the year, however, the prices of aluminium, nickel, lead and zinc fell sharply, mainly on account of the slowdown in the US economy. Hence, base-metal prices ended the year 4.2% down from end-1999 levels.

Within the food commodities category, wheat prices fluctuated widely through most of 2000, but tended to rise towards the end of the year amid predictions of an extended period of cold weather in the US winter wheat belt and speculative buying. In contrast, coffee prices fell almost continuously, owing to an oversupply in world markets and speculative selling. On balance, however, food prices ended the year 0.9% up from end-1999 levels.

Chart 1.5
COMMODITY INDICES *
(base rate 1995 = 100)



* Figures prior to 2000 were re based by CBM
Source: The Economist

Prices of non-food agricultural commodities rose in early 2000, but subsequently they tended to fall on account of oversupplies, particularly of rubber. Accordingly, at the end of the year, prices of non-food agricultural commodities were, on balance, down by 4.3% from end-1999 levels.

The price of gold started the year on a strong footing, supported by strong physical buying. Later, however gold was depressed by negative market sentiment fuelled by expectations of increased supplies and central-bank selling. Nevertheless, towards the end of the year the price of gold rose modestly, benefiting from a stronger euro and a weakening dollar. As a result, gold ended the year at US$273.50 per ounce, down by 5.7% from the US$289.90 per ounce at which it ended 1999.

2. The Domestic Economy

Central Bank estimates indicate that real GDP growth in 2000 was comparable to that registered in 1999, with the real output of the Maltese economy expanding by about 4.0%. Export-oriented manufacturing firms, particularly those in the electronics sub-sector, contributed strongly to GDP growth during the year and compensated for a sluggish performance in the tourist industry and in the locally-oriented manufacturing and services sectors. The rate of economic expansion was also dampened by the significant drop in the profits of some State-owned companies as a result of the sharp increase in international oil prices. The electronics sub-sector accounted for a significant rise in investment, which boosted imports of capital goods and led to a deterioration in net exports of goods and services. In fact, gross fixed capital formation increased significantly in 2000, helped also by an incipient recovery in construction activity.

The rate of job creation accelerated during the year, with employment in the directly productive sectors increasing for the first time since 1995. As a result, the unemployment rate fell to 4.5%, its lowest level in three years. At the same time, headline inflation rose slightly, reflecting the impact on prices of the changes in indirect taxation announced in the November 1999 Budget. Underlying inflation, however, continued to drop in line with the trend of the previous three years, reflecting both the restraining influence on demand of fiscal tightening and low imported inflation.

Table 2.1
GDP BY CATEGORY OF EXPENDITURE

Lm millions

	1996	1997	1998	1999	January-September 1999	January-September 2000
AT CURRENT MARKET PRICES						
Private consumption expenditure	764.9	803.5	846.0	913.2	677.9	731.7
Government consumption expenditure	259.8	264.1	269.0	271.2	201.2	211.7
Gross fixed capital formation	345.3	326.4	333.6	329.3	237.2	297.2
Inventory changes	-1.4	3.0	-10.7	11.6	-15.6	21.8
Domestic absorption	**1,368.6**	**1,397.0**	**1,437.9**	**1525.3**	**1,100.7**	**1,262.4**
Exports of goods and services	1,045.6	1,095.8	1,194.7	1320.4	975.7	1,185.1
Imports of goods and services	1,212.8	1,204.6	1,270.3	1399.1	1,000.0	1,295.2
Balance of trade in goods and services	**-167.2**	**-108.8**	**-75.6**	**-78.7**	**-24.3**	**-110.1**
GROSS DOMESTIC PRODUCT	**1,201.4**	**1,288.2**	**1,362.3**	**1446.7**	**1,076.4**	**1,152.2**
AT CONSTANT 1995 PRICES						
Private consumption expenditure	750.2	762.1	781.4	827.4	614.2	649.7
Government consumption expenditure	254.9	252.0	242.0	239.4	177.6	184.0
Gross fixed capital formation	334.5	319.3	308.5	311.1	224.0	265.8
Inventory changes	-1.4	2.9	-9.8	10.7	-14.3	20.2
Domestic absorption	**1,338.2**	**1,336.3**	**1,322.1**	**1,388.6**	**1,001.5**	**1,119.7**
Exports of goods and services	1,011.3	1,051.5	1,137.1	1229.0	908.1	959.1
Imports of goods and services	1,158.3	1,138.8	1,167.4	1273.6	910.4	1,037.1
Balance of trade in goods and services	**-147.0**	**-87.3**	**-30.3**	**-44.6**	**-2.3**	**-78.0**
GROSS DOMESTIC PRODUCT	**1,191.2**	**1,249.0**	**1,291.8**	**1,343.9**	**999.3**	**1,041.8**

Source: Central Office of Statistics

Table 2.2
YEAR-ON-YEAR PERCENTAGE CHANGES IN GDP

Percent

	1996	1997	1998	1999	2000 Central Bank estimates
AT CURRENT MARKET PRICES					
Private consumption expenditure	9.2	5.0	5.3	7.9	6.3
Government consumption expenditure	10.5	1.7	1.9	0.8	6.0
Gross fixed capital formation	-5.4	-5.5	2.2	-1.3	16.8
Exports of goods and services	-2.7	4.8	9.0	10.5	21.8
Imports of goods and services	-1.5	-0.7	5.5	10.1	26.8
GROSS DOMESTIC PRODUCT	**4.9**	**7.2**	**5.8**	**6.2**	**5.8**
AT CONSTANT 1995 PRICES					
Private consumption expenditure	7.1	1.6	2.5	5.9	3.8
Government consumption expenditure	8.4	-1.1	-4.0	-1.1	2.8
Gross fixed capital formation	-8.4	-4.5	-3.4	0.8	15.8
Exports of goods and services	-5.9	4.0	8.1	8.1	4.3
Imports of goods and services	-5.9	-1.7	2.5	9.1	8.8
GROSS DOMESTIC PRODUCT	**4.0**	**4.9**	**3.4**	**4.0**	**3.8**

Source: Central Office of Statistics, Central Bank estimates

2.1 Aggregate Demand

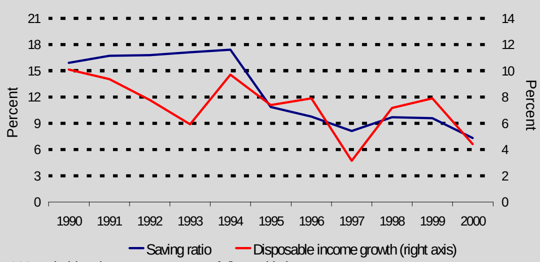
2.1.1 Consumption Expenditure

Private consumption expenditure is estimated to have grown by around 3.8% in real terms during 2000. This compares with 5.9% in 1999, when consumption was boosted by an exceptional rise in expenditure on motor vehicles. In spite of a relatively slow growth in personal disposable income, private consumption expenditure appears to have increased at a stronger pace in 2000 compared to the underlying performance in recent years.

The slower growth of personal disposable income was due to the higher employee national insurance contribution rates and the modifications to the income tax bands that increased the average rate of personal income tax. As the slowdown in personal disposable income growth was less than proportionally reflected in consumer expenditure, there was a drop in the saving ratio in 2000, as Chart 2.1 shows. The Chart further indicates that after 1994 the relatively stable relationship between household saving and disposable income broke down. Since 1995, the saving ratio tended to settle at a lower level, while instances of slower growth in disposable income were reflected more in lower saving rather than reduced consumption. This suggests a structural change in the consumption behaviour of Maltese households, possibly engendered by fiscal reforms, a reassessment of the value of household wealth following the increase in real estate prices in the first half of the nineties, together with easier access to bank credit brought about by the liberalisation of the financial sector.

Government consumption is estimated to have grown at a faster pace during 2000, mainly reflecting a higher wage bill on account of increased employment and higher outlays on health services. This notwithstanding, the relative importance of Government consumption as a component of

Chart 2.1
HOUSEHOLD SAVING RATIO* AND DISPOSABLE INCOME



* Household saving as a percentage of disposable income
Data for 2000 are Central Bank of Malta estimates
Source: Economic Policy Division, Economic Survey

aggregate demand continued to decline, reflecting a tighter fiscal stance.

2.1.2 Gross Fixed Capital Formation

After having remained subdued during the previous four years, investment rebounded during 2000. This in large part reflected the installation of new equipment in the electronics industry. By contrast, investment levels in other manufacturing sub-sectors, particularly those producing for the local market, were unchanged. At the same time, investment in construction declined for the fourth year in a row, despite the speeding up of work on the new hospital. It should, however, be noted that the 1999 data on construction activity had included expenditure on oil exploration and the redundancy payments awarded to workers in a public sector construction firm. Excluding these exceptional factors, construction activity during 2000 is estimated to have increased by nearly 10%.

2.1.3 External Demand and Supply

At current prices, exports of goods and services surged by 22% in 2000, though this partly reflected the rise in the value of re-exports of oil. In real terms, exports increased by 4.3%, of which the greater part is attributable to the electronics sub-sector. This was offset by a drop in tourism earnings and in the exports of the rest of the manufacturing sector, both of which had increased in 1999. The main factors behind these developments are analysed in Section 2.4 of this Report, below.

Table 2.3

LABOUR MARKET: MAIN INDICATORS

Number of persons

	December	
	1999	2000
Labour supply	145,901	147,700
Males	104,848	105,316
Females	41,053	42,384
Registered unemployed	7,695	6,583
Males	6,611	5,665
Females	1,084	918
Unemployment rate (%)	5.3	4.5
Gainfully occupied	138,206	141,117

Source: Employment and Training Corporation

The rise in oil prices that affected the value of re-exports also conditioned the value of imports, which increased by 27% overall. Though less pronounced, growth in imports in real terms was a substantial 9%. This mainly reflected the imports of capital goods referred to earlier, which caused the deficit in net exports of goods and services to widen by Lm88.5 million to Lm167.7 million in nominal terms.

2.2 The Labour Market

Labour market data indicate that the upward trend in unemployment in evidence since 1995 was halted during 2000, reflecting a sharp rise in the gainfully occupied population. As a result, the unemployment rate fell to its lowest level in three years, at 4.5%.

The acceleration in the rate of job creation during the year under review was mainly, but not exclusively, generated by the private sector. In particular, there was a turnaround in the demand for labour by the private direct production sector, primarily in the electronics sub-sector. On the other hand, a number of manufacturing firms, particularly in the textiles, clothing and footwear and the furniture sub-sectors, continued to shed labour. Another factor contributing to the rise in employment in private direct production was the recovery in the demand for labour by the construction industry, as discussed below in Section 2.4.3.

Employment in private market services grew by around 1,535, or 3.1% during 2000. Nevertheless, the sources of growth in employment within this sector have changed significantly during the last two years. During 2000, there was a marked deceleration in the demand for labour in the hospitality sector, with the number of jobs rising by half the amount recorded in 1999. This slowdown, which reflected the relatively weak performance of the tourist industry, was, however, more than offset by an expansion of employment in the wholesale and retail sub-sector, where a substantial rise in the number of self-employed was reported. Part of this expansion might have been

Table 2.4
GAINFULLY OCCUPIED BY SECTOR
Number of persons

	December					
	1999			2000		
	Public	Private	Total	Public	Private	Total
i. Direct production	**3,037**	**37,074**	**40,111**	**3,014**	**38,122**	**41,136**
including						
Footwear and clothing	0	3,515	3,515	0	3,422	3,422
Construction	140	5,399	5,539	135	5,901	6,036
Electronics, appliances and supplies	0	5,249	5,249	0	5,890	5,890
Food	23	3,066	3,089	22	3,093	3,115
Agriculture[1]	0	2,529	2,529	0	2,611	2,611
Transport equipment[2]	828	2,221	3,049	818	2,080	2,898
Other[3]	2,046	15,095	17,141	2,039	15,125	17,164
ii. Market services	**12,281**	**49,067**	**61,348**	**12,823**	**50,602**	**63,425**
including						
Wholesale and retail	15	15,471	15,486	0	15,835	15,835
Hotel and catering	353	9,123	9,476	338	9,321	9,659
Community and business	3,848	9,740	13,588	4,422	10,431	14,853
Transport	2,236	5,655	7,891	2,305	5,755	8,060
Malta Drydocks	2,905	0	2,905	2,779	0	2,779
Banks and financial institutions	401	3,790	4,191	405	3,752	4,157
Other	2,523	5,288	7,811	2,574	5,508	8,082
iii. Temporarily employed	**3,994**	**656**	**4,650**	**3,544**	**870**	**4,414**
including						
Apprentices and trainees	786	656	1,442	336	870	1,206
Pupil workers	3,208	0	3,208	3,208	0	3,208
Student workers	0	0	0	0	0	0
iv. Government[4]	**32,097**	**0**	**32,097**	**32,142**	**0**	**32,142**
Gainfully occupied	**51,409**	**86,797**	**138,206**	**51,523**	**89,594**	**141,117**

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

Source: Economic Policy Division, Economic Survey; Employment and Training Corporation

due to tighter enforcement of employment regulations rather than to increased opportunities. The community and business services and the ‘other’ services sub-sectors continued to register improved employment levels. At the same time, the reported higher employment in the transport, storage and communications sub-sector was partly due to a reclassification of workers, such as tourist guides, who had previously been included in other categories.

As in 1999, part-time employment expanded rapidly during 2000, rising by over 10%. The bulk was again accounted for by persons for whom part-time work constituted their primary occupation. Data on the sectoral breakdown of part-time employment, published for the first time this year, indicate that nearly 75% of part-time jobs are in the services sector, mostly in the community and business, the wholesale and retail and hotels and catering establishments sub-sectors. Direct production, mainly the agriculture and the food manufacturing sub-sector, employs a further 20% of the part-time workforce, while only 5% of part-timers are employed in the public sector.

Table 2.5
PART-TIME EMPLOYMENT

Number of persons

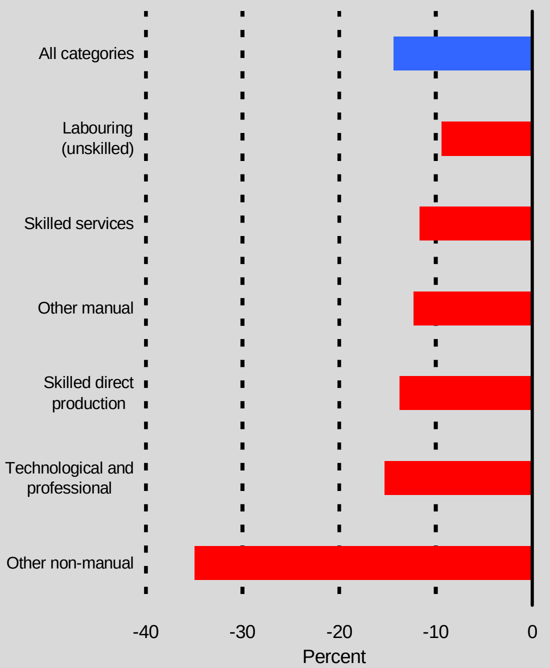
	December	
	1999	2000
Part-time holding a full-time job	**16,123**	**17,833**
Males	12,226	13,276
Females	3,897	4,557
Part-time as primary job	**16,975**	**18,689**
Males	6,826	7,357
Females	10,149	11,332
Total part-time	**33,098**	**36,522**
Males	19,052	20,633
Females	14,046	15,889

Source: Employment and Training Corporation

2.2.1 Unemployment

As observed above, the average unemployment rate fell during 2000 for the first time since 1995, as the rate of job creation outpaced the growth in the labour supply. Unemployment averaged 4.8% of the full-time labour supply during the year, down by 0.5 percentage points from its 1999 level, to end the year at 4.5%. This positive development, however, did not affect the growth, observed in recent years, of the structural element in the unemployment total.

Chart 2.2
DECREASE IN UNEMPLOYMENT BY SKILL CATEGORY IN 2000



Source: Employment and Training Corporation

Data relating to the distribution of the unemployed by type of skill, illustrated in Chart 2.2, indicate that there was a drop in all categories. The new job opportunities that arose during 2000, particularly in the direct production sector, led to a significant decline in the number of persons seeking manual employment. Nevertheless, this drop was smaller, in percentage terms, than those recorded in other categories. The number of persons registering for work in the skilled services category fell by more than a third, reflecting recruitment by Government departments. At the same time, the decline in the number of technically trained unemployed was essentially due to the expansion of the electronics industry. As a result, the proportion of persons on the unemployment register seeking unskilled employment rose slightly, accounting for three-quarters of the unemployed at the end of the year.

Meanwhile, the age structure of the unemployed continued to shift towards the older age categories, while the average duration of unemployment lengthened further. Thus, the proportion of the unemployed aged over 49 years stood at 15.7% at the end of the year, while more than half had been unemployed for over 51 weeks. The increase in the demand for labour thus mainly benefited the skilled and the relatively young.

2.3 Prices and Wages

2.3.1 Retail Prices

As can be seen from Chart 2.3, retail price inflation

Chart 2.3
RETAIL PRICE INFLATION

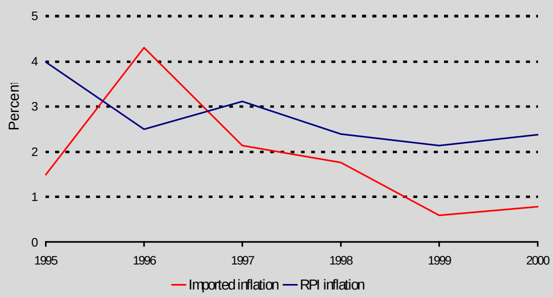
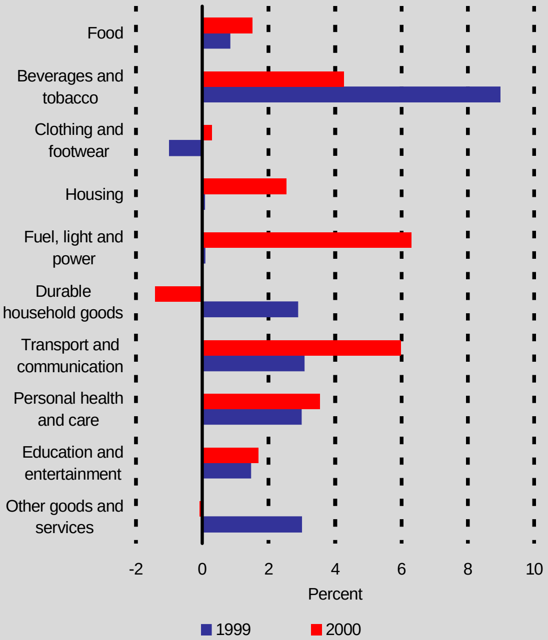


Chart 2.4
INFLATION RATES OF COMMODITY SECTIONS IN THE RPI



Source: Central Office of Statistics

edged up during 2000, after having eased during the previous two years. The twelve-month moving average measure of inflation rose by 0.24 percentage points, to 2.37%, compared with the decrease of 0.26 points registered in 1999.

The increase in the Retail Price Index (RPI) did not, however, reflect underlying inflationary pressures, but rather the impact on consumer prices of the changes in indirect taxation introduced in the November 1999 Budget[1]. Central Bank estimates suggest that underlying inflation, i.e. retail price inflation netted of changes in indirect taxes and seasonal factors, continued to drop during the year under review. The 1999 Budget measures are estimated to have added more than one percentage point to the headline rate of inflation during 2000. These measures, however, should be deflationary in the longer term, due to their dampening effect on aggregate demand.

The low rate of imported inflation, which reflected the weakness of the euro against the Maltese lira and the relatively subdued inflation in Malta's main trading partners, was an important factor behind the decline in underlying inflation. Furthermore, the rise in international oil prices, which fuelled upward price pressures in most economies, had no impact on the domestic price level as it was absorbed completely by the State-owned energy utility. At the same time, domestic demand growth remained at a level that precluded any significant domestically-induced inflationary pressures, especially in relation to the expansion of the retail supply base in recent years and the subsequent increase in price competition. The gradual removal of protective levies also exerted a restraining effect on prices during the year.

As can be seen from Chart 2.4, the sub-indices of the RPI that registered the greatest increases were those affected by changes in indirect taxes or subsidies. In particular, the higher price levels reflected in the housing and the fuel, light and power sub-indices were due to the reduction of rebates on utility bills. Similarly, the larger increase registered in the transport and communication sub-index was due to the extension of VAT to fuel and telephony services, whereas part of the sharper rise in food prices was caused by the removal of the subsidy on flour. On the other hand, the decline in the rate of inflation of the beverages and tobacco sub-index was the result of smaller increases in taxes on cigarettes and alcohol when compared to those introduced in the Budget for 1999.

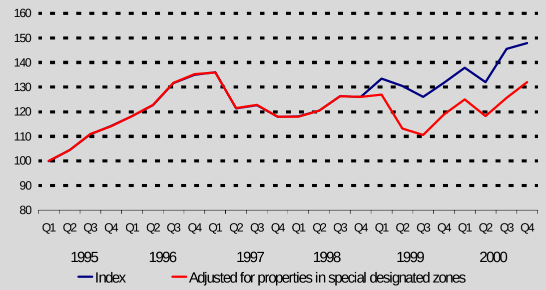
The average price of durable household goods declined during 2000, probably due to pre-emptive moves by local furniture manufacturers to retain market share in anticipation of the removal of import levies in 2001. This factor may also account for the small decline in the other goods and services sub-index, which includes detergents, another area where import levies are being gradually removed.

2.3.2 Real Estate Prices

Movements in asset prices are a useful indicator of underlying inflationary pressures in the economy that are not reflected in the RPI basket. One of the principal

[1] These included the extension of value-added tax (VAT) to fuel and telephony services, the removal of the subsidy on flour, an increase in the excise duty on cigarettes and reductions in the rebates given on utility bills.

Chart 2.5
ADVERTISED REAL ESTATE PRICES
(1995 Q1=100)



Source: Estate Agents, press cuttings

investment assets in Malta is real estate. The Bank monitors movements in real estate prices through an index of asking prices for property, stratified by property type and by locality. The principal shortcomings of this approach are that asking prices are higher than actual contracted prices, and the difficulties involved in finding comparable properties on the market at different points in time.

Chart 2.5 illustrates the overall index of property prices, and a similar index which adjusts for properties in special-designated zones intended for sales to foreigners that tend to exert an upward bias on the overall index. Property price inflation was at a peak in 1996 and thereafter tended to develop cyclically reflecting swings in demand. In the year 2000, an increase in property asking prices was observed, which may be indicative of an incipient recovery in market demand.

2.3.3 Wages

Central Bank estimates based on average weekly wage data from collective agreements suggest that overall wage inflation declined during 2000. It should be borne in mind, however, that these estimates, which are presented in Table 2.6, exclude overtime pay, production bonuses, and any other allowances or income in kind, which also add to labour costs. Moreover, the analysis focuses only on the wages of unionised workers covered by collective agreements, and thus may not be representative of developments in the non-unionised sectors of the Maltese economy.

The deceleration in wage growth is, however, consistent with the relatively slow increase in household disposable income reported for 2000. Furthermore, during 1999, a number of firms, particularly in the public sector, had signed new collective agreements with the trade unions representing their workers. As a result of these agreements, the average wages for skilled and clerical workers were boosted significantly during 1999, though more moderate rises were agreed upon for 2000 and 2001. Wage growth during 1999, moreover, also reflected the doubling of the lump sum paid to all civil service employees under the terms of the current collective agreement[2].

Table 2.6
ESTIMATED CHANGE IN AVERAGE WAGES[1]

Percent

Category	1996	1997	1998	1999	2000
Unskilled	6.9	5.6	6.4	6.1	2.6
Skilled	5.2	5.4	3.3	5.4	2.3
Clerical	6.1	7.7	3.7	6.5	2.0
Administrative[2]	2.1	3.2	2.0	2.7	2.2
Average wage across categories	**5.7**	**5.8**	**4.3**	**5.7**	**2.4**
excluding Government employees	***5.8***	***6.9***	***5.5***	***6.4***	***2.9***

[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.

[2] Under this collective agreement, Government undertook to make an annual cash payment to each employee, which was not incorporated in salary structures. This lump sum amounted to Lm78 in 1996, 1997 and 1998, and to Lm156 in 1999 and 2000.

Table 2.7
MANUFACTURING PERFORMANCE - SELECTED INDICATORS[1]

Percent

	1998	1999	2000
Growth in exports	**14.7**	**7.9**	**36.4**
of which:			
Communication equipment and other apparatus	14.1	4.9	36.3
Others	0.6	3.0	0.1
Growth in local sales	**-1.0**	**-2.4**	**-0.2**
of which:			
Food and beverages	-2.3	1.0	0.6
Others	1.3	-3.4	-0.7
Growth in net investment	**1.1**	**46.8**	**120.6**
of which:			
Communication equipment and other apparatus	-2.2	17.3	135.1
Others	3.3	29.5	-14.5

[1] Based on a survey of representative firms conducted by the Department of Industry.
Figures may not add up due to rounding.

Source: Economic Policy Division, Economic Survey

The decline in wage inflation during 2000 is particularly evident in the unskilled category, where the rate of increase in wages was less than half that registered in the previous four years. At the same time, as the Table shows, the rate of growth in the salaries of the managerial grades has remained relatively stable - and low - over the years. However this may simply reflect the fact that salary increases only represent a part of the overall remuneration package received by managerial staff.

2.4 Sectoral Analysis

2.4.1 Manufacturing

An official survey of large manufacturing firms indicates that manufacturing activity accelerated sharply during the first nine months of 2000. Thus, exports by the sampled firms expanded by Lm183.6 million at current market prices during the period, compared to Lm37.1 million in the comparable period of 1999. While almost the entire increase came from the electronics sub-sector, the furniture and the plastic and rubber sub-sectors also reported positive results. By contrast, firms in the wearing apparel and in the printing and publishing sub-sectors reported a drop of Lm8.2 million in export sales during the period, compared with a Lm6.4 million increase during the first nine months of 1999.

The firms surveyed also reported a Lm0.2 million year-to-year drop from the 1999 level in sales to the local market. This was a smaller decline than those registered in the previous two years, affected in part by higher indirect taxes on the value of sales of the tobacco sub-sector. Some sectors which traditionally had been oriented to the local market, such as furniture and food and beverages, experienced strong export growth.

The survey results indicate that within the manufacturing sector there exist pronounced differences between the electronics sub-sector, on the one hand, and the other export-oriented firms and the manufacturing establishments producing for the domestic market, on the other. For instance, whereas the average weekly earnings of employees in the communications equipment and apparatus sub-sector, which includes electronics firms, amounted to Lm133 in 2000, workers in other exporting sub-sectors and in locally-oriented firms earned an average of Lm101 and Lm104, respectively. Nonetheless, wages amounted to just 3.1% of the turnover of the communications

Table 2.8
TOURISM ACTIVITY INDICATORS

	1998	1999	2000[1]	Percentage change 1998	1999	2000
Tourist arrivals	**1,182,240**	**1,214,230**	**1,215,713**	**6.4**	**2.7**	**0.1**
of which:						
UK	448,763	422,368	428,780	2.7	-5.9	1.5
Germany	203,199	212,430	204,749	5.3	4.5	-3.6
Rest of Europe	301,777	329,294	330,270	7.3	9.1	0.3
Others	228,501	250,138	251,914	14.2	9.5	0.7
Bed nights stayed (millions)	**11.3**	**11.7**	**10.3**	**0.9**	**3.5**	**-12.0**
Average length of stay	**9.5**	**9.5**	**8.4**	**-1.0**	**0.0**	**-11.6**
Earnings (Lm millions)	**254.6**	**271.4**	**268.5**	**1.9**	**6.6**	**-1.1**
Earnings per tourist (Lm)	**215.0**	**224.0**	**221.0**	**-5.3**	**4.2**	**-1.3**

[1] Provisional

Source: Central Office of Statistics.

equipment and apparatus sub-sector, compared to nearly a fifth in other sub-sectors. This reflects the considerable import content of the electronics industry's output, coupled with the capital intensity of its production process.

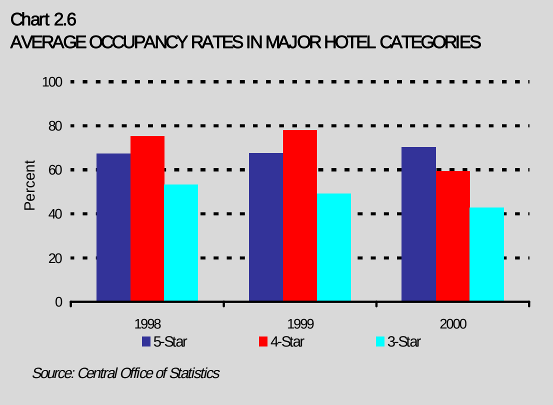
2.4.2 Tourism

The tourism sector registered a further slowdown during 2000. As Table 2.8 shows, gross earnings generated by the sector declined by 1.1% to Lm268.5 million. Total arrivals remained virtually unchanged from their 1999 level, as opposed to the increases of 2.7% and 6.4% recorded in 1999 and 1998 respectively. Tourism activity during the year was characterised by two main trends: the gradual recovery in arrivals from the UK, Malta's largest source market, and the industry's lacklustre performance in the German market, which is the second largest. Data on the accommodation and the average length of stay of tourists also indicate relatively weak results, particularly for the 3- and 4-star hotel categories. Meanwhile, cruise passenger arrivals were down by over 9% from the 1999 level, while gross earnings per tourist contracted by 1.3%.

Tourist arrivals from the UK rose by 1.5% during the year under review, in contrast with a 5.9% drop in 1999. This reflected the favourable economic conditions in the UK and the strengthening of sterling vis-à-vis the Maltese lira. On the other hand, arrivals from Germany dropped by some 3.6%, while those from other European Union countries, which had been a major source of growth in previous years, remained virtually unchanged from the 1999 levels. Meanwhile, after the expansion recorded in the previous two years, cruise passenger arrivals were down by 17,056, in part reflecting increased competition from non-Mediterranean destinations.

Tourist arrivals continued to be dominated by the 50+ age group, which constituted 36.7% of the total. This shows that Malta has potential for specialising in this expanding niche market by promoting the favourable winter climate conditions and the county's culture and history, both much appreciated by this particular age group.

The number of arrivals, however, does not give a comprehensive picture of the performance of the hospitality sector. For this purpose, the arrivals figure has to be supplemented by data on the average visitor's length of stay, hotel occupancy rates and the revenue generated . Though a change in statistical methodologies (introduced at the start of 2000) limits the comparability of data on accommodation and length of stay, it is quite clear that there was a downturn. The number of bed nights sold fell by 12% to 10.3 million during 2000, resulting in a lower average



length of stay: 8.4 days, as against 9.5 in 1999. This might reflect the global trend towards shorter holidays. However, a shorter length of stay may lead to lower earnings in the sector, unless higher spending visitors can be attracted. The data on hotel occupancy, however, indicate that the latter may be happening.

As can be inferred from Chart 2.6, the growth in hotel bed capacity continued to outpace the demand, in part due to the opening of a number of new hotels during 2000. However the breakdown by category shown in the chart reveals marked differences in occupancy levels between the 5-star hotels and the 3- and 4-star categories. While the latter reported lower occupancy rates, the occupancy levels of 5-star hotels rose by almost 3 percentage points over 1999, notwithstanding the opening of two new hotels, which expanded bed capacity in this category by 28%[3].

Moreover, whereas the revenue per room in 2000 remained stable for the 3- to 4-star hotel categories, for 5-star hotels it increased by 18.5%.

2.4.3 Construction

Although the turnover of the construction sector is reported to have declined by Lm1.2 million during the first nine months of 2000, the nominal value added of the sector remained stable after decreasing during the previous two years, while employment in the sector increased on average by 5.3%. Turnover and value added data for the period tend to understate the actual level of activity as the cash-based accounting methodology used by Government does not reflect the value of work completed but not yet paid for.

As Table 2.10 shows, the construction sector continued to rely heavily on Government-financed projects, as its sales to the private sector fell for the third consecutive year. Government expenditure on construction, on the other hand, was boosted by the speeding up of work on the new hospital. The substantial increase in employment in the sector during the period tends to suggest that construction firms were gearing themselves for an expected recovery in demand as a result of the development projects on which work was expected to begin in 2001.

Table 2.9
AVERAGE ACHIEVED ROOM RATE BY HOTEL CATEGORY

Indicator	January-September			
	1999[1]	2000	Difference	
	Lm	Lm	Lm	% Change
Average achieved room rate				
5-Star	29.1	35.1	6.0	20.4
4-Star	15.2	15.7	0.5	3.6
3-Star	8.8	8.7	-0.1	-0.8
Revenue per occupied room				
5-Star	59.7	70.7	11.1	18.5
4-Star	28.1	28.7	0.6	2.2
3-Star	13.2	14.2	1.0	7.5

[1] 1999 Data was re-based due to a higher survey participation rate in 2000
Source: MHRA Hotel Survey, July-September 2000 & Year to Date Review.

[3] See the Malta Hotels and Restaurants' Association Survey, April-June Review.

Table 2.10
CONSTRUCTION ACTIVITY INDICATORS

	January-September		
	1998	1999	2000
Total sales (Lm millions) of which:	**82.1**	**82.4**	**81.2**
Private sector	55.5	53.2	49.8
Government enterprises	4.0	2.0	2.5
General Government	22.5	27.2	28.9
Value added (Lm millions)	**27.1**	**24.2**	**24.9**
Share of value added in GDP (%)	3.0	2.6	2.5
Private employment (January-December average)	**5,563**	**5,387**	**5,671**
Share in gainfully occupied (%)	3.9	4.0	4.1

Source: Central Office Of Statistics

2.5 Outlook for 2001

Central Bank of Malta projections indicate that in 2001 underlying GDP growth should be slightly higher than in 2000, as the balance on trade in goods and services is projected to improve substantially. The latter will be mainly driven by a deceleration in import growth, especially of capital goods, as the electronics sub-sector's capital programme is largely completed.

Exports should also grow at a faster pace than in 2000, notwithstanding the fact that the electronics industry might be temporarily affected by a cyclical downturn in the global semiconductor market. The expansion in capacity effected in 2000 is expected to translate into a higher output volume in coming years. At the same time, other export-oriented manufacturing sub-sectors should recover further in view of the resilience of the European economy and the expected strengthening of the euro. Conversely, tourism activity is forecast to remain at last year's level, especially on account of an anticipated drop in arrivals from Germany. The introduction of better-targeted marketing programmes, following the increased funding for the Malta Tourism Authority, could however lead to an improvement in the second half of the year. Gross fixed capital formation is expected to stabilise during 2001. While the surge in investment witnessed in 2000 will not be repeated, the commencement of work on a number of projects should boost construction activity.

Private and public consumption should continue to grow at around the same rate as in 2000. This is not expected to result in any significant contraction in the household saving ratio, since disposable income should grow at a faster pace due to higher wages and a slower increase in taxation.

Price inflation should decline slightly, even though imported inflation may rise if the Maltese lira loses ground against the euro. Domestically-induced price pressures are, in fact, expected to decline, reflecting continued fiscal consolidation, the absence of new indirect tax measures in the latest Budget and restrained domestic demand. The stepping-up of trade liberalisation should also dampen upward pressures on prices, as local manufacturers compete more aggressively to retain market share. Wage pressures should remain contained, in view of industry's efforts to maintain price competitiveness and restructure.

The rate of job creation is projected to decelerate during 2001, after last year's increase in the demand for labour by the direct production sector. The employment expansion in the electronics sub-sector was, in fact, mainly of a one-off nature, whereas the locally-oriented manufacturing sub-sectors could continue to shed labour as they

Table 2.11

OUTLOOK FOR SELECTED ECONOMIC INDICATORS

Percent

	1999	2000	2001
		Central Bank estimates	
GDP growth at constant market prices	4.0	3.8	4.0 - 4.5
Growth in GDP components at constant prices			
Private consumption expenditure	5.9	3.8	3.5 - 4.0
Government consumption expenditure	1.1	2.8	2.5 - 3.0
Gross fixed capital formation	0.8	15.8	(0.5) - 0.0
Exports of goods and services	8.1	4.3	6.5 - 7.0
Imports of goods and services	9.1	8.8	2.5 - 3.0
Unemployment rate	5.3	4.8	4.5 - 5.0
Inflation rate	2.1	2.4	1.5 - 2.0
Fiscal borrowing requirement (% of GDP)	8.6	6.0	5.0 - 5.5
External goods and services deficit (% of GDP)	5.2	10.8	5.0 - 5.5

Figures in parenthesis are negative.

become more capital-intensive. The private services sector, on the other hand, should continue to grow, though operators in the tourism industry may attempt to consolidate their businesses in view of uncertain prospects. Thus, while the unemployment rate may remain broadly stable at the 2000 level, the structural element in unemployment may be further accentuated.

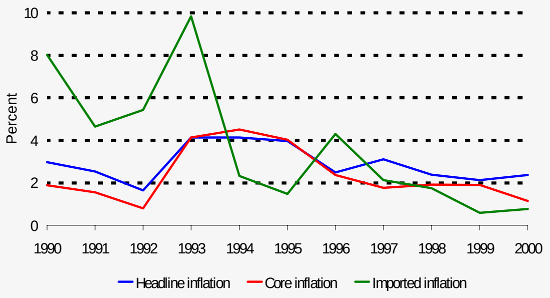
Box 1:

Price Dynamics in the Maltese Economy

Price stability is the primary objective of the Central Bank of Malta's monetary policy. In view of the openness of the economy, however, the Bank has adopted the fixed exchange rate of the Maltese lira as its main operating target. The lira is pegged to a basket of stable, low inflation currencies. This anchor for monetary policy leads to a convergence of the domestic rate of inflation to that prevailing in Malta's main trading partner countries, and thus helps to safeguard the country's long-term competitiveness. The success of this policy approach hinges on the maintenance of an adequate level of foreign currency reserves to compensate for the Maltese economy's vulnerability to external shocks.

Retail price inflation in Malta has been relatively subdued over the past decade, averaging 3% and actually falling below that level since the second half of 1998. There was, however, a relatively rapid acceleration in inflation - from just over 1% at the end of 1992 to almost 5% two years later - following a 10% devaluation of the Maltese lira in November 1992. The core inflation measure estimated by the Central Bank, which excludes the effects of changes in indirect taxation, confirms the downward trend in inflation since 1995, and shows underlying inflation in Malta during the past five years fluctuating between 1.5% and 2% and settling at the lower limit by mid-2000.

Chart 1
Price Developments in Malta (1990-2000)



Sources: Central Bank of Malta, Central Office of Statistics

As imported finished goods, services and raw materials constitute some 60% of consumption expenditure in Malta, core inflation tends to follow movements in imported inflation, but with a lag of two to three quarters and moving on a relatively less volatile path. This may be explained by the behaviour of Maltese importers, who tend to build up substantial inventories when exchange rate movements are favourable. At the same time, growing competition in the distribution sector, mainly the wholesale and retail trade, is proving to be a restraining influence on price increases.

The concept of purchasing power parity (PPP) suggests that, given certain conditions, a basket of goods should have the same price both at home and abroad if measured in the same currency. This implies that if the weights given to individual goods and services within each basket are similar, the domestic rate of retail price inflation should be in line with imported inflation. A major reason why this law does not hold is the presence of non-tradables, that is goods and services that cannot be traded internationally - either on account of transport costs or because of trade regulations or other factors related to rigidities in the economy. Labour productivity is generally higher in the tradable sector. But if wages rise at a similar rate across all industries, including those in the non-tradable sector, driven by productivity gains in the tradable sector, the average production costs of non-tradables would increase leading to a sharper rise in their prices relative to those in the tradable sector. Thus overall inflation is determined by imported inflation (which roughly equates the price changes of tradables) and by the difference in productivity growth between the tradable and the non-tradable sectors. Price pressures could also originate from across-the-board wage increases that are not related to productivity gains, such as those resulting from a wage-indexation mechanism.

Balassa and Samuelson (1964)[1] observed that since the difference in productivity between rich and poor countries is higher in the tradable than in the non-tradable sectors, absolute price levels tend to be higher in the rich countries. Since the Maltese tradable sector is relatively efficient, being mostly foreign-owned and export-oriented and benefiting from the same level of technological sophistication as that prevailing in Europe, this theory implies that, as far as Malta's domestic price level is concerned, there should be little scope for catching-up with Europe.

In fact, the Purchasing Power Parity (PPP) estimates that were recently derived for Malta suggest that the domestic price level is quite close to the European average. No significant "catching-up" process is thus envisaged for Malta were it to join the EU, at least as far as the general price level is concerned, though price adjustments on a sectoral level may be necessary, particularly in the non-tradable sector.

In order to better focus on its main goal, i.e. price stability, the Central Bank of Malta has constructed a number of econometric models that serve as a basis for its research and policy formulation processes. These models are used to simulate the effects of changes in a number of exogenous variables on the major economic indicators. In this way the Bank's Monetary Policy Council can reach its decisions after considering the likely effect of policy measures and possible developments in external conditions on the economic outlook. Econometric studies on price dynamics in Malta carried out by the Bank have yielded a number of interesting conclusions.

The Bank's structural model indicates that increases in the personal direct tax rate lower inflation in the long-run, as they tend to curb aggregate demand and ease labour market conditions. On the other hand, the effect on prices of permanent changes in indirect taxes is mainly of a one-off nature, with the change in inflation mirroring the change in the specific tax. In subsequent years, however, the rate of inflation tends to decelerate marginally, depending on the impact exerted by the change in taxation on aggregate demand. Changes in government expenditure, particularly those resulting from an increased absorption of labour resources by the State, have more pronounced effects on inflation as they are found to influence the unit labour cost of production.

Not surprisingly, given the limited channels of transmission between the monetary and the real sectors of the Maltese economy, the Bank's studies have shown that its monetary policy stance has to date only had a marginal impact on inflation. This could, however, change in the future as the domestic financial sector and channels of monetary transmission develop further.

By contrast, the Bank's models show that there is a strong response of domestic inflation to imported inflation, particularly when this originates from the foreign price component rather than from the exchange rate component. On the other hand, since Malta is a price-taker in international markets, changes in the level of foreign demand are found to have very little effect on domestic prices.

This assessment reveals that the major influence on price dynamics in Malta is imported inflation. This is indeed one of the main reasons behind the present exchange rate arrangement for the Maltese lira, which is designed to generate stability in imported inflation through a peg with stable, low inflation currencies. The domestic unit labour cost of production is also an important determinant of changes in the rate of inflation, however, mainly on account of its effect on the labour market and aggregate demand.

[1] Balassa, B., 1964, *The Purchasing-Power Parity Doctrine: a Reappraisal*, Journal of Political Economy, 62, 584-96.
Samuelson, P.A., 1964, *Theoretical Notes on Trade Problems*, Review of Economics and Statistics, 46, 145-54.

3. The Balance of Payments and the Maltese Lira

3.1 The Balance of Payments[1]

Provisional balance of payments data indicate that during 2000 Malta's current account deficit widened considerably in response to a number of exogenous factors. These included a higher import bill for energy products, as international petroleum prices hardened further over the year; a substantial rise in imports of capital goods, as a number of manufacturing firms, particularly those in the electronics sub-sector, embarked on capital investment programmes; and a surge in investment income outflows as foreign entities in Malta registered a large increase in profits, most of which were reinvested in their locally-based subsidiaries.

Meanwhile the surplus on the capital and financial account experienced a marked contraction, mainly under the impact of portfolio investment outflows by residents in response to the further easing of capital controls and a fall in inward direct investment. The latter, nonetheless, remained at a substantial level, and its apparent decline was due to the fact that in the previous year investment inflows were boosted by the proceeds of the sale of Mid-Med Bank to the international banking group, HSBC. As a result of these developments in the balance of payments, the official reserves registered a marked decline over the year.

3.1.1 The Current Account

The deficit on the current account grew to Lm226.2 million during the year, from Lm49.3 million in 1999. About half of this deterioration was attributable to higher outflows in the investment income account, reflecting a significant increase in the profits earned by foreign owned manufacturing firms and banking institutions. In fact, almost all of these outflows were re-invested locally and were thus reflected in the capital and financial account as inward direct investment flows. Apart from the negative outturn on the investment income account, the widening in the current account deficit was also due to a widening in the merchandise trade gap and a decline in the surplus on the services account. In fact, the overall deficit on goods and services became much more pronounced during the year, reaching Lm167.7 million from Lm79.2 million in 1999.

Merchandise Trade Balance

As Table 3.2 shows, the merchandise trade gap widened by Lm42 million to Lm270.6 million, with both exports and imports sharply up from the 1999 levels. The value of merchandise exports rose by Lm283.3 million, or 35%, mainly on account of higher sales by the machinery and transport equipment sector. An improved export performance was also registered by the food, beverages and tobacco, manufactured

Table 3.1
MAIN BALANCES

Lm millions

	1998	1999	2000 [1]
Overall balance	**38.5**	**125.2**	**-145.4**
Current account	-84.5	-49.3	-226.2
Short-and long-term financial flows	111.9	161.3	72.5
Capital account	11.1	13.2	8.3
Movements in reserve assets [2]	**-73.6**	**-96.3**	**97.6**
Statistical discrepancy	**35.1**	**-28.9**	**47.8**

[1] Provisional
[2] A negative sign indicates an increase in reserve assets
Source: Central Office of Statistics

[1] Compiled on an accruals basis

Table 3.2
THE CURRENT ACCOUNT

Lm millions

	1998		1999		2000 [1]	
	Credit	Debit	Credit	Debit	Credit	Debit
CURRENT ACCOUNT BALANCE		**84.5**		**49.3**		**226.2**
GOODS AND SERVICES BALANCE		**81.4**		**79.2**		**167.7**
GOODS BALANCE		**229.5**		**228.7**		**270.6**
Goods	708.3	937.8	805.0	1,033.7	1,088.3	1,358.9
SERVICES BALANCE	**148.1**		**149.5**		**102.9**	
Transport	122.3	145.7	132.9	165.3	135.5	196.8
Travel	254.6	74.9	271.4	80.1	268.5	87.8
Other services	81.5	89.7	83.4	92.7	81.3	97.9
INCOME (NET)		**25.4**	**12.9**			**65.2**
Compensation of employees	4.3	2.4	3.9	3.4	4.3	3.2
Investment income	193.5	220.9	489.9	477.5	417.0	483.2
CURRENT TRANSFERS (NET)	**22.3**		**17.0**		**6.7**	

[1] Provisional

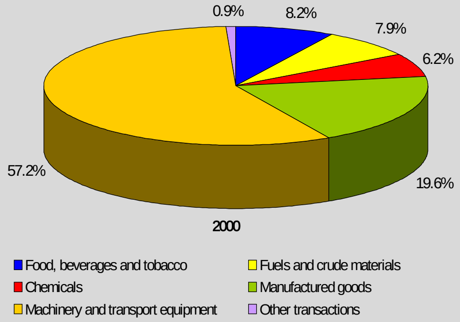
Source: Central Office of Statistics

goods and crude materials sectors.

While imports grew at a slower pace than exports, the increase in imports in absolute terms, at Lm352.2 million, was larger than that of exports. The rise in imports, however, was itself largely linked to that of exports, as imports of industrial supplies accounted for about 63% of the total. But the year 2000 also saw an exceptional growth in imports of capital goods, which were up by 40% from the 1999 level. To a large extent, this reflected the significant investment undertaken by the electronics industry, although the setting up of a second mobile telephony operator and a sustained rise in imports of motor vehicles for commercial purposes also contributed. Another important factor behind the rise in imports was the surge in oil prices on international markets. This pushed Malta's fuel imports bill up by some Lm46 million, or nearly 80%, though more than half of this amount was re-exported. In fact, oil-bunkering transactions rose by Lm24 million, leaving a net rise of Lm22 million, or 61%, in imports of fuel and oil for domestic use. Meanwhile, imports of consumer goods grew at a slower pace than in 1999.

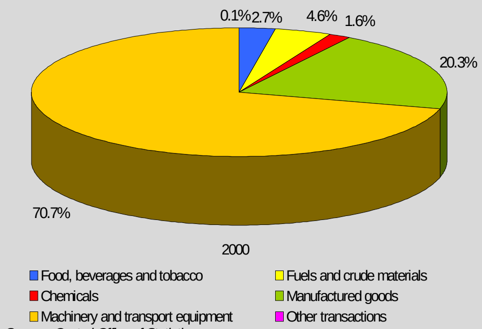
As Charts 3.3 and 3.4 show, the EU remained Malta's most important trading partner, both with regard to exports and imports. The EU's share of exports continued to decline, falling from 48.7% in 1999 to just a third in 2000. In contrast, exports to the USA rose to just under 29% of the total from about 22% in 1999, while the share of exports to Asia edged up to 23%, from around 21%. These developments reflected the significant impact of the electronics industry on

Chart 3.1
IMPORTS BY COMMODITY SECTOR

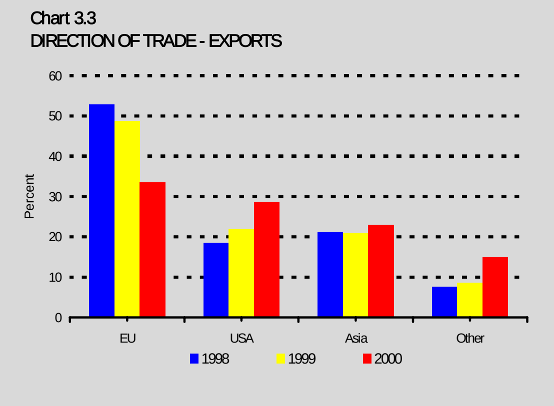


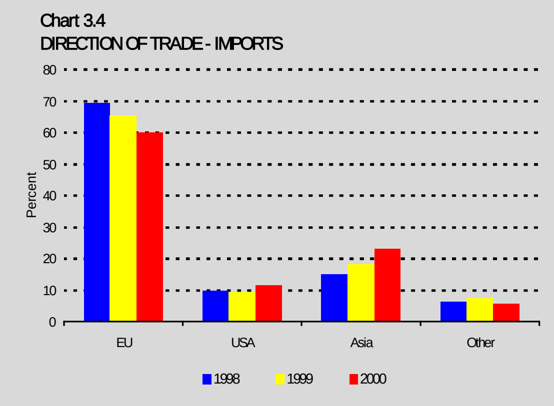
Source: Central Office of Statistics

Chart 3.2
EXPORTS BY COMMODITY SECTOR



Source: Central Office of Statistics





Malta's trading patterns. In fact, similar trends could be observed in imports, which saw the EU's share decline from over 65% to 60%, while Asia's share rose to 23%, from 18% in 1999, while the share of the US added around 2 percentage points to 11.5%. As a result of these developments, Malta's trade surplus with the USA doubled to almost Lm136 million, while its trade deficit with the EU and Asia widened by 50% and 140%, respectively. If the contribution of the electronics sub-sector to import and export figures is removed, however, the geographical distribution of Malta's merchandise trade changes significantly, with the EU 's share in both exports and imports going up to approximately 62 % and 72%, respectively.

Balance on Services

The surplus on services declined by Lm46.6 million, or 30%, in 2000, with around two-thirds of this deterioration being attributable to an increase in net payments on the transportation account. These payments were associated with freight services, which in turn reflected the strong rise in merchandise imports. However, net income from passenger carriage was also down from the 1999 level.

Net receipts from travel were down by Lm10.5 million, reflecting both lower tourism earnings and a 10% rise in expenditure by Maltese nationals travelling abroad. At the same time, the shortfall on other services widened by Lm7.2 million, mainly reflecting higher payments in respect of professional and insurance services.

Investment Income and Transfers

As observed above, the investment income account contributed significantly to the widening of the current

Table 3.3
THE FINANCIAL ACCOUNT
(Net balances)

Lm millions

	1998	1999	2000 [2]
FINANCIAL ACCOUNT BALANCE [1]	**38.3**	**65.0**	**170.1**
Long-term	**126.8**	**174.8**	**-252.8**
Direct investment	97.9	310.1	266.7
Long-term loans	-7.7	-131.7	-502.3
Other long-term investment	36.6	-3.6	-17.2
Short-term	**-14.9**	**-13.5**	**325.3**
Portfolio investment	-32.2	-201.3	-250.8
Other short-term investment	17.3	187.8	576.1
Reserve assets	**-73.6**	**-96.3**	**97.6**

[1] A positive sign indicates an increase in foreign liabilities and a negative sign indicates an increase in foreign assets.
[2] Provisional.
Source: Central Office of Statistics

account deficit during 2000. Indeed, net outflows of Lm65.2 million were recorded on this account during the year, as against net inflows of almost Lm13 million in 1999. This mainly reflected a sharp rise in the profits of foreign owned entities, which represent a return to non-resident shareholders on equity invested in Malta. At the same time, net labour income earned by Maltese residents working abroad was up by Lm0.5 million, while net inward current transfers fell by some Lm10 million.

3.1.2 The Capital and Financial Account

During 2000 net inflows on the capital and financial account, excluding movements in the official reserves, fell by nearly Lm94 million to around Lm81 million. The capital account contributed some Lm5 million to this drop, partly reflecting lower receipts of official grants and migrants' remittances. On the other hand, the Lm89 million decline in net inflows on the financial account reflected both lower inflows of foreign direct investment relative to the 1999 position - which, as stated above, was boosted significantly by the Mid Med Bank sale - and higher portfolio investment outflows.

Long- and Short-term Financial Flows

As can be seen from Table 3.3, net inflows from long-term financial transactions turned negative during 2000, while the balance on short-term flows was in substantial surplus. Consequently the financial account balance excluding movements in official reserves registered a surplus of around Lm73 million. This was well below the Lm161 million surplus recorded a year earlier. Apart from lower direct investment inflows, it was a fall in long-term borrowing that contributed to the deficit on long-term flows. This reflected a rise in net outflows by way of repayments of long-term loans by international banks that were not offset by new long-term borrowings by these institutions. In fact, the net drop in long-term borrowing amounted to around Lm370 million.

Net direct investment flows to and from Malta are further analysed in Table 3.4. The Table shows that inward direct investment by non-residents was down by some Lm43 million from the 1999 level. This showed that notwithstanding the substantial investment undertaken by the electronics industry during the year under review, inward direct investment in 1999 was still higher - due to the purchase by the HSBC banking group of the majority shareholding in Mid-Med Bank, which had boosted such inflows by Lm80 million. At the same time, an increase in the reinvested earnings of other foreign-owned companies operating in Malta was almost completely offset by lower inflows of other investment, which mainly reflected the transactions of international banking institutions.

Additional information on new equity investment in Malta involving non-resident shareholders is available at the Central Bank of Malta and the Malta Financial

Table 3.4
FOREIGN DIRECT INVESTMENT

Lm millions

	1996	1997	1998	1999	2000 [1]
Direct investment in Malta by non-residents					
Share capital	12.9	4.2	4.5	101.1	48.5
Reinvested earnings	34.1	16.9	35.4	37.5	128.1
Other investment	52.7	10.1	63.8	189.4	103.3
Total	99.7	31.2	103.7	328.0	279.9
Direct investment abroad by residents					
Share capital	2.3	7.1	6.9	17.6	10.3
Reinvested earnings	-0.2	-0.7	-1.1	0.3	3.0
Total	2.1	6.4	5.8	17.9	13.3
Net direct investment	97.4	24.8	97.9	310.1	266.7

[1] Provisional

Source: Central Office of Statistics

Table 3.5
NON-RESIDENT PAID-UP CAPITAL

Lm

	1998	1999	2000
Manufacturing and construction	146,822	295,676	292,852
Services	573,395	826,706	3,053,858
Offshore and international trading companies	93,518	287,592	99,999
Total	**813,735**	**1,409,974**	**3,446,709**
No of companies	**62**	**68**	**82**

Source: Central Bank of Malta, Malta Financial Services Centre

Services Centre. This shows that 82 new companies with non-resident shareholding were established in Malta during 2000. As Table 3.5 shows, the value of paid-up share capital in these companies amounted to Lm3.4 million, up by nearly two-and-a half times from the 1999 level. The greater part of this was invested in the services sector, and more specifically in a newly formed banking institution, which accounted for some 80% of the total.

As Chart 3.5 shows, the EU remained the largest source of new equity investment in Malta during the year, accounting for 84% of the total. Capital invested in the banking institution mentioned above in turn accounted for the greater part of this.

Meanwhile, direct investment outflows mostly involved the overseas activities of Maltese private companies. Though lower than in 1999, these outflows remained substantial and mainly reflected the purchase of hotels overseas.

As regards short-term capital flows, the large recorded surplus was wholly attributable to a surge in net inflows into other short-term investments offered by international banking institutions. Meanwhile, net portfolio investment outflows were up by almost Lm50 million (25%), as Maltese residents continued to adjust their portfolios in the light of a further easing of capital controls. The availability of a wider range of financial products, such as foreign collective investment schemes, a more aggressive marketing approach by providers of financial services and the fact that no new long-dated Government securities were issued during the year were other factors contributing to these portfolio investment outflows.

Movements in External Reserves

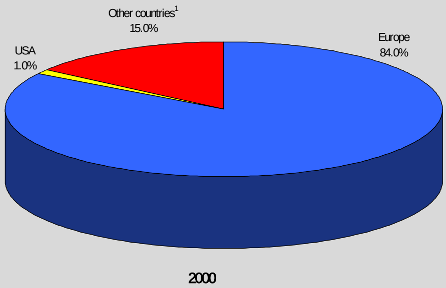
As a result of these developments, the reserve assets of the Monetary Authorities - essentially the Central Bank's external reserves - declined by Lm97.6 million to Lm644.2 million during the year. At this level, they covered 4.4 months worth of imports of goods and services, down from 6.5 months of imports in 1999.

3.2 The Maltese Lira and External Competitiveness

3.2.1 The Maltese Lira

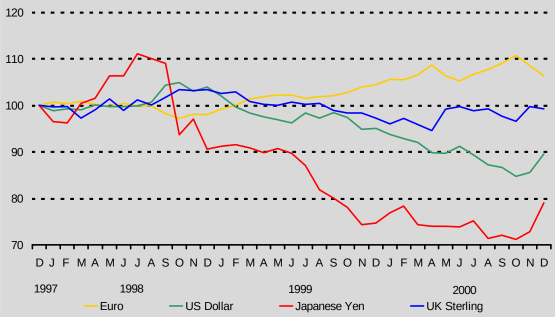
The movements in the exchange rate of the Maltese lira during the year reviewed reflected the composition of the basket of currencies to which the lira is pegged

Chart 3.5
SOURCES OF NON-RESIDENT PAID-UP CAPITAL



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

Chart 3.6
EXCHANGE RATE MOVEMENTS OF THE MALTESE LIRA AGAINST SELECTED CURRENCIES
(index of end-of-month rates, end-1997 = 100)



and the developments in international foreign exchange markets outlined in Chapter 1 of this Report. As can be seen from Chart 3.6, the lira generally strengthened against the euro through most of the year, except for two brief spells: one during May and June and another in the final two months of the year. On average, the Maltese lira strengthened by 5.4% against the euro during the year, as Table 3.6 shows. At the same time, the lira lost ground against the US dollar and the Japanese yen, falling on average by 8.7% and 13.5%, respectively. Against sterling, meanwhile, the Maltese lira was more stable, though its average value for the year was 2.5% lower than in 1999.

3.2.2 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 Maltese economy. A rise in these indices indicates a loss, while a fall reflects a gain in the economy's competitiveness.

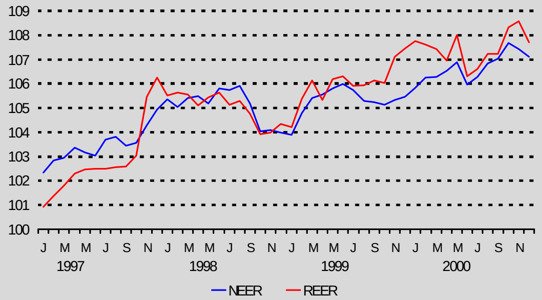
During the year 2000, the NEER index continued to move on an upward trend. Indeed, after rising marginally during 1999, this index moved up by 1.3%. This rise essentially reflected the sharp depreciation

Table 3.6
EXCHANGE RATES OF THE MALTESE LIRA AGAINST SELECTED MAJOR CURRENCIES FOR 2000

	US$	Stg	Yen	Euro[1]
Monthly Averages:				
January	2.4438	1.4895	257.2	2.4087
February	2.3903	1.4929	261.6	2.4303
March	2.3594	1.4943	251.5	2.4439
April	2.3384	1.4767	246.6	2.4675
May	2.2595	1.4990	244.5	2.4925
June	2.3145	1.5348	245.8	2.4377
July	2.3029	1.5265	248.5	2.4493
August	2.2510	1.5120	243.1	2.4872
September	2.1911	1.5265	234.1	2.5110
October	2.1750	1.4979	235.9	2.5424
November	2.1665	1.5191	235.9	2.5311
December	2.2332	1.5262	250.6	2.4870
Average for 2000	2.2855	1.5080	246.3	2.4741
Average for 1999	2.5032	1.5468	284.8	2.3470
% change 2000/1999	-8.7	-2.5	-13.5	5.4
Closing rate on 31.12.2000	2.2843	1.5305	262.3	2.4559
Closing rate on 31.12.1999	2.4230	1.4983	247.6	2.4114
% change 2000/1999	-5.7	2.2	5.9	1.8
High for the year	2.4761	1.5507	269.2	2.5782
	(Jan. 06)	(June 15)	(Feb. 23)	(Oct. 26)
Low for the year	2.1302	1.4479	229.2	2.3844
	(Oct. 26)	(May 04)	(Sept. 12)	(Jan. 05)

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

Chart 3.7
REAL AND NOMINAL EFFECTIVE EXCHANGE RATE INDICES FOR THE MALTESE LIRA
(1995 = 100)



of the euro against the US dollar and the consequent appreciation of the Maltese lira against the European currency. On the basis of exchange rate movements alone, the rise in the index has negative implications for Malta's external competitiveness - particularly in the tourism industry, where Malta is in direct competition with other Mediterranean countries, most of which are members of the euro area.

Meanwhile, as the Chart shows, the REER index, which apart from exchange rate movements takes account of relative inflation rates, followed a similar trend. Indeed, the rise in the REER index gathered further momentum in the course of the year, rising by 1.4%, compared to 0.9% recorded in 1999. Unlike the previous year, however, the rise in the REER index was almost wholly attributable to a similar movement in the NEER index, implying that during 2000 Malta's rate of inflation was more or less in line with that of its competitors.

4. Government Finance

The fiscal deficit at the end of the year 2000 has been provisionally estimated at Lm95 million, or 6% of GDP, implying a larger improvement than was originally anticipated. Moreover, further fiscal consolidation is projected for the current financial year, when the deficit is expected to narrow to Lm83 million. Thus it appears that the objective of bringing the deficit down to around 3-4% of GDP by the year 2004 is within reach and this should dampen pressures on prices and on the balance of payments.

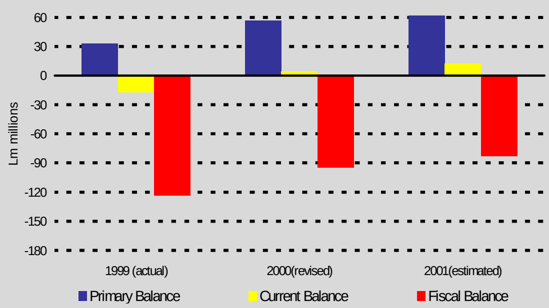
4.1 Fiscal Performance in 2000

The favourable outturn in Government's financial position during 2000 resulted from a substantial increase in revenue that outpaced expenditure growth. As can be seen from Chart 4.1, there was a marked improvement across all major public finance indicators during the year. Thus, the surplus on the primary balance, which is the difference between revenue and recurrent expenditure excluding interest payments, rose to Lm56.9 million from Lm32.7 million in 1999. As a result, the current balance, which includes interest payments, swung from a deficit of Lm17.3 million in 1999 to a surplus of Lm2.4 million. This implies that revenue was sufficient to cover all recurrent expenditure, including interest payments. In turn, the overall fiscal deficit narrowed by Lm28.4 million.

4.1.1 Revenue

Revenue expanded by Lm52 million to Lm556.6 million during the year, mainly as a result of higher direct taxation receipts. As Table 4.1 shows, revenue from income tax and social security contributions was up by Lm21.7 and Lm12.6 million, respectively, from the 1999 levels. The higher yield from income tax stemmed from two main factors: the revision in the income tax bands and a drive to improve efficiency in tax collection. The latter factor, in particular, was strengthened by the changes made in the provisional tax system applied to businesses and the self-employed, in addition to a drive to improve timeliness in tax payments. On the other hand, the increase in social security revenue was entirely attributable to the upward revision in the contribution rate.

Chart 4.1
PUBLIC FINANCE INDICATORS



Source: Ministry of Finance

The yield from indirect taxation also increased substantially during 2000, rising by Lm22.3 million to Lm230.6 million, mainly in the form of higher value added tax (VAT) receipts. The latter was in part attributable to the extension of the tax base to fuel and telephony services, though greater efficiency and improved managerial practices in the collection of the tax also contributed. On the other hand, the ongoing trade liberalisation process and the gradual dismantling of import levies had a negative effect on revenue from customs duties, though this was offset by higher revenue from motor vehicle licences and registration fees and duty on the registration of documents.

The moderate expansion in economic activity noted in Chapter 2 of this Report contributed further to the overall increase in tax revenues during the year.

Meanwhile, revenue from non-tax sources, at Lm67.3 million, was down by Lm4.6 million from the 1999 level, mainly as a result of a decline in the profits of the Central Bank.

4.1.2 Expenditure

Recurrent expenditure (excluding interest payments) amounted to Lm499.7 million in 2000, Lm27.8 million more than in 1999, with social security benefits and

Table 4.1
GOVERNMENT BUDGETARY OPERATIONS[1]

Lm millions

	1999	2000	2001	Change 2000	Change 2001
REVENUE	**504.6**	**556.6**	**610.1**	**52.0**	**53.5**
Direct tax	**224.4**	**258.7**	**284.8**	**34.3**	**26.1**
Income tax	128.3	150.0	163.2	21.7	13.2
Social security[2]	96.1	108.7	121.6	12.6	12.9
Indirect tax	**208.3**	**230.6**	**254.4**	**22.3**	**23.8**
Value Added Tax	85.0	105.0	116.0	20.0	11.0
Customs & excise tax	55.4	56.2	62.1	0.8	5.9
Licenses, taxes, fines	67.9	69.4	76.3	1.5	6.9
Total non-tax revenue	**71.9**	**67.3**	**70.9**	**-4.6**	**3.6**
Central Bank profits	30.1	27.1	27.0	-3.0	-0.1
Other revenue[3]	41.8	40.2	43.9	-1.6	3.7
TOTAL EXPENDITURE	**628.0**	**651.6**	**693.0**	**23.6**	**41.4**
Recurrent expenditure[4]	**471.9**	**499.7**	**543.5**	**27.8**	**43.8**
Social security[2,5]	200.7	209.9	226.0	9.1	16.2
Personal emoluments[6]	156.6	164.5	186.9	7.9	22.4
Contributions to entities[6]	30.0	30.3	33.5	0.3	3.2
Operational and maintenance[6]	39.6	46.2	41.0	6.7	-5.2
Other	45.0	48.9	56.1	3.8	7.2
PRIMARY BALANCE[7]	**32.7**	**56.9**	**66.6**	**24.2**	**9.7**
Interest payments	50.0	54.5	53.9	4.5	-0.6
CURRENT BALANCE[8]	**-17.3**	**2.4**	**12.7**	**19.7**	**10.3**
Capital expenditure	**106.1**	**97.4**	**95.6**	**-8.7**	**-1.8**
Asset formation	60.7	59.2	60.7	-1.5	1.5
Subventions	45.4	38.2	34.9	-7.2	-3.3
FISCAL BALANCE	**-123.4**	**-95.0**	**-82.9**	**28.4**	**12.1**
FISCAL DEFICIT/GDP(%)	**-8.5**	**-6.0**	**-5.1**		

[1] Data for 2000 are revised estimates, and for 2001 are estimates issued by the Ministry of Finance.
[2] Government contributions to the social security account are excluded from both revenue and expenditure.
[3] Excludes revenue from sale of shares and sinking funds of converted loans; includes EU funds.
[4] Excluding interest payments.
[5] Includes social security benefits, family and social welfare, care of the elderly, and treasury pensions.
[6] Excludes expenditure already included under Social Security.
[7] Revenue less recurrent expenditure (excluding interest payments).
[8] Revenue less total recurrent expenditure (including interest payments).

Source: Ministry of Finance

personal emoluments accounting for the greater part of the increase. In fact, expenditure on social security was up by Lm9.1 million, two-thirds of which was absorbed by retirement pensions, while expenditure on personal emoluments was up by Lm7.9 million. The latter reflected both salary increases and higher Government employment, mainly of school teachers. On the other hand, contributions to public entities were practically unchanged from the 1999 level, though higher outlays on health-related expenditure (under the heading of operational and maintenance expenses), and the one-off compensation payment for the removal of bread subsidies, also contributed to the year's expenditure growth.

Interest payments went up by Lm4.5 million to Lm54.5 million during 2000, absorbing almost 10% of overall recurrent expenditure. This reflected the successive budget deficits over the years, and the consequent build-up of public debt needed to finance them.

Capital expenditure dropped by Lm8.7 million to Lm97.4 million in 2000. The 1999 figure for capital expenditure, however, included expenditure on oil drilling, which was substantially higher than the expenditure on the construction of the new hospital incurred in the year under review.

4.2 Projected Fiscal Performance in 2001

The principal measure announced in the Budget for 2001 was the decision to enforce the provisions of the existing income tax law with regard to fringe benefits, thus effectively expanding the tax base. With this measure, as well as further efficiencies in tax collection, the fiscal deficit is expected to narrow further, to Lm83 million, as growth in revenue will again outweigh that in expenditure. The projected improvement in the fiscal position will, however, be smaller than that registered in 2000.[1]

Income tax is projected to yield Lm163.2 million, or Lm13.2 million more than in 2000, while an additional Lm12.9 million should come from social security contributions. At the same time, VAT is expected to yield a further Lm11 million, while an additional Lm12.8 million should come from customs and excise duties and from licences, other taxes and fines. The Central Bank is expected to pass on roughly the same amount of profits as in 2000, but funds from the EU should contribute an additional Lm4 million to non-tax revenue.

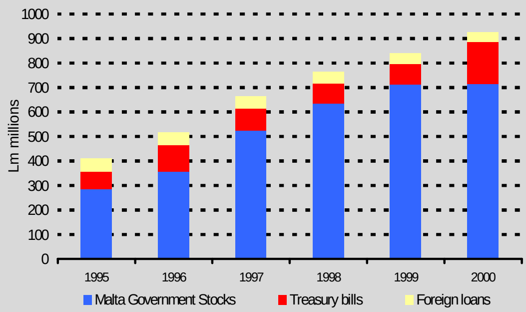
Recurrent expenditure (excluding interest payments) is projected to expand by nearly Lm44 million in 2001, with the main contributory factor being the new Civil Service collective agreement. As a result of this agreement, expenditure on personal emoluments will grow by Lm23 million. However, fewer families will be entitled to children's allowances, while the progressiveness of the tax system should dampen the overall impact of these expenditure increases on public finances. Contributions to entities, mainly the Government's contribution to Church schools, are projected to go up by Lm3.2 million, but interest payments are expected to decline marginally, reflecting the lower interest rates at which maturing stocks were rolled over in 2000. A marginal drop in capital expenditure is also anticipated, mainly on account of a reduction in subsidies to parastatal organisations.

The planned contraction in the fiscal deficit during 2001 is thus, to a large extent, expected to result form further efficiency gains in revenue collection, especially through curbing tax evasion and avoidance practices, together with a continued rationalisation of Government expenditure.

4.3 Government Debt and Financing Operations

During 2000 the fiscal deficit was largely financed by means of Treasury bill issues and the running

Chart 4.2
COMPOSITION OF GROSS PUBLIC DEBT



Source: Malta Stock Exchange, Central Bank of Malta

[1] For further details, refer to "The Budget Estimates for 2001: An overview of the Government's Budgetary Operations", Central Bank Of Malta *Quarterly Review*, December 2000.

Table 4.2
GOVERNMENT DEBT AND FINANCING OPERATIONS[1]

Lm millions

	1999	2000
FISCAL BALANCE	**-123.4**	**-95.0**
Financed by:[2]		
Local loans	78.8	0.5
Foreign loans	-2.1	-5.1
Grants	9.6	9.4
Proceeds from sale of assets	73.3	12.0
Sinking funds of converted loans	2.2	10.7
Increase in stock of Treasury bills outstanding	-0.4	89.7
Decrease in Government deposits	-51.0	41.5
GROSS PUBLIC DEBT	**839.9**	**925.0**
Malta Government Stocks	712.2	712.7
Treasury bills	83.3	173.0
Foreign loans	44.4	39.3

[1] Data for 2000 are estimates issued by the Ministry of Finance.
[2] Negative figures indicate an application of funds.
Source: Ministry of Finance

down of Government deposits with the banking system. While maturing Government stocks were rolled over, no new public issues of stocks were made. However, Lm0.5 million of stocks were created and issued directly to the Foundation for Church Schools. Revenue from the sale of assets was down to Lm12 million, representing the last instalment from the sale of Mid-Med Bank to HSBC, as no further asset sales took place during the year.

At the end of 2000, the Gross Public Debt stood at Lm925 million, up by Lm85.1 million from the end-1999 level. As can be seen from Chart 4.2, the outstanding balance of Malta Government Stocks at the end of the year was unchanged from the previous year's level. However, foreign loans outstanding were marginally lower, as Lm5.1 million were repaid in the course of the year. Meanwhile, the stock of Treasury bills outstanding increased significantly, reaching Lm173 million.

5. Monetary and Financial Developments

The annual rate of growth of broad money halved during 2000, as domestic credit expanded at a slower pace and balance of payments outflows dampened growth in the net foreign assets of the banking system. The slowdown in monetary expansion also reflected the increasing popularity of alternatives to monetary assets – such as units in local collective investment schemes and foreign portfolio investments – as well as the development of the capital market as a source of long-term finance for the private sector.

As the Central Bank left official interest rates unchanged throughout the year, money market interest rates remained stable. Long-term Government bond yields rose, however. Meanwhile, equity prices, which had risen sharply in 1999, peaked in January but declined almost continuously thereafter, ending the year marginally above the end-1999 level.

5.1 The Monetary Base

The monetary base, M0, which is made up of currency in issue and banks' deposits with the Central Bank[1], expanded at a slower pace during 2000, increasing by Lm21.2 million, or 3.9%, compared with 7.3% in 1999. As Table 5.1 shows, banks' deposits with the Central Bank accounted for most of the increase in M0.

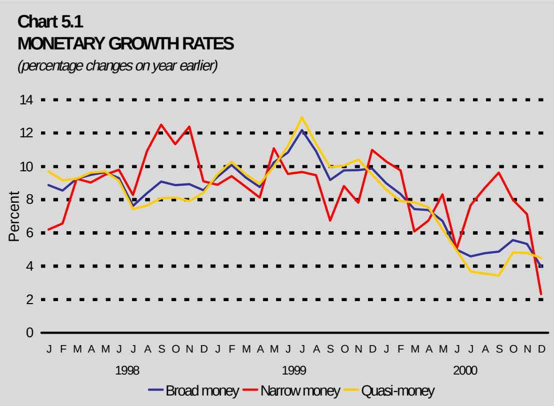
Apart from showing the components of M0, Table 5.1 also shows the Bank's assets and remaining liabilities, movements in which are the sources of changes in the monetary base. *Ceteris paribus*, an increase in the Bank's assets leads to a corresponding rise in the monetary base whereas an increase in the Bank's remaining liabilities causes it to contract. During 2000 growth in the monetary base was driven largely by an increase in the Central Bank's "fixed and other assets", which expanded by Lm62.3 million as the Bank injected liquidity into the banking system through repos. The expansion in M0 during the year also reflected a drop in Government deposits with the Central Bank. In contrast, a sharp drop in the Bank's external reserves, which shrank by Lm96.2 million, dampened M0 growth. As a result of the reserve loss and the increase in the monetary base, the ratio between the

Table 5.1
THE MONETARY BASE AND ITS SOURCES

Lm millions

	1999	2000	Change
Currency in issue	418.5	423.2	4.7
Banks' deposits	124.8	141.3	16.5
Monetary base	**543.3**	**564.5**	**21.2**
Central Bank assets			
Foreign assets	740.3	644.1	-96.2
Claims on Government	6.2	9.2	3.0
Fixed and other assets	72.1	134.4	62.3
Less:			
Remaining liabilities			
Private sector deposits	6.0	4.0	-2.1
SDR allocations	6.4	6.4	0.0
Government deposits	96.2	56.2	-40.0
Capital and reserves	89.1	89.1	0.0
Other liabilities	77.6	67.6	-10.0

[1] Excluding term deposits.



two dropped from 136% in December 1999 to 114% a year later.

5.2 Monetary Aggregates

Broad money, or M3, which consists of currency in circulation and residents' deposits with the banking system, expanded by Lm97.1 million to Lm2,538.9 million during 2000. As this was less than half the increase recorded in 1999, the annual growth rate of M3 dropped from 9.9% to 4%, its lowest level in a decade. Monetary growth decelerated steadily through most of the year, as Chart 5.1 shows, reaching a temporary low of 4.6% in July and recovering to 5.6% in October before dropping in the final two months of the year.

Although deposits denominated in Maltese liri accounted for most of the increase in M3, foreign currency deposits expanded at a faster pace, possibly reflecting the liberalisation of exchange controls and higher interest rates on foreign currencies. Thus, the foreign currency components of M3 added Lm18.2 million, or 8.8%, during 2000, compared with 7.5% the year before.

Narrow money, M1, which consists of currency in circulation and demand deposits, contributed only marginally to broad money growth during the year. In contrast with the vigorous growth of the previous two years, M1 rose by just 2.3% to Lm594.7 million, as Table 5.2 shows. Narrow money growth fluctuated widely during the year, dropping to 5% in June, recovering to a peak of 9.6% in September, and falling again during the last quarter.

Currency in circulation accounted for most of the increase in narrow money, rising by Lm11.7 million, or 3%, during 2000. Demand for cash eased during the first quarter as the public ran down currency holdings that had been built up during the final quarter of 1999 in anticipation of the millennium changeover. But currency in circulation recovered in the second

Table 5.2
MONETARY AGGREGATES

Lm millions

	1998		1999		2000	
	Amount	% Change	Amount	% Change	Amount	% Change
Broad money	**2,222.6**	**8.6**	**2,441.8**	**9.9**	**2,538.9**	**4.0**
of which:						
Narrow money	**523.6**	**9.1**	**581.1**	**11.0**	**594.7**	**2.3**
Currency in circulation	369.5	1.6	384.6	4.1	396.3	3.0
Demand deposits	154.1	32.7	196.6	27.5	198.4	0.9
Quasi-money	**1,699.0**	**8.4**	**1,860.7**	**9.5**	**1,944.2**	**4.5**
Savings deposits	585.1	1.9	637.4	8.9	629.4	-1.3
Time deposits	1,113.8	12.2	1,223.3	9.8	1,314.8	7.5
Foreign currency components of broad money[1]	**192.2**	**5.2**	**206.6**	**7.5**	**224.7**	**8.8**
Demand	8.9	20.4	10.4	17.0	9.5	-9.5
Savings	107.3	-3.8	122.6	14.3	123.1	0.3
Time	76.0	19.3	73.5	-3.3	92.2	25.5

[1] Including external Maltese lira deposits.

quarter and continued to expand moderately afterwards.

In contrast with the double-digit growth rates that were registered during the previous three years, demand deposits rose marginally during 2000, adding a mere Lm1.8 million, or 0.9%. Corporate current accounts, in particular, put on less than Lm1 million, after having risen by Lm33.6 million during 1999. Similarly, the increase in personal demand deposits, at Lm3.5 million, was around a quarter of the rise recorded during 1999.

Quasi-money, which is the sum of savings and time deposits, accounted for almost the year's entire M3 growth, rising by Lm83.6 million to Lm1,944.2 million. Nevertheless, the annual rate of growth of quasi-money shed five percentage points, dropping to 4.5% in 2000. After relatively strong growth during the first quarter, quasi-money expanded moderately during the second. It then contracted during the third quarter, with the annual growth rate hitting the year's low at 3.4% in September. In the final quarter, however, quasi-money recovered strongly.

For the first time in ten years, savings deposits decreased, contracting by 1.3%, as Table 5.2 shows. In part, a drop in deposit rates, which may have led investors to seek alternative financial products, could have prompted the decline. In fact, savings deposits fell especially sharply in May and September, when both the Government and the private sector issued bonds on the primary market. In addition, during the year, bearer savings deposits were almost completely phased out, with some account holders choosing not to renew them as named savings accounts. Thus, personal savings deposits expanded at less than half the pace recorded during 1999. Moreover, whereas corporate deposits had risen by 32.1% in 1999, they fell by 6.4% during the year reviewed.

Although time deposits again accounted for most of the increase in M3 during 2000, the trend decline in their annual rate of growth persisted. Thus, as Table 5.2 shows, they expanded by 7.5%, compared with 9.8% and 12.2% during the previous two years, respectively. Deposits with a term to maturity below one year expanded rapidly, as in 1999, and accounted for most of the increase in time deposits. In contrast, deposits with a term to maturity greater than one year contracted. Households' deposits, which expanded by Lm83.2 million, grew more rapidly than they had done in 1999, but corporate time deposits, which had nearly doubled in 1999, fell slightly.

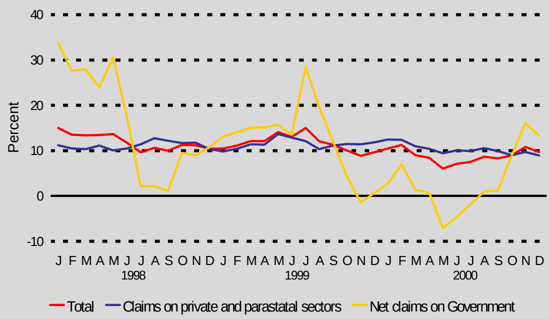
5.3 Determinants of Monetary Growth

Monetary expansion in 2000 was driven mainly by growth in domestic credit, although the net foreign assets of the banking system also contributed marginally. At the same time, an increase in the net non-monetary liabilities of the banking system dampened broad money growth. Both claims on the private and parastatal sectors and the banking system's net foreign assets expanded at a slower pace than in 1999, while the net non-monetary liabilities of the banking system grew more strongly. As Table 5.3 shows, these factors outweighed the pick-up in net claims on Government, causing the pace of broad money growth to slow down sharply.

Domestic credit increased by Lm193.3 million to Lm2,184.2 million in 2000. Although the annual growth rate, at 9.7%, remained broadly on a par with that recorded in 1999, it dipped below those registered during most of the 1990s. After accelerating at the beginning of the year, the annual rate of credit growth retreated to 6% in May, as Chart 5.2 indicates, before gathering pace in the following months.

Despite a further reduction in the fiscal deficit, and in the absence of major privatisation receipts, the Government financed a significant proportion of its

Chart 5.2
DOMESTIC CREDIT
(percentage changes on year earlier)



borrowing needs from the banking system. Thus, net claims on Government, which had risen by just Lm2.1 million in 1999, increased by Lm47.6 million, or 13.3%, during the year reviewed. Net claims on Government fluctuated widely during the year, with the annual growth rate dropping to -7.1% in May, before accelerating sharply in the second half of the year, as Chart 5.2 shows. Movements in Government deposits with the Central Bank largely accounted for these fluctuations and explain almost all the increase in net claims on Government during the year. At the same time, a drop in the deposit money banks' holdings of Malta Government stocks almost completely offset growth in their Treasury bill portfolio.

Claims on the private and parastatal sectors, which rose by Lm145.7 million to Lm1,778.5 million, accounted for three quarters of the increase in domestic credit during the year. Nevertheless, after having picked up during 1999, the annual growth rate of claims on these sectors shed three percentage points to end the year at 8.9%, its smallest annual percentage rise in ten years. The slowdown in these claims, which occurred in spite of a small drop in retail lending rates during the year, reflected loan repayments and write-offs in respect of credit to State-owned enterprises, private firms' issues of long-term debt securities to raise funds and, possibly, a more cautious bank lending policy. As Table 5.4 shows, the annual rate of growth of claims on the private sector dropped to 11.6% in 2000, while claims on the parastatal sector, which had expanded by 9% in 1999, contracted by 5.1%.

Loans and advances, including discounted bills, account for over 90% of the banks' claims on the private and parastatal sectors. After having accelerated during 1999, credit expanded less rapidly

Table 5.3
BROAD MONEY AND ITS DETERMINANTS

Lm millions

	1998	1999	2000
Broad money	**2,222.6**	**2,441.8**	**2,538.9**
Domestic credit	**1,815.8**	**1,991.0**	**2,184.2**
Net claims on Government	356.0	358.1	405.7
Claims on private and parastatal sectors	1,459.8	1,632.9	1,778.5
Net foreign assets	**878.4**	**969.2**	**974.8**
Monetary Authorities	640.0	740.3	644.2
All banking institutions	238.4	228.8	330.7
less:			
Other items (net)	**471.7**	**518.3**	**620.2**
SOURCES OF MONETARY GROWTH[1]			
Domestic credit	**8.4**	**7.9**	**7.9**
Net claims on Government	1.7	0.1	1.9
Claims on private and parastatal sectors	6.7	7.8	6.0
Net foreign assets	**6.5**	**4.1**	**0.2**
Monetary Authorities	3.8	4.5	-3.9
All banking institutions	2.7	-0.4	4.2
less:			
Other items (net)	**6.3**	**2.1**	**4.2**
Broad money	**8.6**	**9.9**	**4.0**

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

in 2000, increasing by Lm124.7 million, or 8%. In contrast, banks' holdings of corporate securities went up by almost one third to Lm91 million.

In line with the overall trend, credit to most categories of borrower decelerated during the year. However, the breakdown of credit given in Table 5.4 should be interpreted cautiously in the light of an ongoing reclassification exercise. Thus, for example, the reported rapid growth in lending to agriculture and fisheries and to the "transport, storage and communications" sector – as well as the slowdown in credit to the "other services sector"– are largely due to this factor.

Following two years of rapid growth, the net foreign assets of the banking system rose by only 0.6% during 2000, reaching Lm974.8 million, as Table 5.3 shows[2]. The annual growth rate, which is illustrated in Chart 5.3, peaked in April and declined during the second half of the year. The deceleration partly reflected balance of payments developments, but was also influenced by a base effect: during 1999, privatisation receipts had boosted the Central Bank's external reserves and, hence, the net foreign assets of the entire banking system.

The net foreign assets of the Monetary Authorities dropped by Lm96.2 million during the year, mainly because of net sales of foreign exchange to the banking system and payments for fuel imports. The decline continued through most of the year, as Chart 5.3 suggests, with the annual growth rate swinging

Table 5.4
CLAIMS ON PRIVATE AND PARASTATAL SECTORS [1]

Lm millions

	1999			2000		
	Amount	Annual Growth (%)		Amount	Annual Growth (%)	
Claims on the private sector	1,367.8	12.4		1,526.9	11.6	
Claims on the parastatal sector	265.1	9.0		251.6	-5.1	
TOTAL	**1,632.9**	**11.9**		**1,778.5**	**8.9**	
LOANS AND ADVANCES[2]	Amount	Annual Growth (%)	Share of Total (%)	Amount	Annual Growth (%)	Share of Total (%)
Energy and water	108.9	1.9	7.0	104.7	-3.9	6.2
Agriculture and fisheries	10.8	-3.1	0.7	19.0	76.7	1.1
Manufacturing, shiprepair/building	205.0	0.2	13.1	203.4	-0.8	12.1
Building and construction	96.9	17.3	6.2	99.3	2.5	5.9
Hotel, restaurant and tourist trades	222.0	16.3	14.2	237.5	7.0	14.1
Wholesale and retail	275.7	10.0	17.6	292.2	6.0	17.3
Personal	342.6	17.3	21.9	386.2	12.7	22.9
Transport, storage and communications	81.1	-4.2	5.2	96.8	19.4	5.7
Other services	81.6	30.2	5.2	82.8	1.4	4.9
All other	138.3	7.6	8.8	165.6	19.7	9.8
TOTAL LOANS AND ADVANCES[3]	**1,562.8**	**10.5**	**100.0**	**1,687.5**	**8.0**	**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. Inter-bank claims are excluded.

[2] Data on the breakdown of loans and advances for 2000 are provisional due to an ongoing reclassification exercise.

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

[2] Data on the net foreign assets of the banking system were revised to conform fully to accruals-based accounting principles and international statistical standards.

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

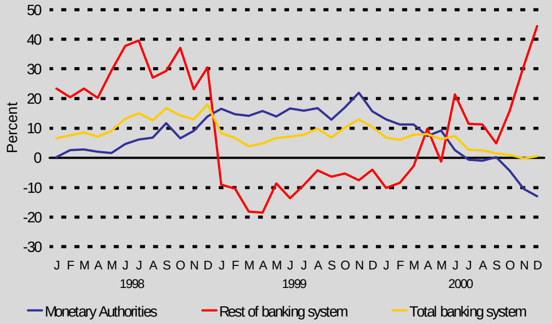
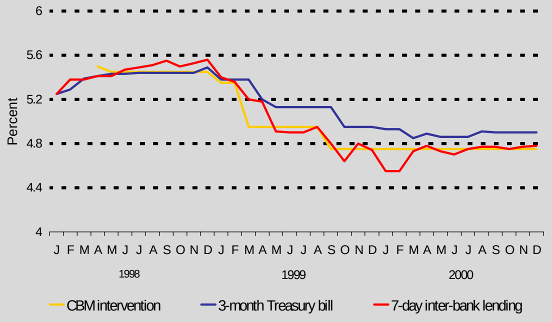


Chart 5.4
MONEY MARKET INTEREST RATES
(end of month)



from 15.7% at the end of December 1999 to -13% a year later.

In contrast, the net foreign assets of the rest of the banking system, which had dropped by 4% during 1999, expanded by Lm101.8 million, or 44.5%, during the year reviewed[3]. The banks' net foreign assets fluctuated widely during the year, as Chart 5.3 suggests, falling during the first and third quarters, but rebounding strongly during the second and the fourth quarters of the year. The net foreign assets of the domestic banks, which more than doubled, accounted for most of the annual increase. They added Lm70.8 million as the two major banks, in response to higher short-term interest rates abroad, rebuilt foreign asset portfolios that had been run down during the previous two years. At the same time, the net foreign assets of the international banks continued to expand at a steady pace, rising by Lm31 million, or 17.9%.

The net non-monetary liabilities of the banking system, which are shown as "other items (net)" in Table 5.3, expanded considerably during the year, dampening monetary growth. This aggregate consists of the banks' non-monetary liabilities, such as capital and reserves, provisions and debentures issued, less their other assets, such as premises and equipment and equity investments in subsidiary banks. During 2000, other items (net) increased by 19.7% to Lm620.2 million, mainly because the deposit money banks added to their capital and reserves. Moreover, one bank issued bonds on two occasions during the year, boosting the non-monetary liabilities of the banking system.

5.4 The Money Market

Securities with terms to maturity of less than one year are traded in the money market. The Central Bank operates in this market to influence liquidity in the banking system and short-term interest rates. These operations are described elsewhere in this Report.

As official interest rates remained unchanged during 2000, money market rates remained stable during the year as Chart 5.4 shows. Apart from a temporary drop at the beginning of the year, the seven-day inter-bank lending rate hardly changed, ending the year at 4.78%, four basis points above the end-1999 value. Similarly, the primary market yield on three-month Treasury bills fluctuated minimally around 4.9% throughout the year.

In the inter-bank market turnover decreased markedly, dropping to Lm301.4 million from Lm954.8 million in 1999. The increased use by the banks of repos with the Central Bank to obtain short-term finance may have contributed to lessen activity in this market.

Since the Government switched to the money market to finance its borrowing needs during 2000, the cumulative value of Treasury bills issued rose to Lm431.5 million from Lm363.9 million during 1999. As a result, the amount of bills outstanding at the end of the year reached Lm173 million, up from Lm83.3 million in December 1999. The banks became more active in the primary Treasury bill market, subscribing to

[3] For the purposes of this analysis, domestic banks include the deposit money banks, the "other banking institutions", Bank of Valletta International and HSBC Overseas Bank (Malta). The last two banks are not included with international banks.

Table 5.5

ISSUES OF LONG-TERM DEBT SECURITIES

Lm millions

	1998	1999	2000
Government			
Total issues	158.5	125.6	87.0
Redemptions	48.5	46.8	86.5
Net issues	110.0	78.8	0.5
Corporate			
Total issues	-	17.0	65.3
Redemptions	-	3.0	-
Net issues	-	14.0	65.3
Total net issues	**110.0**	**92.8**	**65.8**

Note: 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.

Sources: Central Bank of Malta, The Treasury

64.1% of the amount issued, with other investors - including Malta Government Sinking Funds (MGSF) - taking up the remainder. Although the Treasury issued bills with terms to maturity ranging from one month to one year, most issues had a term to maturity of 91 days.

In spite of the increased activity on the primary market, secondary market trading in Treasury bills continued to contract. Total turnover decreased from Lm288.8 million during 1999 to Lm75.1 million during the year reviewed. The decline resulted mainly from a drop in the value of deals between the MGSF and the banks, which reflected the fact that the former participated in the primary market to a lesser extent than in 1999. Trading involving the Central Bank also decreased, dropping from Lm88.4 million in 1999 to Lm31.6 million.

5.5 The Capital Market

Net public issues of long-term debt securities continued to decline during 2000, as the Government did not resort to the capital market to raise fresh funds. The private sector, however, had recourse to the bond market to an unprecedented extent.

The Government launched two major bond issues during the year, one in May and the other in September. However, since both issues were intended to roll over maturing debt, net issues of long-term debt securities by the Government were minimal, as can be seen in Table 5.5. In May, the Government sold Lm58.5 million worth of stocks, with terms to maturity ranging between seven and fifteen years and coupon rates of up to 6.1%. In September, the Government issued a further Lm28 million worth of stocks, with terms of nine and fourteen years and coupon rates of 5.9%

Table 5.6

SECONDARY MARKET TRADING IN GOVERNMENT STOCKS

Lm millions

	1998	1999	2000
Purchases to CBM portfolio	8.0	3.8	7.7
Sales from CBM portfolio	63.8	16.9	4.2
Other deals[1]	40.2	29.9	49.4
Total	112.1	50.7	61.2

[1] Including deals effected by the CBM broker on behalf of Government Sinking Funds and Ecclesiastical Entities.

Sources: Central Bank of Malta, Malta Stock Exchange

Chart 5.5
GOVERNMENT BOND YIELDS
(end of month)

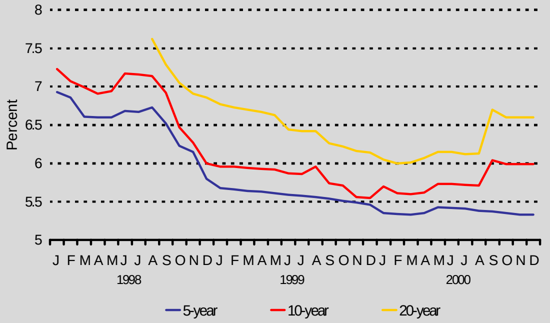
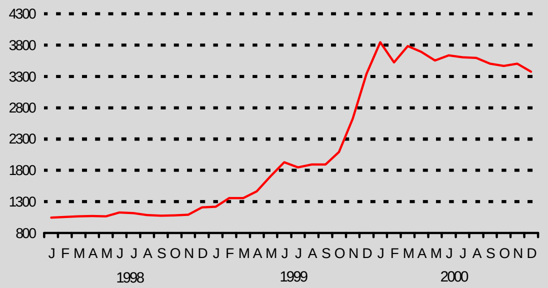


Chart 5.6
MALTA STOCK EXCHANGE SHARE INDEX
(end of month)



Source: Malta Stock Exchange

and 6.6%, respectively. Banks subscribed to around half the stocks issued during the year, with institutional investors and the general public taking up the remainder.

Net issues of corporate bonds rose almost five-fold to Lm65.3 million during the year. One bank tapped the capital market twice, issuing bonds denominated in Maltese liri and in US dollars worth approximately Lm26.3 million in aggregate. Three private firms also launched primary issues of bonds and convertible debt securities. Towards the end of the year, Malta Government Privatisation plc issued Lm10 million worth of convertible bonds that would eventually allow holders to switch into equity in privatised companies. No corporate bonds were redeemed during the year.

After having halved during 1999, secondary market trading in Government stocks recovered, rising by almost a quarter to Lm61.2 million, as Table 5.6 shows. Investor interest was relatively strong at the longer end of the market, with trading in the two stocks with a term to maturity of over fifteen years accounting for more than a third of the total. As the Table indicates, Central Bank participation in this market continued to decrease, with deals involving the Bank accounting for less than a quarter of the total turnover.

The greater variety of instruments available appears to have stimulated trading in the secondary corporate bond market. Turnover doubled to Lm4.6 million[4], with the 6.15% Bank of Valletta bond, issued earlier in the year, accounting for around half the activity.

The decline in long-term Government bond yields in evidence during the second half of 1998 and throughout 1999 was partially reversed in 2000. Thus, yields on Government bonds with terms to maturity above five years rose. For example, as Chart 5.5 shows, the yield on ten- and twenty-year Government bonds increased by almost half a percentage point each to 5.99% and 6.6%, respectively. In contrast, the yield on five-year Government bonds continued to fall, ending the year at 5.33%, or 13 basis points below its end-1999 level. Corporate bond yields generally rose during the year.

The private sector also raised capital through public share offerings during the year. Two companies, International Hotel Investments plc and Plaza Centres plc, which launched initial public offerings in the course of the year, were admitted to the Malta Stock Exchange's official list. Another company, Datatrak plc, was the first company admitted to the Exchange's Alternative Companies List.

Trading in equities on the Malta Stock Exchange dropped to Lm81.3 million, from Lm137.5 million in 1999, when the privatisation of Mid-Med Bank had resulted in a large number of shares changing hands. Maltacom and the two larger banks continued to be the most frequently traded equities, between them accounting for more than three quarters of the total turnover.

[4] Including preference shares.

The steep climb in equity prices witnessed in 1999 continued into the beginning of 2000, with the Malta Stock Exchange share index peaking at 4,013.37 in January. As Chart 5.6 shows, however, share prices gradually declined thereafter, with the Index closing on 3,375.72 in December, or 3% above its end-1999 close.

6. The Banking System

During 2000 more institutions resorted to the capital market to raise finance. In turn, savers channeled more of their funds into the domestic and foreign capital markets, in lieu of traditional bank deposits. This process of disintermediation moderated the expansion in the deposit money banks' balance sheet. The banks' profitability improved nevertheless as their gross income rose faster than their operating expenses and provision charges were slightly less than in the previous year. In turn, higher retained earnings strengthened the deposit money banks' capital base. Meanwhile, following the rapid expansion that took place in previous years, the international banking sector expanded at a slower pace. At the same time, the other banking institutions sector shrunk, as one such institution merged with its parent deposit money bank.

6.1 Deposit Money Banks' Balance Sheet

6.1.1 Liabilities

Growth in resident deposits with the deposit money banks slowed down considerably in 2000, and an increase of just Lm74 million was recorded, pushing the total to Lm2.1 billion. In fact, as can be seen from Chart 6.1, the net deposit gain was significantly smaller than any recorded in recent years, as savers channelled more of their savings into the domestic and foreign capital markets instead. Greater efficiency in tax collection was another likely factor behind the slowdown in deposit expansion. As Table 6.1 shows, at the end of the year Lm1.3 billion were held in time deposits, Lm0.6 billion in savings deposits and the remaining Lm0.2 billion in demand deposits.

Chart 6.1
ANNUAL CHANGES IN DEPOSIT MONEY BANKS' DEPOSITS

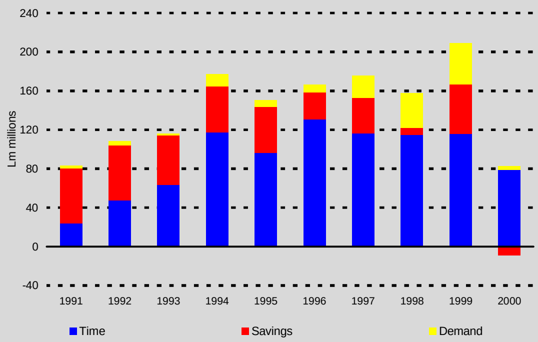
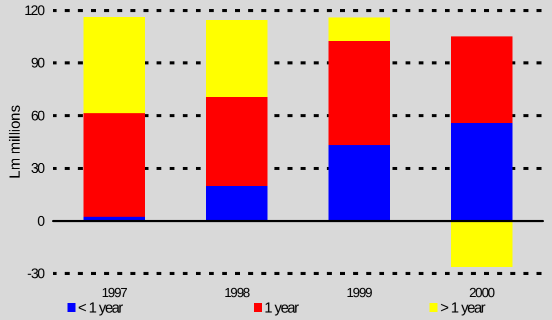


Table 6.1
DEPOSIT MONEY BANKS' BALANCE SHEET

Lm millions

	1999	2000	Change
ASSETS			
Cash and deposits with the Central Bank of Malta	170	153	-17
Foreign assets	615	730	115
Loans and advances	1,464	1,608	144
Local investments	574	601	27
Fixed and other assets	169	151	-18
LIABILITIES			
Capital and reserves	127	158	32
Foreign liabilities	356	405	48
Other domestic liabilities	470	567	97
Deposits	2,039	2,113	74
Time	1,218	1,297	79
Savings	633	624	-9
Demand	189	192	4
AGGREGATE BALANCE SHEET	2,992	3,243	251

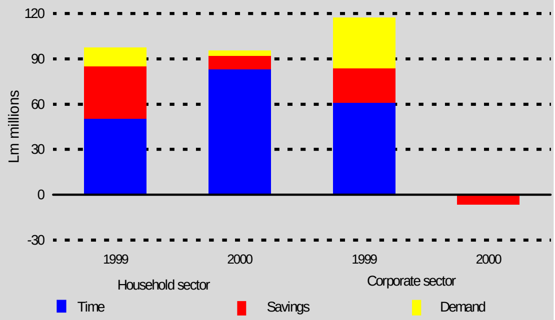
Chart 6.2
ANNUAL CHANGES IN DEPOSIT MONEY BANKS' TIME DEPOSITS BY MATURITY



The slowdown in growth was evident across all deposit categories. Thus, time deposits were up by Lm79 million, compared to the average yearly increase of Lm115 million recorded between 1997 and 1999. Deposits with a maturity of less than one year were the prime source of growth in this category during the year under review. In fact, as can be seen from Chart 6.2, these grew by a larger amount than in 1999, compensating for the smaller increase in one-year deposits. However, deposits with a term to maturity of more than one year actually dropped, causing the observed slowdown. Investors clearly sought other investment outlets, yielding potentially higher returns. This factor also exerted a negative impact on savings deposits, which, in contrast with previous years, declined, as Chart 6.1 shows. At the same time, demand deposits increased by just Lm4 million. A sustained liquidity build up was noted earlier in the year, but this was almost completely reversed in the fourth quarter.

As at year end, the personal and corporate sectors held approximately 97% of total resident deposits with the deposit money banks. As Chart 6.3 shows, the overall increase in households' deposits during 2000

Chart 6.3
ANNUAL CHANGES IN DEPOSIT MONEY BANKS' TIME DEPOSITS BY OWNERSHIP AND CATEGORY



was comparable to the previous year's, but the composition was different, with a much larger proportion of funds being added to time deposits than to savings and demand deposits. Meanwhile, corporate sector deposits contracted during the year.

During the year under review, bearer deposits, which stood at around Lm25 million at the beginning of the year, were phased out. Hence, the above changes may to some extent reflect a shift out of bearer accounts into named deposits.

During 2000, the deposit money banks obtained an additional Lm48 million from foreign sources. Hence, their foreign liabilities rose to Lm405 million, though the share of such liabilities in the total remained stable at 12%. A higher volume of foreign repos accounted for almost half the year's increase in the banks' foreign liabilities, with a wider non-resident deposit base accounting for the remainder. Borrowings from foreign banks were practically unchanged from the previous year's level.

Other domestic liabilities expanded by Lm97 million during 2000, ending the year at Lm567 million. Part of this increase resulted from the issue of bonds by a major bank. Additional funds were also obtained through repos conducted with the Central Bank. Other increases were attributable to the higher balance in provisions for bad and doubtful debts plus an increase in the banks' revaluation reserves. These were, however, partly offset by a reduction in interbank deposits. On the other hand, the banks' retained profits for the year, which were boosted by the one-off transfer of past profits from an international subsidiary to its parent bank, raised the deposit money banks' capital and reserves to Lm158 million.

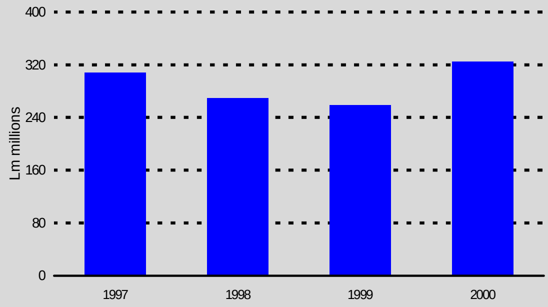
6.1.2 Assets

In 2000 the deposit money banks' loans and advances rose by Lm144 million, taking the outstanding balance on their loan portfolio to Lm1.6 billion, or half their total assets. This increase was comparable to that reported in the previous year, in spite of the underlying slowdown in domestic credit expansion[1]. In fact, credit to the public sector contracted, due to some loan repayments, while lending to the private sector advanced at a slower pace. However, interbank credit, which had fallen in 1999, expanded during the year under review.

In view of generally higher interest rates abroad, the deposit money banks channelled more of their funds into foreign securities. As a result, the banks' foreign assets rose by Lm115 million to Lm730 million, and accounted for 22.5% of total assets, an increase of 2 percentage points over the previous year. This increase in foreign assets was double that recorded in foreign liabilities. In fact, as can be seen from Chart 6.4, the banks, rebuilt their net foreign asset[2] position in 2000, reversing the earlier decline.

Meanwhile, the deposit money banks increased their local investments by only Lm27 million, a quarter of the addition recorded in the previous two years. In fact, Malta Government Stock[3] portfolio were reduced in search of higher yielding assets. Overall claims on Government, however, rose slightly as the banks' acquired a larger portfolio of Treasury bills. The banks also participated actively in the capital market issues that took place during the year, raising their holdings of securities issued by the private sector.

Chart 6.4
NET FOREIGN ASSETS OF DEPOSIT MONEY BANKS



The deposit money banks' holdings of cash and deposits with the Central Bank at the end of the year were Lm17 million below the previous year's level. This was largely due to a reversal of the build-up of liquidity in 1999 before the turn of the millenium as a precaution against a potential surge in the demand for cash. Banks also reduced their surplus reserves with the Central Bank, investing their funds in more

Table 6.2
DEPOSIT MONEY BANKS' INCOME AND EXPENDITURE STATEMENT

Lm millions

	1999	2000	Change
Interest income	170.1	185.8	15.7
Interest expenses	118.5	129.9	11.4
Net interest income	**51.6**	**55.9**	**4.3**
Fees and commissions	9.7	12.2	2.5
Foreign exchange gains	7.5	9.0	1.5
Other non-interest income	10.0	29.3	19.3
Non-interest income	**27.2**	**50.5**	**23.2**
GROSS INCOME	**78.8**	**106.4**	**27.5**
Wages	28.7	32.3	3.6
Other expenses	19.9	22.7	2.8
Operating expenses	**48.6**	**55.0**	**6.4**
Provisions	**11.8**	**11.3**	**-0.4**
PROFITS BEFORE TAX	**18.5**	**40.0**	**21.6**

[1] For further details, refer to the chapter on "Monetary and Financial Developments" in this Report.
[2] Foreign assets less foreign liabilities.
[3] The issues of Malta Government stocks during 2000 reflected simply a rollover of existing stocks, with the overall balance being kept unchanged. This limited the extent to which banks could increase their local investments.

profitable assets. **Fixed and other assets** were Lm18 million below the previous year's level, as interbank claims[4] declined.

6.2 Deposit Money Banks' Performance

6.2.1 Profitability

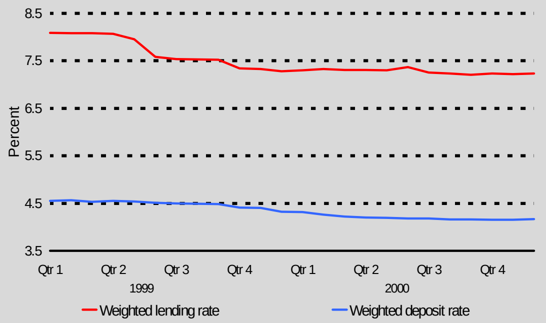
The deposit money banks registered aggregate **profits before tax** of Lm40 million in 2000. The latter were largely boosted by the one-off transfer of past profits from an international bank to its parent bank. Nevertheless, the banks' underlying performance improved, as their gross income rose faster than operating expenses whereas **provision charges** were marginally lower than in 1999.

As can be seen from Table 6.2 and Chart 6.5, the deposit money banks obtained almost Lm16 million more in interest income during 2000. This more than compensated for an additional Lm11.4 million incurred in interest expenses, pushing up the banks' **net interest income** by Lm4.3 million. At the same time, revenues from fees and commissions were Lm2.5 million higher. A further Lm1.5 million gain resulted from foreign exchange transactions. These increased revenues, together with the one-off profit transfer mentioned earlier, boosted the deposit money banks' **non-interest income** to Lm50.5 million. On the other hand, **operating expenses** were up by Lm6.4 million, of which, Lm3.6 million reflected a higher wage bill.

6.2.2 Interest Rates

As explained elsewhere in this Report, the Central Bank kept its central intervention rate unchanged throughout 2000. Hence, as can be seen from Chart 6.6, the deposit money banks' weighted-average deposit rate remained largely unchanged at around 4.2%. At the same time, the weighted-average lending rate was stable in the region of 7.3 %. Consequently, the interest rate margin, or the difference between lending and deposit rates, was unchanged at 3.1 percentage points.

Chart 6.6
INTEREST RATES ON LOANS AND DEPOSITS



6.2.3 Capital Adequacy

The deposit money banks' capital base strengthened further during 2000, with their aggregate **capital adequacy** ratio[5] rising from 11.5% to 13.1%, comfortably above the 8% statutory requirement. As Chart 6.7 shows, the 1.6 percentage point gain in the ratio resulted almost entirely from an increase in the banks own funds, largely reflecting higher retained earnings[6], that more than compensated for a larger amount of risk-weighted assets. In fact, the expansion in the banks' own funds pulled this ratio up by 3.3 percentage points and outweighed the effect,

Chart 6.5
DEPOSIT MONEY BANKS' PERFORMANCE

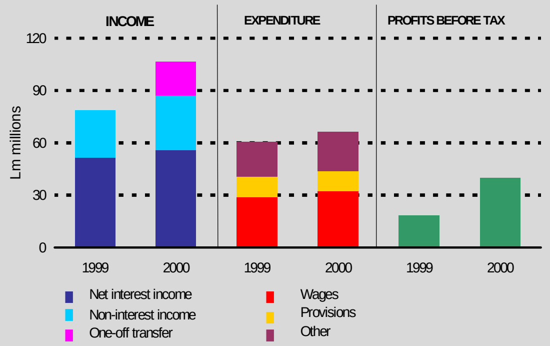
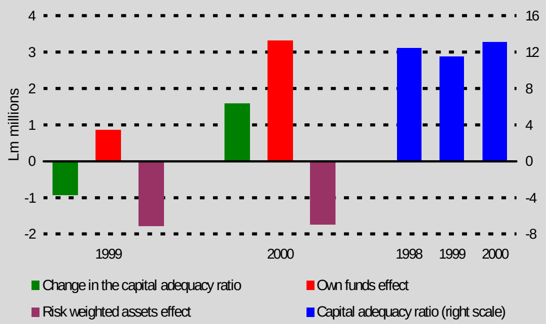
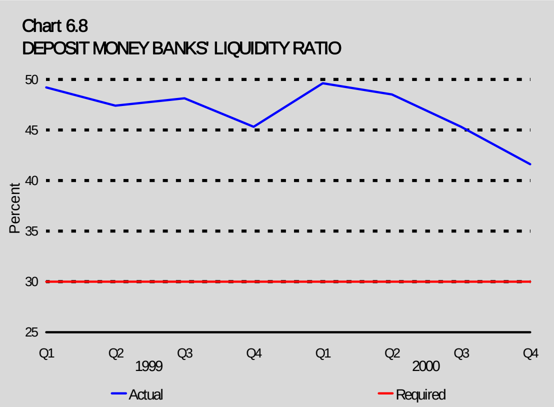
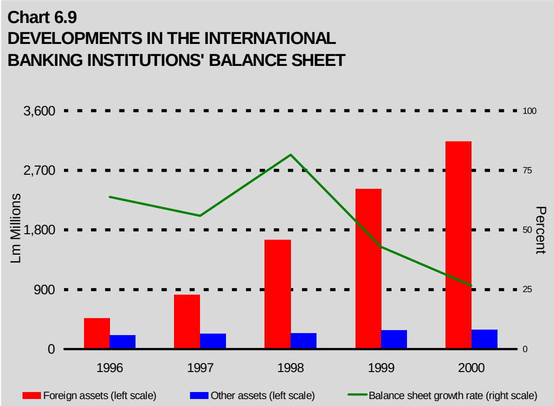


Chart 6.7
BREAKDOWN OF THE CHANGE IN THE CAPITAL ADEQUACY RATIO



4 As distinct from inter-bank credit.
5 This ratio compares the value of the banks' own funds to a measure of risk-weighted assets and off-balance sheet items.
6 This includes the one-off profit transfer mentioned earlier.





estimated at 1.7 percentage points, caused by the increase in risk-weighted assets.

6.2.4 Liquidity

At the end of 2000, the deposit money banks' net short-term liabilities showed an increase of Lm106 million. On the other hand, the banks reduced their overall liquid assets by Lm14 million during the year, running down excess reserves with the Central Bank as well as holdings of marketable debt securities. Hence, as Chart 6.8 shows, the banks' liquidity ratio, which compares their liquid assets to their net short term liabilities, dropped by almost 4 percentage points, to 41.6%. This was, however, still comfortably above the 30% statutory requirement.

6.3 International Banks

The international banking sector, which includes offshore banks and subsidiaries or branches of foreign banks, continued to expand during 2000, with its total assets surpassing Lm3.4 billion. Foreign assets, which make up approximately 92% of the international banks' balance sheet, continued to accumulate at a steady pace. However, as Chart 6.9 shows, the rate of growth in the international banks' balance sheet decelerated

Table 6.3
INTERNATIONAL BANKING INSTITUTIONS' BALANCE SHEET

Lm millions

	1999	2000	Change
ASSETS			
Cash and money at call	2	2	0
Foreign assets	**2,418**	**3,136**	718
Foreign securities	1,193	932	-260
Loans and advances to non-residents	815	1,221	405
Other foreign assets	410	983	573
Loans to residents	6	6	0
Local investments	261	268	7
Other domestic assets	17	11	-6
LIABILITIES			
Capital and reserves	189	194	6
Foreign liabilities	**2,454**	**3,137**	683
Balances due to other banks abroad	1,121	874	-247
Non-resident deposits	1,079	1,032	-48
Other foreign liabilities	254	1,231	977
Other domestic liabilities	39	59	20
Resident deposits	21	32	11
AGGREGATE BALANCE SHEET	2,703	3,423	720

Table 6.4
OTHER BANKING INSTITUTIONS' BALANCE SHEET

Lm millions

	1999	2000	Change
ASSETS			
Foreign assets	7	7	0
Claims on private and public sector	144	132	-12
Fixed and other assets	8	7	-1
LIABILITIES			
Capital and reserves	21	20	0
Debentures	60	60	0
Borrowing from banks	60	52	-8
Other liabilities	17	13	-5
BALANCE SHEET TOTAL	158	145	-13

further, after the rapid expansion that took place in previous years.

During the year the international banks added Lm718 million to their foreign asset portfolio. As can be seen from Table 6.3, foreign security holdings were scaled back, but this was more than offset by higher lending to non-residents and an increase in other foreign assets. In turn, local investments were up by Lm7 million, as the international subsidiaries of domestic banks held higher balances with their parent banks. In contrast, other domestic assets dropped by Lm6 million.

In line with the nature of their business, the international banks secured their funding requirements through an increase in foreign liabilities. These were up by Lm683 million at the end of the year, in spite of a drop in resident deposits and lower borrowings from banks abroad. On the other hand, deposits held by residents with these international banks, increased by Lm11 million. Other domestic liabilities also rose, by Lm20 million, mainly reflecting profits for the year. At the same time, the international banks added Lm5 million to their capital and reserves.

6.4 Other Banking Institutions

During 2000, Valletta Investment Bank, a subsidiary of Bank of Valletta plc, transferred its business to its parent bank. This impacted strongly on the developments in the other banking institutions' combined balance sheet. In fact, as Table 6.4 shows, total assets shrunk by Lm13 million. The parent deposit money bank absorbed the subsidiary's claims on the private sector[7], contributing to the observed drop. On the liabilities side, this produced a parallel fall in the value of outstanding borrowings from banks.

As a result of this development, the number of reporting institutions within the other banking institutions' category dropped to three as at year end. These were a credit institution specializing in housing finance and an investment bank, both subsidiaries of HSBC Bank Malta plc, plus another small financial institution.

[7] This did not have a significant impact on the balance sheet of the parent deposit money bank as it mainly led to a reclassification from claims on a subsidiary to claims on the private sector.

Part II

CENTRAL BANK POLICIES,

OPERATIONS AND ACTIVITIES

1. Monetary and Exchange Rate Policy

1.1 Policy Overview

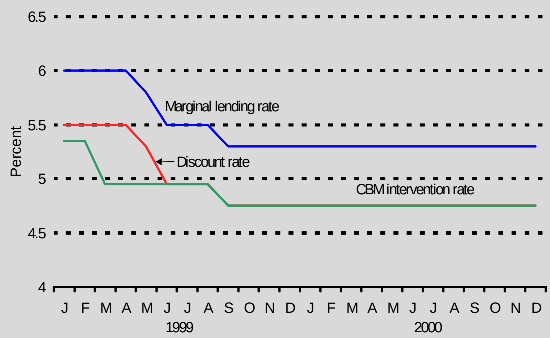
The Central Bank is responsible for the conduct of monetary policy in Malta. It also plays an important role in the formulation of exchange rate policy, which is the joint responsibility of the Bank and the Government. According to the Central Bank of Malta Act, the Bank is responsible for promoting the "orderly and balanced economic development of Malta and a rising level of employment and income consistent with the maintenance of monetary stability in Malta and the external value of the currency".

The Bank interprets this responsibility as a mandate to pursue price stability as its primary policy goal. In fact, this mandate will be more clearly expressed in proposed amendments to the Central Bank of Malta Act. In the long term, price stability promotes balanced economic growth and sustainable increases in employment and incomes. It is an essential prerequisite for preserving the external value of the currency. The alternative, which is to allow inflation to accelerate, may deliver short-term gains in incomes and employment, but would erode competitiveness, jeopardising the external value of the currency and threatening employment and income in the longer term.

The Bank seeks to achieve price stability by keeping the Maltese lira pegged to a basket of three currencies - the euro, the US dollar and sterling - with shares that broadly reflect Malta's external trading patterns. By pegging the external value of the Maltese lira to currencies of low-inflation countries, the Bank limits imported inflation, which is an important concern in a small, open economy. The exchange rate peg thus acts as a nominal anchor for domestic inflation, restraining growth in domestic prices and wages.

The Bank's Monetary Policy Council sets the stance of monetary policy to support the exchange rate peg. The Council, which is chaired by the Governor and is made up of the other members of the Board and three senior Bank officials, generally meets once a month. After a wide ranging analysis of recent economic and financial developments and future prospects in Malta and abroad, the Council decides on the appropriate level of official interest rates. The Council decided to leave official interest rates unchanged during 2000. Therefore, both the Bank's central intervention rate and the discount rate remained at 4.75% throughout the year, as Chart 1.1 indicates.

Chart 1.1
TRENDS IN OFFICIAL INTEREST RATES



In April the Bank removed restrictions setting the maximum rate of interest that banks could charge on loans for residential housing. As a result, the gradual process of interest rate liberalisation in the banking sector, which began in the mid-1990s, was completed. The removal of this last restriction had no significant effect on bank lending rates, with banks responding by offering new house finance products.

1.2 Tools of Monetary Policy

The Central Bank uses a number of tools to maintain the exchange rate peg. First, it keeps the exchange rate at the desired level by buying or selling foreign exchange according to market conditions. For example, if demand for foreign exchange falls, the Bank buys foreign currency, adding to its reserves and preventing an appreciation of the Maltese lira. Conversely, when the demand for foreign exchange rises, putting downward pressures on the Maltese lira, the Bank sells foreign exchange from its reserves to support the exchange rate.

Second, the Bank may adjust official interest rates to dampen upward or downward pressures on the exchange rate. Changes in official interest rates influence money market rates, capital market yields and retail bank deposit and lending rates. Higher interest rates make Maltese financial assets more attractive and, in time, dampen domestic demand, countering downward pressure on the Maltese lira. In contrast, lower interest rates stimulate demand and make foreign assets more attractive. Under a fixed exchange rate regime, to the extent that capital is free to flow across borders, domestic interest rates must move closely in line with those abroad. In Malta, however, the remaining exchange controls still give the Bank some latitude in setting official interest rates.

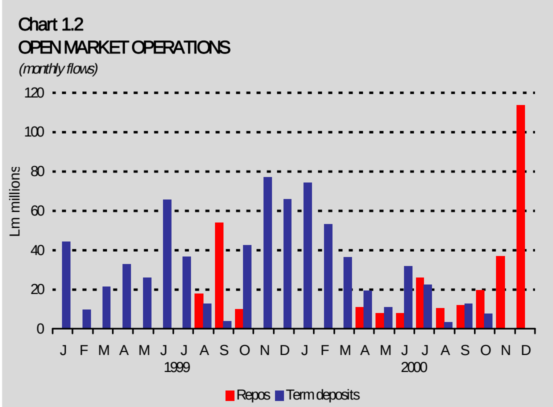
The Bank uses open market operations, that is, transactions in Government securities with the banks, to influence their liquidity and ensure that money market interest rates are consistent with the Bank's monetary policy stance. To limit the effects of fluctuations in the banks' liquidity on interest rates, the Bank also offers them lending and deposit facilities. Finally, banks are obliged to hold a proportion of their deposit liabilities as "required reserves" with the Central Bank. Reserve requirements reduce liquidity in the banking system and thus limit the potential for credit expansion in the economy.

1.2.1 *Foreign Exchange Market Intervention*

During 2000, the Bank was a net buyer of Maltese liri in the foreign exchange market, selling foreign exchange against the lira to meet demand. The Bank made net sales of foreign exchange worth Lm120.4 million to banks and financial institutions in the spot foreign exchange market. On the other hand, it bought Lm26.3 million worth of foreign currency as forward contracts matured. In addition, sales of foreign exchange in terms of forward contracts amounted to Lm0.4 million. No foreign exchange swaps against Maltese liri were carried out during the year.

1.2.2 *Open Market Operations*

As the Bank left both the discount rate and its central intervention rate unchanged during the year, interest rates applied in open market operations remained



stable in a narrow band around the central intervention rate. The Bank injected funds through repos at a constant rate of 4.8%, while the rate paid on term deposits rose marginally, from 4.7% in December 1999 to 4.72% a year later.

The Bank held auctions of deposits with a term to maturity of two weeks to absorb liquidity temporarily from the banking system, while it used repos, generally with the same term to maturity, to inject liquidity. Bilateral repos with different terms to maturity were also conducted. Liquidity in the banking system decreased as the year progressed. Therefore, as Chart 1.2 shows, whereas during the first half of the year the volume of funds absorbed from the banks exceeded the amount injected, this situation was reversed during the second half of the year. During the year as a whole, the Bank absorbed Lm271.6 million through term deposit auctions, down from Lm437.9 million during 1999. In contrast, the volume of funds injected into the banking system through repos tripled to Lm244.9 million.

1.2.3 *The Discount Window and Other Standing Facilities*

The Central Bank may also discount Treasury bills and other eligible securities to provide liquidity to the banking system. As in 1999, however, this facility was not used during 2000. Banks did, however, make use of the Central Bank's marginal lending facility, formerly known as the collateralised loan facility. Through this facility banks are allowed to take out overnight loans from the Central Bank secured by pledges of collateral. In July, this facility was streamlined, with the overnight interest rate being linked to the central intervention rate. The facility was used twice during the year, with a total of Lm0.9 million being lent. The overnight lending rate remained constant, at 5.3%, throughout the year.

The Bank also offered an overnight deposit facility, which was introduced in September 1999. Banks made ample use of this facility during 2000, placing an aggregate of Lm97.7 million in overnight deposits with the Central Bank. The rate of interest paid on these deposits was set at 1.8% throughout 2000.

1.2.4 Reserve Requirements

The framework governing reserve requirements remained unchanged during the year reviewed such that the banks were required to maintain reserve deposits with the Central Bank equivalent to 5% of their deposit liabilities. To allow for some flexibility, banks are allowed to meet their reserve requirements on an averaging basis: that is, they may go below the required level at times, provided the requirement is met on average during each maintenance period. The reserve requirement is calculated monthly, with the maintenance period running from the 15th day of each month to the 14th day of the following month. The Bank continued to pay interest at 2.7% per annum on required reserve deposits.

1.2.5 Administration of Exchange Controls

The Central Bank continued to administer exchange controls as agent of the Government in terms of the Exchange Control Act. However, in January responsibility for the approval of transactions related to direct investment by non-residents in locally registered companies was transferred to the Malta Financial Services Centre (MFSC). Moreover, authorised dealers, that is, banks and foreign exchange bureaux, were given authority to approve a wider range of payments on both the current and the capital accounts of the balance of payments.

In January, too, controls on current account transactions were liberalised further, with allowances for travel being raised and restrictions on payments of certain insurance premiums being lifted completely. At the same time, a variety of measures was introduced to remove restrictions on capital account transactions. These included the total liberalisation of direct investment abroad by residents, an increase in portfolio investment allowances and greater latitude in opening and operating bank accounts denominated in foreign currency[1].

As a result of these measures, many transactions between residents and non-residents no longer required the Central Bank's approval. Nevertheless,

Table 1.1
TRANSACTIONS NOTIFIED TO THE CENTRAL BANK IN TERMS OF THE EXCHANGE CONTROL ACT

Lm millions

	1999	2000
Cash gifts	6.4	7.1
Portfolio investments in foreign currency	18.2	46.0
Borrowing by local companies owned by non-residents		
From domestic banks	4.9	16.2
From foreign shareholders	3.7	0.9
Borrowing by resident companies from overseas lenders	39.7	8.0
Borrowing by resident persons from overseas lenders	0.4	0.1
Borrowing by non-residents from domestic banks	0.2	1.4

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 3 years require Central Bank approval.

[1] In a Press Release dated 22 December 1999, the Bank published a complete list of all the exchange control liberalisation measures that were to come into effect in January 2000.

authorised dealers continued to provide the Bank with regular returns on the transactions carried out. Details of these transactions, most of which are needed for the compilation of the balance of payments, are given in Table 1.1.

In the November Budget Statement for 2001, the Minister of Finance announced further steps to liberalise exchange controls that aimed at easing limits on current payments and at removing, or further relaxing, restrictions on capital payments. They included increased travel and portfolio investment allowances, the further relaxation of controls on residents' foreign currency deposits and the removal of certain restrictions on lending between residents and non-residents. These measures were due to enter into effect in January 2001.

1.3 External Reserves Management

The Central Bank of Malta Act obliges the Bank to hold external reserves in proportion to its currency and deposit liabilities. This proportion, which was set at 60% by the Minister of Finance in 1994, remained unchanged during the year under review.

In line with this legal requirement and in order to maintain the exchange rate peg, the Central Bank manages a portfolio of foreign assets. Part of this portfolio consists of liquid assets, which allow it to intervene in the domestic foreign exchange market – as described above – as well as to meet demand for foreign exchange from the Government, the banking system and other customers. The rest is invested to earn income, while keeping risks low.

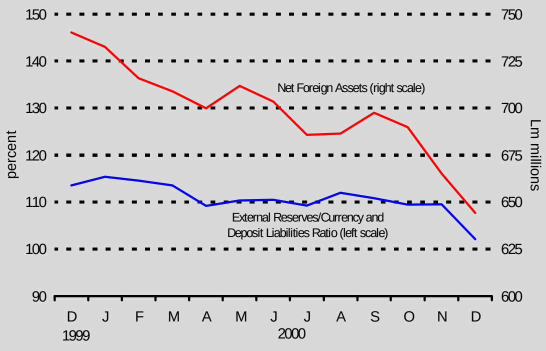
The Bank's Investments Policy Committee lays down the parameters governing the management of its external reserves. The Committee is chaired by the Governor and includes the Deputy Governor and other senior Bank officials. The Committee reviews the performance of the Bank's external portfolio, discusses investment policy and establishes guidelines for the Bank's dealers in the international markets. The Bank's foreign asset portfolio mainly consists of deposits with banks abroad and securities issued by non-residents. It also contains gold, Special Drawing Rights and claims on the International Monetary Fund. The Bank monitors and controls credit risks related to its dealings with foreign financial institutions and only holds claims on top-rated banks and issuers of securities.

Principally because of net sales of foreign exchange to banks and payments for fuel imports, the Bank's foreign asset holdings contracted during the year[2]. As Chart 1.3 shows, the Bank's external reserves dropped from Lm740.3 million at the end of December 1999 to Lm644.2 million a year later. As a result, the statutory ratio between the Bank's external reserves and its currency and deposit liabilities declined from 113.6% at the end of 1999 to 102.1%.

In the spot market, the Bank deals with banks and financial institutions in US dollars, euros and pounds sterling, generally in amounts exceeding Lm150,000. The Bank also deals in the forward market for foreign exchange. It publishes opening exchange rates daily and quotes real-time exchange rates throughout the day on Reuters. The Bank also trades in gold. During 2000 it sold 1,195 kilograms of gold grain, with a value of Lm4.8 million, to local manufacturers, up from just over Lm4 million worth a year before.

To gauge pressures on the external reserves, the Bank monitors movements in the banks' open foreign exchange positions daily. Furthermore, banks are asked to report on the value and economic purpose of foreign exchange transactions above a Lm10,000

Chart 1.3
THE CENTRAL BANK'S FOREIGN ASSETS



2 Movements in the reserves ultimately reflect developments in the balance of payments, which are discussed earlier in this Report.

threshold. Turnover in the domestic foreign exchange market reached Lm1,989 million in 2000, compared with Lm2,035 million a year before[3]. Inter-bank trading in foreign exchange was limited, with turnover dropping to Lm13.2 million from Lm29.6 million in 1999.

1.4 Money and Capital Markets

During the year reviewed, the Central Bank continued to withdraw from the primary market in Government securities. Thus, as in previous years, the Bank did not participate in the primary Treasury bill market. Moreover, for the first time, the Bank did not take part in the primary market for Government stocks either. Hence, amounts of stock that the Bank held were not rolled over upon maturity. However, the Bank continued to act as market maker in the secondary markets for Government securities, standing ready to buy and sell both Treasury bills and Government stocks as necessary. In this way, the Bank added to market liquidity, enhancing the attractiveness of these instruments to investors.

In the secondary market for Treasury bills, the Bank regularly quoted selling and buying rates for both retail and wholesale amounts, with yields related to official interest rates and primary market yields. Trading volume involving the Central Bank continued to fall, dropping by nearly two thirds in the context of an overall decline in secondary market activity. The fact that the Bank was using open market operations to inject funds into the banking system to a greater extent than in 1999 may have contributed to the lower turnover, as banks preferred not to sell Treasury bills to obtain liquidity. Thus, the Bank bought Lm19.7 million and sold Lm11.8 million worth of bills during the year. In contrast, during 1999, the Bank made purchases and sales of Lm44.3 million and Lm44.1 million, respectively.

The Bank's broker bought and sold Government stocks on the floor of the Malta Stock Exchange. Secondary market turnover in Government stocks involving the Bank also continued to decrease, falling to Lm11.9 million from Lm20.8 million in 1999. During the year, the Bank made net purchases on the secondary market, buying Lm7.7 million worth of stocks and selling Lm4.2 million. In contrast, during 1999, the Bank had made net sales, buying Lm3.8 million and selling Lm16.9 million, respectively.

In early 2000 the Bank set up a Financial Markets Committee to support the development of the domestic money and foreign exchange markets. The Committee, which is made up of representatives of the Central Bank and domestic credit institutions, formulated an agreement on value dating and compensation charges in the domestic inter-bank market. It also agreed that domestic market practitioners would generally follow the code of conduct drawn up by ACI, an international association of financial market practitioners.

1.5 Economic Information and Statistics

In order to enable the Central Bank to conduct its monetary policy effectively and to fulfil its statutory role as adviser to the Government on economic and financial matters, the Bank continued to monitor and analyse economic and financial developments both in Malta and abroad. Moreover, during 2000, the Bank continued to develop and enhance its statistical database so as to bring this up to international standards and enable it to meet the requirements of the European Central Bank (ECB) and Eurostat.

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

The Central Bank also keeps the general public informed on economic and financial developments in Malta through its regular publications – namely, its *Quarterly Review,* its *Annual Report* and the monthly

[3] Excluding inter-bank deals and deals involving the Central Bank.

Statistical Release on Monetary Aggregates and their Determinants (see Chapter 4 below). These publications, which are also posted on the Bank's Internet web-site, are all produced by the Bank's Economics Department.

The Central Bank regularly provides the Central Office of Statistics (COS) and the Government's Economic 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 Eurostat – as well as to international credit-rating agencies.

During 2000, 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, early in the year, the Bank started to submit data on a regular basis to Eurostat. In collaboration with the IMF, the Bank completed the necessary preparations so that Malta could start to participate in the Fund's General Data Dissemination System (GDDS). In fact, on September 11 the metadata for Malta were posted on the web-site of the Fund's Dissemination Standards Bulletin Board (DSBB). The Bank also compiled metadata about the compilation of statistics for the ECB, which will be publishing this information, alongside similar contributions by the other EU accession countries, in an appropriate manual.

Meanwhile, the Bank started to design a new set of statistical returns for banks licensed to operate in Malta so as to be able to meet ECB reporting requirements. In this respect, discussions with the banks were carried out through a specifically appointed Technical Committee on Financial Statistics. Similarly, the Bank, in collaboration with the COS, started to align its data collection system regarding the balance of payments and Malta's international investment position with EU standards.

To supplement the information gathered from 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*. The Bank continued to update and refine its econometric models of the Maltese economy. In this regard, an expert from the Italian central bank visited Malta to advise the Bank on econometric techniques.

During the year the Bank participated in a number of forums dealing with economic analysis and data compilation both in Malta and abroad. Staff members from the Economics Department sat on technical committees with personnel from the relevant Government departments or agencies working on statistics and welfare reform, as well as the potential impact on the economy of the acquisition of immovable property in Malta by non-residents. Moreover, the Bank and the COS started 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. Meanwhile, a representative from the Bank, in conjunction with officials from the Ministry of Finance, the Treasury and the COS, continued to form part of the Action Group on Government Finance Statistics. During 2000, the Action Group carried out preliminary work on amendments to the Government's Chart of Accounts so as to ensure that government finance statistics are classified in accordance with IMF and Eurostat standards.

2. Regulatory and Supervisory Activities

In terms of the Central Bank of Malta Act, the Bank is responsible for promoting a sound financial structure and fostering an orderly capital market in Malta. Moreover, as the Competent Authority in terms of the Banking Act, 1994 and the Financial Institutions Act, 1994, the Bank has the duty and authority to licence, regulate and supervise banks and financial institutions. Finally, in terms of the Malta Stock Exchange Act, the Bank is responsible for overseeing the affairs of the Exchange to ensure that the securities market is sound.

The Joint Banking Committee, which is set up in terms of the Banking Act, is responsible for formulating banking regulatory and supervisory policy and monitoring the soundness of the banking system. The Committee is chaired by the Governor and includes four other Central Bank officials, two representing the Bank as the Competent Authority and two by virtue of the Bank's functions in terms of the Central Bank of Malta Act. During 2000, the Committee met seven times and approved a number of amendments to Banking Directives and Financial Institutions Directives and the issue of Policy Papers.

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

In terms of mutual arrangements between the Austrian Supervisory Authorities and the Central Bank of Malta, representatives from the Federal Ministry of Finance and the National Bank of Austria visited the Central Bank to discuss matters related to the supervision of subsidiaries of Austrian banks in Malta. Due to the presence of Austrian and Turkish banks in Malta, the Bank continued to work to establish formal Memoranda of Understanding with the Austrian and Turkish regulatory authorities.

2.1 Policy Developments

During 2000, the Joint Banking Committee approved amendments to the Banking Directives on large exposures, solvency, own funds and statutory information. The Committee also approved a Financial Institutions Policy Document on lending, with particular emphasis on factoring and forfaiting.

During the year, the Bank commenced work on new Banking Directives on Loan Loss Provisioning and Consolidated Supervision. A Banking Notice on Credit Risk Management, which would replace the current Notice on provisioning, was also being drafted. After consultation with all interested parties, these documents are expected to be finalised in 2001.

The Bank also co-ordinated work on the setting up of a deposit protection scheme for Malta. In this regard, the Bank established a working group with representatives of the credit institutions.

Bank officials also contributed to the promotion of financial leasing activities through discussions with officials of the Inland Revenue Department and credit institutions with the aim of drafting the relevant tax regulations.

Towards the end of the year, the Bank formally established a Financial Stability Office to detect and limit risks to the overall stability of the local financial system. The Bank also carried out a preliminary self-assessment in relation to the *Core Principles Methodology for Banking Supervision* issued by the Basle Committee on Banking Supervision (see Chapter 5, below). This exercise is being updated following consultation with technical experts from the International Monetary Fund (IMF). The Bank will continue to co-ordinate efforts for Malta to undertake an assessment under the IMF Financial Sector Assessment Programme.

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]	HSBC Home Loans (Malta) Bank Ltd[7]
APS Bank Ltd[1]	Iktisat Bankasi AS[2,3]
Bank of Valletta plc[1,8]	Investkredit International Bank Malta Ltd[2,5]
Demirbank T.A.S.[2,3]	Izola Bank Ltd[2,6]
Disbank Malta Ltd[2,5]	Lombard Bank Malta plc[1]
EGS Bank[2,3]	Sparkasse Bank Malta plc[2,5]
Finansbank Malta Ltd[2,5]	Raiffeisen Malta Bank plc[2,5]
First International Merchant Bank Ltd[6]	Tekstil Bankasi AS[2,3]
HSBC Bank Malta plc[1,7]	Turkiye Garanti Bankasi AS[2,3]

Financial Institutions Licensed under the Financial Institutions Act (1994)

All Financial Services Ltd[4]	Fexco (Malta) Ltd[4]
Britannia Financial Services Ltd	HSBC Finance (Malta) Ltd[7]
ChangeMart Financial Services Ltd[4]	PDK Financial Services Ltd[4]
Collins Exchange Bureau Ltd[4]	Thomas Cook Financial Services Malta Ltd[4]
Cremona Exchange Bureau Ltd[4]	Valletta Investment Bank Ltd[8]
Eurochange Company 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)

Bank of Valletta International Ltd[2,8]	HSBC Overseas Bank (Malta) Ltd[2,7]
Erste Bank (Malta) Ltd[2,5]	Volksbank Malta Ltd[2,5]

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
8 Member of Bank of Valletta Group

2.2 Licensing of Credit and Financial Institutions

As the Competent Authority appointed in terms of the Banking Act and the Financial Institutions Act, the Bank is responsible for licensing credit and financial institutions. The licensing procedures that the Bank follows are based on international practices and are set out in Directives issued by the Bank in terms of the respective laws. Licensing policy remained unchanged during 2000. In order to obtain a licence, banks and financial institutions have to satisfy a number of requirements, including a minimum level of own funds.

During 2000, the Central Bank granted licences to three new credit institutions. In March, the Bank licensed Finansbank TAS, a Turkish bank, to establish a subsidiary to carry on the business of banking in foreign currency with non-residents. In November, the Bank granted a similar licence to Sparkasse Bank Malta plc, a subsidiary of Sparkasse Schwaz, an Austrian savings bank. In October, another Turkish bank, Akbank TAS was licensed to undertake banking business in foreign currency with non-residents through a locally established branch.

During the year, the conditions of the licence granted to a financial institution were amended to enable it to carry out wider cross-border payments and money transmission services. No licences were restricted or revoked during the year. In August, HSBC Bank plc

(UK) voluntarily surrendered its licence to operate its branch in Malta following the transfer of the business of the branch to HSBC Bank Malta plc. A list of credit and financial institutions that were licensed to operate in Malta at the end of the year under review is given in Box 2.

2.3 Supervision of Credit and Financial Institutions

As the Competent Authority appointed in terms of the Banking Act and the Financial Institutions Act, the Bank is responsible for ensuring that credit and financial institutions comply with the provisions of the relevant legislation and directives. Whenever an institution is found not to comply fully, steps are immediately taken to ensure that it does so within the shortest time possible.

A team of inspectors supervises banks and financial institutions. Supervision is carried out through a combination of on-site inspections, when inspectors visit the premises of licensed institutions, and off-site examinations, which involve the analysis of prudential reports and regulatory returns which are submitted to the Bank on a regular basis. Reports on the inspectors' findings are then issued to the managements of the respective institutions.

During 2000, the Bank's inspectors undertook 18 on-site examinations. The inspectors assessed credit risk and asset quality and verified compliance with regulations and guidance notes on the prevention of money laundering. They examined controls applied to limit market risks and assessed the overall risk management framework applied by the banks. They also carried out full reviews of financial institutions and examined compliance at branches of foreign-owned institutions. In the case of branches of foreign banks, however, the final responsibility for prudential supervision rests with the authorities in the country where the bank is incorporated.

Off-site examiners continuously monitored licensed institutions' activities by analysing the returns that banks and financial institutions have to submit to the Competent Authority. During 2000, the Bank began to receive new returns on banks' open foreign currency positions and introduced new reports to monitor their exposure to interest rate risk.

Supervisors focus especially on the quality of licensed institutions' risk management. To this end, the Bank also surveys the level of awareness of various risks facing credit institutions through occasional questionnaires. The work of both on-site and off-site examiners is brought together in an analysis of the whole risk profile of each institution. This analysis serves to identify areas that need to be examined further and to allocate supervisory resources accordingly.

Supervisors also maintain close relationships with the external auditors of credit and financial institutions. In particular, the Bank evaluates the external auditors' annual management letters and each institution's replies to them.

2.4 Combating Money Laundering

The Central Bank, together with the other regulators, is actively involved in the formulation and implementation of policies aimed at combating money laundering. The Bank participated in the process that led to the amendment of the Prevention of Money Laundering Regulations that came into force during 2000. It is also contributing to the establishment of a Financial Intelligence Unit, to be set up in accordance with internationally recognised standards. The Bank is co-ordinating a committee working on the amalgamation of Guidance Notes to the financial sector on the prevention of money laundering that had been issued by the Bank itself, the MFSC and the MSE. Furthermore, 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).

In line with international practice, to combat money laundering, the Bank instructed banks to stop offering bearer deposits as from the end of June 2000. In September, the Bank also issued a directive to all credit institutions to identify the ultimate beneficiary when undertaking transactions with companies which involve nominee shareholding.

2.5 Other Activities

At the beginning of the year, the Bank monitored the impact of the millennium date change on credit and financial institutions. The transition was smooth and all licence holders were found to have maintained the standards set by international banking regulators to deal with this event.

In terms of the Malta Stock Exchange Act, the Bank monitored the affairs of the MSE through meetings with senior officials of the Exchange itself.

In addition to the foregoing activities, the Bank undertook extensive work aimed at establishing the level of compliance of local legislation with the EU *Acquis*.

During the year, senior officials from the Bank participated in meetings called by the Commonwealth Secretariat (see Chapter 5 below). In June, a senior official of the Bank formed part of an expert working group within the Secretariat that drew up guidelines on corporate governance for the financial sector. These were later discussed at a two-day seminar organised by the Secretariat, in collaboration with the Malta Institute of Directors and the Central Bank, which was held in Malta. Subsequently, the Commonwealth Secretariat Working Group on Corporate Governance issued a paper on corporate governance within the financial sector.

3. Banking and Currency Operations

As banker to the Government and to the rest of the domestic banking system, the Central Bank provides a range of banking services to the public sector and to credit and financial institutions. The Bank also advises the Government and public corporations on financial matters and provides a limited number of banking services to its own staff. Furthermore, as sole issuer of local currency, the Bank seeks to ensure that the supply of currency notes and coins is at all times sufficient to meet the demand and that the notes and coins in issue are fit for circulation and any counterfeits are quickly detected.

3.1 Banker to the Public Sector

The Central Bank maintains accounts, both in Maltese lira and in foreign currencies, for the Treasury and other Government departments, the Malta Government Sinking Funds and public sector corporations. It also provides foreign exchange services to the public sector.

During 2000, the Central Bank cashed a total of 2.4 million cheques drawn on it and issued by Government departments. These included the one-off compensation payment for the removal of bread subsidies that was paid to each household early in the year. As a result, the volume of Government cheques drawn on the Bank rose by 2% year-on-year, while their value, at Lm460 million, was up by 7%.

To reduce costs associated with the processing of cheques, the Bank continued to encourage the use of the more efficient direct credit system when effecting Government payments. Thus, the volume of direct credits rose from 0.3 million to 0.4 million, with their value reaching Lm97 million from Lm76 million in 1999. The number of people who opted to have their salaries and pensions paid through this system continued to increase, while the launch of a direct interest credit facility provided to holders of Malta Government stocks contributed further to the observed growth.

Foreign exchange services provided to the Government and public corporations by the Bank included transactions supported by letters of credit, inward and outward bills for collection, inward transfers, guarantees, and foreign exchange transactions carried out by SWIFT or bank drafts.

The value of foreign exchange receipts processed on behalf of Government and public sector corporations, at Lm80 million, was significantly down from the previous year's level, as the 1999 figure included a larger tranche of the receipts associated with the sale of Mid-Med Bank plc to the HSBC group. On the other hand, foreign exchange payments on behalf of the public sector rose to Lm135 million, boosted by the higher fuel import bill that resulted from the hike in international oil prices.

The Central Bank is also responsible for the servicing of the Government's foreign debt. In 2000, repayments of capital amounted to Lm5.6 million, whereas interest payments on the Government's outstanding external debt were close to Lm2 million. At the same time, Lm2.8 million were transferred to sinking funds earmarked for future foreign debt repayments.

The Bank, during 2000, continued to administer the Foreign Pension Subsidy Scheme on behalf of the Government. Under this scheme, Maltese nationals 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 this scheme continued to decline during the year under review, falling to Lm27,004 from Lm28,463 in 1999.

The Central Bank also manages banking transactions relating to trade between Malta and Libya. Under an arrangement between their respective central banks, the two countries settle outstanding balances arising from trade transactions between them at the end of each quarter.

3.2 Banker to the Banking System

As banker to the rest of the domestic banking system the Central Bank also offers local and foreign currency deposit facilities to domestic credit and financial institutions. The latter maintain balances at the Bank to comply with statutory reserve requirements, to settle inter-bank 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. Thus, the Bank plays a central role in the management of the local payment and settlements system.

All inter-bank transactions are settled through the accounts banks hold at the Central Bank. The Bank accepts payment instructions from credit institutions mostly via SWIFT. During 2000, the number of such transfers reached 17,653, up from 13,071 in the previous year. Their value reached Lm3.5 billion compared to Lm3.1 billion a year earlier.

The Central Bank also manages the Malta Clearing House, through which cheques are settled. The number of cheques cleared rose to 7.4 million, up by 4.3% from the previous year's level. Their value grew at a faster pace, rising from Lm2.4 billion in 1999 to Lm2.7 billion in 2000.

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.

Box 3:
Payments and Settlements System - Recent Developments

In February 2000 a Payments System Committee was set up under the chairmanship of the Deputy Governor and comprising representatives of the Bank's Resource Management, Banking and Finance and Financial Markets divisions. The first task of the Committee was to propose amendments to the Central Bank of Malta Act so as to enable the Bank to regulate payment systems in Malta and ensure finality of payments.

The Committee met regularly during the year, drawing up rules to govern inter-bank payments and an action plan to upgrade the systems being used. The Committee explored the technology necessary to deliver a more effective real-time payment system and consulted with the commercial banks to establish the necessary standards. To this end, a technical sub-committee was set up in conjunction with the Malta Commercial Banks Association (MCBA), and it was agreed to use SWIFT Standards for all inter-bank payments.

The Committee also drew up regulations for the Maltese Real-Time Inter-bank Settlement System (MARIS). The rules governing the operations of MARIS were then presented to the commercial banks operating in the domestic market and to the Malta Stock Exchange.

By the end of the year, plans were in hand to ensure that the upgraded system would be operational by the last quarter of 2001. It will use SWIFT Fin Copy Services for messaging. It is expected that MARIS will continue to handle all inter-bank Maltese Lira transfers in respect of money market transactions, foreign exchange deals and other inter-bank settlements. Transactions involving sales and purchases of securities quoted on the Malta Stock Exchange will also be settled through the system.

The Central Bank of Malta, during 2000, also established a new department within the Banking and Finance Division to oversee the operations of payment systems in Malta.

3.3 Currency Operations

As at end 2000 the stock of currency notes and coins issued and outstanding amounted to Lm423 million, one percent higher than at the end of 1999. As Chart 3.1 shows, this was a much smaller increase than that recorded in the previous year. Furthermore, as bank deposits grew at a faster rate, the share of currency notes and coins in broad money continued to decline, falling below 17%. The extraordinary increase in currency in circulation noted at the end of last year reflected a precautionary build up of cash holdings by banks on account of the anticipated problems - which, in the event did not materialise - connected with the Millennium change. This was, however, only temporary and was reversed in January 2000, as can be seen from Table 3.1. On the other hand, the increase in currency in circulation in December 2000 reflected the higher demand for cash associated with the festive season.

The value of currency notes in issue at the end of December 2000 amounted to Lm405.7 million, up by 0.9% from the 1999 level, but their composition remained more or less the same as at the end of the previous year. Thus, as Chart 3.2 shows, the Lm10 note remained the most popular note, accounting for 65.1% of the value of notes outstanding, and this was followed by the Lm20 note, with a 26.6% share in the total. On the other hand, the value of the outstanding stock of coins in circulation rose slightly, to just over Lm17 million. As with the note issue, the composition of the coins in issue remained broadly the same as at the end of 1999, though the Lm1 coin increased its share by slightly more than one percentage point, to 31.3%, as shown in Chart 3.3.

In September 2000, the 4th series Lm10 note was demonetised. No new issue was made during the year.

Chart 3.1
CURRENCY ISSUED AND OUTSTANDING

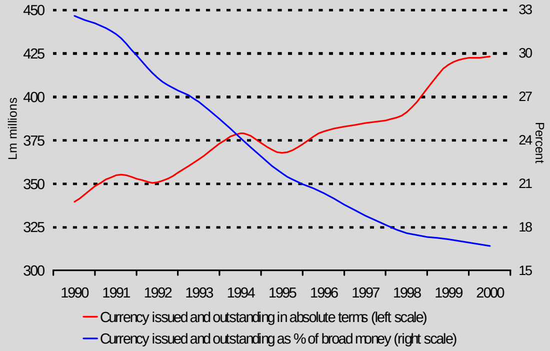


Table 3.1

CURRENCY NOTES AND COINS ISSUED BY AND PAID INTO THE CENTRAL BANK OF MALTA IN 2000

Lm thousands

	Issued	Notes and Coins Paid-In	Net Issue	Issued and Outstanding[1]
January	4,474	26,619	-22,144	396,341
February	13,389	12,307	1,082	397,423
March	12,066	13,267	-1,200	396,223
April	18,215	11,576	6,637	402,860
May	14,551	12,737	1,814	404,674
June	17,099	12,094	5,006	409,680
July	17,266	13,414	3,852	413,532
August	15,732	15,408	324	413,856
September	15,005	15,015	-10	413,846
October	17,193	15,138	2,055	415,901
November	12,869	13,547	-678	415,223
December	18,817	10,852	7,965	423,188
2000	**176,676**	**171,974**	**4,702**	**423,188**
1999	170,786	141,808	28,978	418,485

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

Chart 3.2
COMPOSITION OF THE LM405.7 MILLION IN CURRENCY NOTES ISSUED AND OUTSTANDING AS END 2000

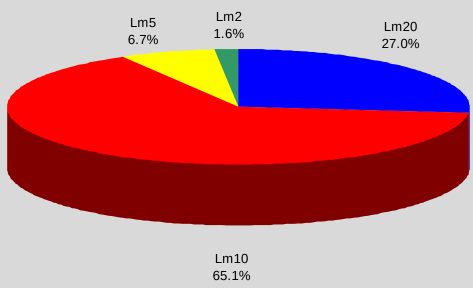
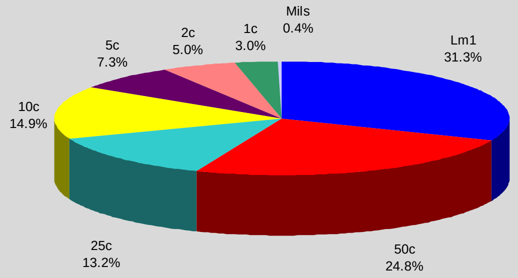


Chart 3.3
COMPOSITION OF THE LM17.5 MILLION IN COINS ISSUED AND OUTSTANDING AS END 2000



3.4 Commemorative Coins

In October 2000 the Central Bank issued a commemorative coin to mark the beginning of the new millennium. This issue departed from the customary round shape and was given an oblong shape with rounded corners. 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, a size of 40 x 20 mm and weighs 15 grams. The coin has a legal tender value of Lm5 and is subject to a minting limit of 32,000. On its reverse the coin depicts two Romano-Maltese coins that were in circulation in the third century A.D., while on its obverse are displayed the armorial bearings of Malta and of the Central Bank. The coin forms part of the Masterpiece Millennium Collection, a project organised by the Royal Mint in which 23 other countries are also participating.

3.5 Anti-Counterfeit Measures

Throughout 2000, the Central Bank continued to monitor closely all incidents of counterfeit currency. The Public Awareness Campaign launched in December 1999 was intensified through regular interviews and participation in educational programmes on the local media. Informative brochures explaining the security features of the currency were also extensively distributed.

4. Internal Management

4.1 Administration

4.1.1 The Board of Directors

At the end of 2000 the Board of Directors of the Central Bank was composed of Mr M C Bonello, Governor and Chairman of the Board, together with Mr D A Pullicino, Deputy Governor, Prof E Scicluna, Mr A F Lupi and Mr S Falzon as members. Mr H Zammit Laferla was Secretary to the Board. The Board met 19 times during the year.

Mr A F Lupi was re-appointed to serve as a director for a further year with effect from 21 January 2000. The appointments of the other directors, Prof E Scicluna and Mr Saviour Falzon, were also renewed for a period of one year with effect from 15 November 2000.

4.1.2 Management

The Executive Management Committee is responsible for all decisions related to the Bank's internal management and administration. This Committee, which is composed of the Governor (as Chairman), the Deputy Governor and the five Deputy General Managers of the Bank, held 44 meetings during the year.

In the course of the year, a number of changes were made to the Bank's organisational set-up in order to improve human resource efficiency and to reflect changing responsibilities and developments in the financial sector.

In line with the progressive liberalisation of exchange controls and the increased delegation of authorisation procedures to the banks and for the first time the MFSC, the Bank continued to review the functions performed by its Balance-of-Payments Department which previously had as its main focus the administration of exchange control. As a result, the two offices within the Department responsible for the administration of exchange controls and balance-of-payments data compilation were officially merged and two sections created. The Capital Flows Section continues to be responsible for administering remaining exchange controls while the Data Compilation Section is responsible for the balance-of-payments compilation process. The Balance-of-Payments Department still forms part of the Research Management Division, which also assumed responsibility for a newly created External Relations Office. The latter replaces the Governor's Office and, besides taking over the responsibilities previously assigned to that office – namely those related to public relations and international relations – also incorporates an EU Desk which provides information and support services to other departments of the Bank on all EU-related matters. The re-structuring process within the Bank also involved the setting up of a Financial Stability Office within the Banking Supervision and Audit Division. This Office focuses on issues relating to the Bank's role in maintaining overall stability in the domestic financial system. During 2000 the Bank also formally set up its own Legal Unit, which is managed by the Bank's legal officer and reports directly to the Deputy Governor.

4.1.3 Official Representation Overseas

During the year members of the Board, accompanied by senior management officials, represented the Bank at various official meetings overseas. In April the Governor attended the Spring Meetings of the International Monetary Fund (IMF) and the World Bank, which were held in Washington DC.

In May the Governor was a guest at symposia organised by the National Bank of Belgium and the Banque de France to commemorate their 150th and 200th anniversaries, respectively. During the same month the Deputy Governor attended the Annual Meeting of the European Bank for Reconstruction and Development (EBRD), which was held in Riga, Latvia.

In June the Governor attended the Central Bank Governors' Symposium hosted by the Bank of

England and the 70th Annual General Meeting of the Bank for International Settlements (BIS) in Basle. In August the Deputy Governor visited the Banca d'Italia to discuss technical assistance issues.

In September, the Governor, accompanied by Prof E Scicluna, a director of the Bank, attended the joint Annual Meetings of the IMF and the World Bank in Prague. In November the Governor took part in the 14th Annual European Finance Convention in Paris where he delivered a speech on exchange rate policy options in a pre-accession scenario. During the same month the Deputy Governor represented the Bank at a Central Banking Conference organised by the European Central Bank (ECB).

In December the Governor participated in a seminar for central bank governors from accession countries which was organised by the ECB and the Austrian National Bank. During this seminar, which was held in Vienna, the Governor was a lead speaker in the discussion on price dynamics, competitiveness and monetary policy in the context of a fixed exchange rate regime.

4.2 Human Resources

The full-time staff complement at the Central Bank at the end of the year 2000 stood at 300. In addition, the Bank employed 18 staff members on a part-time basis. During the year the Bank recruited two trainee economic officers after a public call for applications.

As in previous years, the Bank also offered temporary employment under the student-sponsorship scheme to thirteen students from the University of Malta and the Paolino Vassallo Upper Lyceum. The Bank also offered temporary summer work placement to a student from the Danny Cremona School of Agriculture who, in addition, benefited from the Bank's participation in the Extended Skills Training Scheme of the Employment and Training Corporation (ETC).

4.2.1 Training and Development

As in previous years, the Bank continued to provide staff members with extensive training both through in-house programmes and through external courses organised by local and foreign institutions.

The Training Section within the Human Resources Department organised a total of twenty in-house training courses which attracted 443 participants. These focused mainly on management, supervisory development, information technology and specific job-related skills.

In May the Bank, with technical assistance from the Bank of England, also organised a two-day residential seminar for its senior and office managers with the aim of critically evaluating its mission statement, corporate objectives and organisational structure. Subsequently, a Mission Statement Working Group was formed to follow up and conclude the work of the seminar. The revised Mission Statement is carried on the third page of this Report.

In view of its growing international commitments the Bank felt the need to enhance staff members' language skills and organised lectures in French and German for interested staff members after office hours. During the year the Bank also set up a translators' pool in the French, Italian and German languages from among its staff members.

In the course of the year, the Bank renewed its Employee Assistance Programme, which had been launched in conjunction with Caritas – Malta in 1999. Several awareness sessions for staff in the executive and supervisory grades were organised by Caritas co-ordinators with the aim of making participants sensitive to personal problems that may be encountered at the place of work.

A total of 86 staff members participated in seminars and courses organised by local institutions on various issues mostly related to management, industrial relations, economic development and information technology. A number of staff members also attended courses, workshops or conferences organised by foreign institutions - such as the European Central Bank, the International Monetary Fund, the Financial Stability Institute and a number of central banks. In all, staff members took part in 55 training and development courses overseas during the year. The areas covered included monetary and economic issues, reserves management, banking supervision and financial stability, legislation, information technology, payment systems, statistics, balance-of-payments compilation and internal audit controls.

4.2.2 Academic and Professional Courses

In an attempt to enhance the academic skills of its employees the Bank, entered into an agreement with the Faculty of Economics, Management and Accountancy of the University of Malta to launch a course of studies designed specifically to upgrade the skills of qualified staff members who wished to follow a Master's programme in Economics at a later stage. A staff member is already pursuing this course while several others are following specific modules to attain the required level of competence.

An increasing number of staff members were also making use of the Bank's Study Scheme while pursuing self-development opportunities. At the end of the year, 34 employees were benefiting from this scheme.

During 2000 a staff member obtained a Master's degree in Economics from the University of York while another successfully completed his studies leading to a Master's degree in Contemporary European Studies from the University of Sussex. Another two employees upgraded their Banking Diploma to an Honours degree in Financial Services from UMIST, while another staff member obtained the dual qualifications of the BSc Honours degree in Financial Services and the ACIB Diploma. One employee obtained the Diploma in Management from the University of Malta and another the IMIS Higher Diploma, while yet another staff member, who was sponsored by the Bank under its training and development programme, successfully completed his studies leading to the award of the Diploma in Library and Information Studies from the University of Malta. Another seven employees obtained the Malta Banking Certificate.

At the end of the year two employees in the clerical category were following full-time courses in legal studies and information technology, respectively, at the University of Malta. A further 53 staff members were pursuing approved courses of study related to the Bank's core functions on a part-time basis. These included 7 employees who were following post-graduate courses, 34 who were following first degree programmes and 12 others who were pursuing courses leading to the award of a diploma.

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 which monitors this issue attended various meetings convened by the Department of Women in Society in order to keep themselves informed of the latest developments and guidelines in this area.

At the end of 2000, female staff members accounted for 32.9% of the Bank's full-time complement. A substantial number of female employees also participated in training and development activities, including part-time self-development programmes. Female participation in internal courses, local external courses and overseas courses was also consistently high.

4.2.4 Collective Agreements with Trade Unions

During the year, the Bank renewed its agreement with the Malta Union of Bank Employees (MUBE), the union representing staff members in the executive grades. As with its agreements with the unions representing the clerical and the non-clerical grades, this agreement expires in December 2001.

4.3 Information Technology

Following the implementation in 1999 of countermeasures to combat the Y2K problem, no difficulties were encountered with the Bank's IT systems with the arrival of the new millenium. During 2000, the Bank continued to gain experience in the operation of its core accounting system, Flexcube, which was introduced in 1999. In fact the first line of support to system users was handed over to the Bank's IT Department and, as from the second quarter of 2000, support from the system providers changed from on-site to global support. The system was also upgraded to enable straight-through processing for certain SWIFT messages.

As regards the Reuters information service, the Bank during the year carried out an evaluation exercise of the range of services offered by Reuters in preparation for a changeover to a new platform in 2001.

The Bank also developed a number of software applications tailored to the specific requirements of particular offices and departments. These included systems designed for the Money and Capital Markets and the Investments and Reserves Offices. By the end of the year, work had also started on the development of software systems for the Bank's Human Resources and Economics Departments.

A call for tenders for the upgrading of the Bank's network infrastructure was issued in November, 2000. This project is intended to provide a faster medium for users of the network.

4.4 Risk Management and Audit

Following the preparations made in connection with the Y2K Contingency Plan in 1999, the Bank decided to utilise the experience gained to draw up a comprehensive Business Continuity Plan. Meanwhile, the Bank's Risk Management Unit continued to work on a restructuring of the Bank's standing instructions and to incorporate these into a document that would consolidate the Policies and Procedures of the Bank's operations. The aim of this exercise is to ensure that risks across the Bank's various operational areas are properly controlled and documented for appropriate monitoring. The exercise also involves the design of a new database structure so as to make access by the respective office managers more user friendly.

As part of continuing efforts to ensure high standards of accountability, the Bank's Audit Department carried out more than six hundred audit examinations during the year. A general review of most audit programmes was also undertaken with a view to incorporating a systems-based approach. The Bank also moved towards the adoption of a Risk-Based Auditing System. This would ensure that resources were deployed efficiently through the identification and quantification of risk and the evaluation of controls designed to mitigate risk.

4.5 Legal Issues

The Bank's Legal Unit, which was formally set up early in the year, initially focused attention on issues related to the proposed amendments to the Central Bank of Malta Act. The Unit also prepared draft directives relating to settlement finality and cross-border credit transfer services which could be brought into force once the proposed amendments to the Act are given legal effect. Preliminary work in connection with the proposed amendments to the Banking Act and Financial Institutions Act, as well as on the legal framework for a deposit protection scheme, was also undertaken. Proposals were also drawn up to introduce the recognition of post-bankruptcy netting in Maltese legislation. By the end of the year the Bank was finalising other legal provisions on post-insolvency netting in respect of financial transactions in general.

During the year the Bank worked closely with the Legal Services Unit of the European Central Bank (ECB), which drew up country reports on the accession countries. The Bank also established close relations with the legal units of the national central banks of the European System of Central Banks and of the other E.U. accession countries.

The Bank, in conjunction with the commercial banking sector, also submitted its recommendations on the *White Paper on the Legislative Framework for Information Practices* which was issued by the Government in relation to the adoption of legislation on electronic commerce and data protection in Malta.

4.6 Information Services

4.6.1 Awareness Campaigns

During the year, the Bank brought a number of issues to the attention of the public through the media. These included warnings on the circulation of counterfeit banknotes and illegal foreign currency exchange, as well as clarifications on issues regarding the Bank's operations.

4.6.2 Publications

The Bank continued to publish its own independent analysis of economic and financial developments in Malta and abroad through its *Quarterly Review*. The Review also carried the results of the Business Perception Surveys conducted by the Bank, as well as a number of articles and speeches on selected topics of an economic and financial nature. These included articles on the impact of private and public saving gaps, on the current account, privatisation, preparations for Economic and Monetary Union, financial instability and the free movement of capital.

In March, the Bank published its *Annual Report*, which included a review of the Bank's policies, operations and activities as well as its financial statements for the year ending December 31, 1999. As usual, the Report included an extensive analysis of economic and financial developments during that year.

During the year the Bank continued to publish data on monetary aggregates and their determinants on a monthly basis. These monthly statistical releases included figures on the money supply, the external reserves and domestic credit, together with a brief commentary. The data published in these monthly reports conformed with the concepts, definitions and classifications recommended by the International Monetary Fund (IMF) in its GDDS framework. The Bank also continued to publish a weekly money market report in the local press.

The Bank's publications, together with other related information, were regularly posted on the Central Bank's own website, *www.centralbankmalta.com*.

4.6.3 Library

The Library of the Central Bank serves as the main source of information on banking, finance and economic matters in Malta. Although the library is intended primarily for use by the Bank's own staff, it is also used by Government departments and other public sector bodies, credit and financial institutions, private firms, students and members of the general public, particularly those engaged in research on economic and financial matters.

Following the introduction of a new integrated library software system, the Library undertook an extensive exercise to barcode all the books in its collection. During the year, the Library also made increasing use of electronic means for disseminating information. A new CD-ROM database was introduced, giving access to eleven major European and international databases. Attention was also given to upgrading the Library's non-book materials, including newspaper clippings and the cataloguing of journal articles. In particular, the Library accelerated its efforts at tapping sources of information related to the European Union and, in this regard, a staff member attended a course on European Union information organised by the Association of Special Libraries in London.

The separate depository in the External Relations Office of the Bank's Information Services Department continued to receive and store publications issued by international organisations, such as the International Monetary Fund, the World Bank Group, the European Bank for Reconstruction and Development and other institutions.

4.7 Social, Cultural and Educational Activities

During 2000 the Bank organised various activities of a social, cultural and educational nature. In March the Bank was honoured by a visit from the President of the Republic, His Excellency Professor Guido de Marco, who was conducted round the Bank's premises where he met staff members and was given an extensive overview of the Bank's operations. In April the Bank organised a concert of classical music at the Mediterranean Conference Centre as part of the festivities commemorating its 32nd anniversary.

In November the Bank organised a one-day conference on Capital Movements and Financial Services as part of the Malta TAIEX Week. This conference which was attended by delegates from the banking and financial sectors, was addressed by officials from the European Commission, the Dutch central bank, CONSOB Italy and SDOE Greece. During the same month, the Central Bank, as a Flexcube user, hosted the Flexcube European Users' Meeting for users, prospective customers and officials of the software company. The Bank, together with Malta Financial Services Centre (MFSC), also assisted the Institute of Directors, Malta, in the organisation of a two-day conference on corporate governance that was promoted by the Commonwealth Secretariat concurrently with the Commonwealth Finance Ministers meeting which was being held in Malta in September.

As in previous years the Bank's public relations programme included the organisation of educational visits for various groups, both local and foreign. During these visits, officials from the various offices of the Bank addressed participants on the roles and functions of the Central Bank.

The Bank continued to provide assistance to a number of organisations involved in philanthropic activities and also made arrangements for staff members to donate blood on various occasions throughout the year. The Bank also continued to support its Staff Social Club, which on its part organised a substantial number of social, cultural and philanthropic activities.

5. Relations with International Institutions

The Central Bank gives considerable importance to all matters related to Malta's membership of international institutions. In fact, during 2000, the Bank set up an External Relations Office with the specific aim of enhancing its relations with such institutions. During the year, the Bank maintained close contact with the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD) or World Bank, and the European Bank for Reconstruction and Development (EBRD).

Furthermore, as the process for Malta's accession to membership of the European Union (EU) gained further momentum, the Central Bank stepped up its efforts to apply the relevant parts of the EU *acquis* to the Maltese financial sector. In particular, the Bank set up new committees and task forces to make appropriate proposals to promote harmonisation of the legislative and operative framework governing Malta's financial sector with that of the EU. In the meantime, the Bank continued to strengthen its relationship with the European Central Bank (ECB) and with the national central banks of EU member states and accession countries.

The Bank also continued to monitor Malta's negotiating position with a view to assessing the implications which EU membership would have for Malta's obligations under the World Trade Organisation (WTO) Agreement, especially those related to trade in financial services and capital movements.

The Central Bank continued to co-operate with the Bank for International Settlements (BIS), particularly in the fields of banking supervision and international financial stability. In this context, senior Bank officials participated in a number of workshops and discussions that were held at the BIS. Although the Bank is not a member of the BIS, it is customary for the Governor of the Central Bank to be invited to its Annual General Meeting. As in past years, the Governor attended the 2000 meeting in an observer capacity. In the meantime, as mentioned earlier in this Report, the Central Bank also completed a self-assessment of its compliance with the recommendations of the *Core Principles Methodology for Banking Supervision* of the Basle Committee on Banking Supervision.

In September, the Bank's Governor and Deputy Governor also took part in the Commonwealth Conference on Corporate Governance that was held in Malta, where one of the sessions focused on the role of central banks in promoting good governance in the banking and financial sector. The Bank's Deputy General Manager responsible for Banking Supervision and Audit represents the Bank on the Commonwealth Working Group on Corporate Governance in the Financial Sector.

5.1 International Monetary Fund

As the institution representing Malta at the IMF, the Central Bank carried out several tasks related to membership of the Fund. The Governor of the Central Bank is the Governor for Malta on the Board of Governors of the IMF. In this regard, the Governor voted, in consultation with the Minister of Finance, on a number of resolutions proposed by the Fund's Executive Board.

During the year, the Bank did not effect any payments in addition to those made during 1999 in connection with the Eleventh General Review of Quotas. As a result, the IMF's holdings of Maltese currency remained unchanged from the Lm35.2 million (SDR 61.75 million) level reported at the end of the previous year. Malta's reserve position in the Fund also remained unchanged at Lm23.0 million (or SDR 40.25 million).

The Bank, however, continued to participate in the operations of the Fund's SDR Department. During the year, the Bank's net receipts of SDRs amounted to SDR2.0 million (Lm 1.1 million). These receipts consisted mainly of interest on Malta's creditor position with the Fund, including those arising from Malta's past contributions to the Enhanced Structural Adjustment Facility (ESAF) Account. As a result of these transactions, Malta's total holdings of SDRs at the end of 2000 stood at SDR24.5 million (or Lm14 million), representing an increase of SDR2 million (Lm 1.1 million) over the comparable balance of the previous year.

Under Article IV of the Fund's Articles of Agreement, the IMF is authorised to exercise surveillance over its members' exchange rate policies and to collect any economic and financial information required for that purpose. To this end, the IMF regularly holds consultations with the authorities of member countries to assess the sustainability of their policies and to discuss macroeconomic developments. In the case of Malta, Article IV Consultation Missions are held every two years. Such a Mission last visited Malta in March 1999. A follow-up to this Mission, however, was held in April 2000. During this visit meetings were held with the Minister of Finance, the Minister for Economic Services, the Malta Financial Services Centre and the Central Office of Statistics - besides the Central Bank. Meetings were also held with various other Government departments and public sector bodies, as well as a number of representatives from the private sector.

During the year, the Bank continued to follow the IMF's initiatives in the area of standards and codes, particularly the Code of Good Practices on Transparency in Monetary and Financial Policies. In this context, the Bank also took part in bilateral meetings between Fund staff and officials from interested jurisdictions with a view to achieving further harmonisation in practices related to the dissemination of macro-prudential indicators.

The Central Bank also continued to receive technical assistance from the IMF. A technical mission visited Malta in July to advise on the collection, compilation and update of economic and financial statistics that make up the Fund's General Data Dissemination System (GDDS). In September, the relevant data for Malta were posted on the IMF's Dissemination Standard Bulletin Board webpage, making Malta the 12th member country to subscribe to the GDDS.

In April, the Governor of the Central Bank, accompanied by a senior Bank official, attended the Spring Meetings of the International Monetary and Financial Committee (IMFC) and the Development Committee of the IMF and the IBRD. In September, the Minister of Finance and the Governor of the Central Bank led a delegation to the 55th Annual Meetings of the World Bank and the IMF, which were held in Prague.

5.2 World Bank (IBRD)

The Minister of Finance is the Governor for Malta on the Board of Directors of the IBRD. Nevertheless, the Central Bank follows developments at the World Bank so as to advise the Ministry of Finance on matters related to Malta's membership of this institution.

During the year, the Maltese Government continued to make use of World Bank technical assistance under the 1999 Framework Agreement for Advisory Services, particularly on issues related to privatisation and pension reform.

5.3 European Bank for Reconstruction and Development (EBRD)

Malta is a founder member of the EBRD, which was established in 1991 to assist the economies of Central and Eastern Europe and those of the former Soviet Union in their transition from centralised to open market economies and to promote private and entrepreneurial initiative in these countries.

The Minister of Finance and the Governor of the Central Bank are, respectively, the Governor and the Alternate Governor for Malta on the Board of Governors of the EBRD. During the year under review, the Central Bank continued to liase with the Ministry of Finance on issues related to the EBRD and provided background information to the Ministry on a number of proposals made by the EBRD's Board of Directors that required the consent of member countries before being formally adopted.

In April, the Central Bank, as agent of the Government, effected the third annual payment of EUR 28,750 (about Lm12,400) in respect of the general capital increase that was approved by the Executive Board of the EBRD in 1998.

In May, the Deputy Governor of the Central Bank formed part of the delegation to the Ninth Annual General Meeting of the EBRD which was held in the Latvian capital, Riga. The Maltese delegation was headed by the Minister of Finance.

5.4 European Union and Related Institutions

During the year, the Central Bank continued to examine the *acquis communautaire* with a view to identifying any legislative and institutional reforms that would be necessary to ensure that the Maltese financial sector would be able to integrate smoothly with that of the EU. In the process, the Central Bank contributed to the updating of various reports on the adoption of the *acquis*. These included the National Plan for the Adoption of the A*cquis* and Malta's position papers on Economic and Monetary Union, the Free Movement of Capital and the Free Movement of Services.

Internally, the Bank established a number of new working groups and committees to study specific issues that were previously identified as priority areas. The Bank's efforts in this area focused mainly on the methodology used for the compilation and dissemination of monetary and economic statistics, on the establishment of a deposit protection scheme, and on the monetary and foreign exchange operations of the European System of Central Banks (ESCB).

At the beginning of the year, the Bank established a Payment Systems Committee and a Legislation Committee. The former was assigned the task of formulating a strategy which would facilitate the eventual integration of the payments system in Malta with the European TARGET system. The latter was established to bring Maltese financial legislation into line with the *acquis*. During the year, the Legislation Committee finalised draft amendments to the Central Bank of Malta Act, while the Payment Systems Committee finalised work in connection with the transposition of the *EU Settlement Finality and Cross-Border Credit Transfers Directive* to Maltese law. Subsequently, in September, a Bill to amend the Central Bank of Malta Act was presented to Parliament for a first reading. In particular, these amendments provide for greater independence of the Central Bank and reorient the Bank's primary functions to focus on price stability.

The Bank also established a Payment System Users' Group (PSUG) to address technical issues related to the payments system with a view to accelerate the standardisation of transactions and settlement procedures in the domestic financial sector. The PSUG took over the responsibilities previously assigned to the Payment System Technical Committee, and includes representatives from the Central Bank, the Malta Stock Exchange and the Malta Commercial Banks' Association. Meanwhile, the Bank continued to brief representatives of commercial banks on the accession process and to discuss with them particular issues relating to the implementation of the relevant provisions of the *acquis*. This exchange of views took place through the EU Advisory Committee for Banks, which superseded the EU Working Group for Banks.

In line with these developments, the Bank continued to strengthen its relationship with the European Central Bank. On a number of occasions, officials from various departments of the Bank participated in seminars, workshops and courses that were organised by the ECB or the national central banks of the Eurosystem. These mostly addressed the implications of the accession process, international reserves management, the payments system and IT requirements and the methodology used in the compilation and reporting of financial and monetary data.

In December, the Governor, accompanied by the Deputy General Manager of the Bank's Research Management Division, took part in a seminar on the accession process in accession countries organised by the ECB. Issues discussed were price dynamics, the role of central banks in the accession process and co-operation between the Eurosystem and the national central banks of accession countries. The Governor was a lead speaker and intervened in a number of discussions that were held during this seminar, particularly those relating to competitiveness and monetary policy in the context of a fixed exchange rate regime. Earlier, in November, the Deputy Governor also took part in the first Central Banking Conference to be hosted by the ECB.

During the year, the Bank's Legal Officer attended the First Meeting of Legal Experts of Accession National Central Banks (NCBs) and the follow-up meetings that were organised by the ECB's Legal Services Department. During these meetings participants discussed the progress made by accession countries with respect to the legal preparations concerning the Eurosystem. Additional bilateral discussions on the subject were held in Malta in July during an official visit by two legal experts from the ECB's Legal Services Department.

During the year, the Bank also made use of expert advice from the national central banks of a number of EU member countries, namely those of Austria, Denmark, the United Kingdom, France, Germany, Ireland, Italy, Portugal and the Netherlands. Experts from the Banca d'Italia, the Central Bank of the Netherlands and the Central Bank of Ireland also visited Malta to advise on the Bank's forecasting and statistical methodologies. On another occasion, Mr Jens Thomsen, Deputy Governor of the Central Bank of Denmark, briefed the Bank's executive staff about the organisational set-up of the Danish Central Bank and on its experience in preparing for the introduction of the euro.

In the meantime, the Central Bank intensified its efforts to build a closer working relationship with the national central banks of the other EU accession countries, particularly through the staff exchange programmes referred to earlier in this Report. During 2000, senior officials from the Bank also attended a Workshop on Financial Sector Reform organised by the National Bank of Poland. This was the second workshop of its kind after that held in Malta in 1999.

The Bank also collaborated with the Maltese Government to establish a close working relationship with the Technical Assistance and Information Exchange Office (TAIEX) of the European Commission. Within this context, the Central Bank organised a seminar on financial transactions that formed part of the Malta TAIEX Week. This seminar, which was held in November, was attended by officials from the Central Bank, the Ministry of Finance, the Malta Financial Services Centre, the Malta Stock Exchange, the Malta Commercial Banks' Association and local banks. Participants in this seminar were addressed by speakers from the European Commission and from a number of regulatory bodies from Italy, Greece and the Netherlands. Two officials from the Bank also participated in TAIEX workshops during the year.

Part III

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 DECEMBER 2000

Directors' report

The directors present their report and the audited financial statements of the Bank for the year ended 31 December 2000.

Principal activities and review of operations

The Central Bank's Mission and Objectives are set out on page 3. The Governor's Statement on pages 12 to 16 and the Bank's Policies, Operations and Activities on pages 63 to 87 give a detailed account of the Bank's activities and operations during 2000.

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 2000, 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 Committee 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 2000 are set out on pages 94 to 111 and disclose an operating profit of Lm25.9 million (1999: Lm23.1 million). The amount payable to Government is Lm25.9 million (1999: Lm27.1 million after transferring Lm4 million from the reserves for risks and contingencies).

Directors' report – continued

Board of directors

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

Mr Michael C Bonello - Governor
Mr David A Pullicino - Deputy Governor
Mr Alfred F Lupi
Mr Saviour Falzon
Prof Edward Scicluna

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
Governor

D A Pullicino
Deputy Governor

Castille Place
Valletta
Malta

28 February 2001

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 2000, 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 94 to 111. As described in the statement of directors' responsibilities on page 92, 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 2000 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 98, and comply with the Central Bank of Malta Act, 1967.

MSD & Co
Malta

28 February 2001

PRICEWATERHOUSECOOPERS
Malta

28 February 2001

Profit and loss account

	Notes	**2000** **Lm'000**	1999 Lm'000
Profit for the financial year	3	**25,902**	23,113
Transfer from reserves for risks and contingencies	21	**-**	4,000
Payable to the Government of Malta in terms of Section 24(4) of the Central Bank of Malta Act, 1967		**25,902**	27,113

There were no recognised gains or losses in 2000 and 1999 other than the profit for the financial year.

Balance sheet

	Notes	**2000**	1999
		Lm'000	Lm'000
Assets			
Cash and bank balances	4	**4,598**	35,312
Gold		**453**	737
Placements with banks	5	**411,271**	447,539
Investment securities	6	**189,225**	217,656
International Monetary Fund	7	**36,940**	35,517
Other foreign currency assets	8	**1,657**	3,560
Total external assets		**644,144**	740,321
Treasury bills	9	**2,726**	471
Domestic debt securities	10	**16,452**	15,681
Other assets	11	**103,964**	44,001
Tangible fixed assets	12	**4,807**	5,096
Prepayments and accrued income		**15,594**	12,974
Total assets		**787,687**	818,544
Liabilities and equity			
Liabilities			
Notes and coins in circulation	13	**423,188**	418,485
Deposits by:			
Banks	14	**141,270**	124,786
Government	15	**56,161**	96,188
Others	16	**10,393**	12,424
Profits payable to Government		**25,902**	27,113
Foreign liabilities	17	**3,655**	-
Other liabilities	18	**37,437**	49,462
Accruals and deferred income		**631**	1,036
		698,637	729,494
Capital and reserves			
Capital	19	**5,000**	5,000
General reserve fund	20	**23,000**	23,000
Special reserve fund	20	**13,000**	13,000
Reserves for risks and contingencies	21	**48,050**	48,050
		89,050	89,050
Total liabilities and equity		**787,687**	818,544

The financial statements on pages 94 to 111 were approved for issue by the Board of directors on 28 February 2001 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	Total Lm'000
Balance at 1 January 1999	5,000	23,000	13,000	52,050	93,050
Transfer to profits payable to Government	-	-	-	(4,000)	(4,000)
Balance at 31 December 1999 and 31 December 2000	**5,000**	**23,000**	**13,000**	**48,050**	**89,050**

Cash flow statement

	Notes	**2000**	1999
		Lm'000	Lm'000
Cash flows from operating activities			
Profit for the financial year		**25,902**	23,113
Increase in interest receivable		**(2,620)**	(4,786)
Decrease in interest payable and accrued expenses		**(405)**	(982)
Depreciation	12	**352**	310
Profit on sale of tangible fixed assets	12	**-**	(5)
Amortisation of premiums and discounts on securities		**(360)**	(222)
Profit on sale of securities		**(167)**	(514)
Cash flows from operating profits before changes in operating assets and liabilities		**22,702**	16,914
Net changes in operating assets and liabilities:			
Placements with banks		**(1,118)**	(190,449)
Other foreign exchange assets		**(1,158)**	4,762
Treasury bills		**135**	4,013
Dealing securities		**(757)**	1,886
Other assets		**(59,963)**	(16,726)
Deposits		**14,703**	10,628
Other liabilities		**(12,025)**	27,384
Net cash used in operating activities		**(37,481)**	(141,588)
Cash flows from investing activities			
Purchase of investment securities		**(10,954)**	(54,344)
Proceeds from sale and maturity of investment securities		**39,896**	10,582
Purchase of tangible fixed assets	12	**(63)**	(178)
Proceeds from sale of tangible fixed assets	12	**-**	10
Net cash from/(used in) investing activities		**28,879**	(43,930)
Cash flows from financing activities			
Net movement in currency in issue		**4,703**	27,573
Payment to the Government under Section 24(4) of the Central Bank of Malta Act, 1967		**(27,113)**	(30,182)
Net cash used in financing activities		**(22,410)**	(2,609)
Decrease in cash and cash equivalents		**(31,012)**	(188,127)
Cash and cash equivalents at 1 January		**84,133**	272,260
Cash and cash equivalents at 31 December	22	**53,121**	84,133

Notes to the financial statements

1. Accounting policies

(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 on the historical cost basis of accounting. The financial statements have been prepared in accordance with the requirements of International Accounting Standards issued by the International Accounting Standards Committee 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.

(b) Gold

Gold holdings are included at current market values. The current market value of gold represents the Maltese lira average of the London fixings for the month of December.

(c) Investment securities

Securities intended for use on a continuing basis are classified as investment securities. Investment debt securities are stated at cost less provision for any permanent diminution in value. In the case of securities redeemable on or before a given date and not subject to abnormal risk of default, the cost is adjusted for the amortisation of premiums and discounts on a straight line basis over the period to maturity. The amortisation of premiums and discounts is included with interest income.

(d) 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 SDR1.75307 to Lm1 as quoted by the Fund at the close of business on 31 December 2000.

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 2000. Adjustments on revaluations of the International Monetary Fund holdings are reflected in the corresponding asset - Currency Subscription.

1. Accounting policies - continued

(e) Government securities held for dealing purposes

Government securities held for dealing purposes are stated at the lower of cost and market value.

(f) Treasury bills

Treasury bills are stated at cost plus accrued interest.

(g) Tangible fixed assets

All tangible fixed assets are recorded at cost less 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%

With effect from this year, the leasehold property is being depreciated over the remaining term of the lease. The effect of this change in estimate is not material for the purposes of giving a true and fair view.

(h) Bad and doubtful debts

Provision for bad and doubtful debts is made as considered necessary, having regard to specific and general factors.

(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) Leases

Operating lease rentals are charged to the profit and loss account in the period in which they become due.

(k) Sale and repurchase agreements

Securities sold under sale and repurchase agreements are retained in the financial statements and the counterparty liability is recorded as an amount due from banks or other customers as appropriate. The difference between the sale and repurchase price represents interest expense and is recognised in the profit and loss account over the term of the agreement. Securities purchased under agreements to resell are recorded as advances to banks or other customers as appropriate. The difference between the purchase and sale price represents interest income and is recognised in the profit and loss account over the term of the agreement.

1. Accounting policies - continued

(l) Derivative financial instruments

Derivative financial instruments, including forward foreign exchange contracts and currency swaps, are disclosed in assets when favourable to the Bank and in liabilities when unfavourable to the Bank. The carrying amount of foreign exchange derivative contracts represents 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 are included in the profit and loss account as they arise. Gains and losses on other derivative financial instruments used for hedging purposes are 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 include:

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

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

2. External reserve ratio

The ratio of external assets to notes and coins issued, excluding coins issued for numismatic purposes, and deposit liabilities is 102.08% (1999: 113.56%). 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:

	2000 Lm'000	1999 Lm'000
Fees and salaries:		
Directors' remuneration	**44**	35
Staff costs	**2,463**	2,421
Depreciation	**352**	310
Auditors' remuneration	**14**	12

4. Cash and bank balances

	2000 Lm'000	1999 Lm'000
Cash in hand	**213**	713
Bank balances - repayable on call and at short notice	**4,385**	34,599
	4,598	35,312

5. Placements with banks

	2000	1999
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**151,410**	207,773
- Three months or less but over one month	**122,241**	108,401
- One month or less	**137,620**	131,365
	411,271	447,539

6. Investment securities

	2000	1999
	Lm'000	Lm'000
By remaining maturity		
- Over five years	**60,670**	87,484
- Five years or less but over one year	**113,125**	117,319
- One year or less but over three months	**14,555**	5,607
- Three months or less	**875**	7,246
	189,225	217,656

The Bank's portfolio of investment securities is composed of listed debt securities.

7. International Monetary Fund

	2000	1999
	Lm'000	Lm'000
Reserve Tranche Position	**22,962**	22,785
Special Drawing Rights	**13,978**	12,732
	36,940	35,517

Malta's membership subscription to the International Monetary Fund amounts to SDR102,000,000 (1999: SDR102,000,000).

The Bank's position with the International Monetary Fund at 31 December 2000 is reflected in the balance sheet as follows:

(a) Reserve Tranche Position included above is equivalent to SDR40,253,682. 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.

7. International Monetary Fund - continued

(b) Special Drawing Rights included above are equivalent to SDR24,505,478. These represent the Special Drawing Rights allocated to Malta amounting to SDR11,288,000, to which a corresponding liability exists in the form of a restricted demand deposit of the Government of Malta included under "Other deposits" (see note 16), together with other Special Drawing Rights acquired in accordance with International Monetary Fund requirements and procedures. Special Drawing Rights allocated to Malta cannot be withdrawn unless such advice is received from the Fund. Other Special Drawing Rights have no specified maturity.

(c) Currency Subscription included with "Other assets" (see note 11) is stated at Lm35,221,821 and represents the balance of the quota paid in Maltese liri. A corresponding liability included with "Other liabilities" (see note 18) exists in the form of Non-Interest Bearing Notes of Lm18,549,000 or SDR32,517,696 and IMF current accounts of Lm16,672,821 or SDR29,228,622.

8. Other foreign currency assets

	2000	1999
	Lm'000	Lm'000
Amounts receivable under banking arrangements		
- Repayable within three months	**-**	1,922
Others	**1,657**	1,638
	1,657	3,560

9. Treasury bills

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

	2000	1999
	Lm'000	Lm'000
By remaining maturity		
- One year or less but over three months	**326**	329
- Three months or less but over one month	**6**	17
- One month or less	**2,394**	125
	2,726	471

10. Domestic debt securities

	2000 Lm'000	1999 Lm'000
Malta Government Stocks held for dealing purposes	**6,452**	5,681
Other securities held for investment purposes	**10,000**	10,000
	16,452	15,681

Malta Government Stocks are listed on the Malta Stock Exchange. Other securities consist of unlisted bonds guaranteed by the Government of Malta.

Amounts include:

	2000 Lm'000	1999 Lm'000
By remaining maturity		
- Over five years	**1,104**	989
- Five years or less but over one year	**2,598**	12,921
- One year or less	**12,750**	1,771
	16,452	15,681

11. Other assets

	2000 Lm'000	1999 Lm'000
International Monetary Fund Currency Subscription	**35,222**	34,955
Amounts receivable under repurchase agreements	**64,700**	-
Derivative financial instruments	**228**	4,937
Others	**3,814**	4,109
	103,964	44,001

The contracted local currency amounts of the derivative financial instruments outstanding at 31 December 2000, consisting of forward foreign exchange contracts and currency swaps, amounted to Lm81,902,000 (1999: Lm116,109,000).

12. Tangible fixed assets

	Leasehold property Lm'000	Others Lm'000	Total Lm'000
Year ended 31 December 2000			
Opening net book amount	4,381	715	5,096
Additions	15	48	63
Disposals	-	(1,839)	(1,839)
Depreciation charge for the year	(65)	(287)	(352)
Depreciation released on disposals	-	1,839	1,839
Closing net book amount	**4,331**	**476**	**4,807**
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
At 31 December 1999			
Cost	4,381	3,273	7,654
Accumulated depreciation	-	(2,558)	(2,558)
Net book amount	4,381	715	5,096

13. Notes and coins in circulation

	2000 Lm'000	1999 Lm'000
Notes	**405,713**	401,999
Coins	**17,475**	16,486
	423,188	418,485

14. Bank deposits

These consist of reserve deposits held in terms of Section 37 of the Central Bank of Malta Act, 1967.

Amounts include:

	2000 Lm'000	1999 Lm'000
By currency		
Maltese liri	**140,256**	123,875
Foreign	**1,014**	911
	141,270	124,786

15. Government deposits

Amounts include:

	2000 Lm'000	1999 Lm'000
By currency		
Maltese liri	**40,555**	82,906
Foreign	**15,606**	13,282
	56,161	96,188
By remaining maturity		
- Repayable within three months	**547**	5,466
- Repayable on demand	**55,614**	90,722
	56,161	96,188

16. Other deposits

	2000 Lm'000	1999 Lm'000
Public Sector Corporations and similar entities:		
- Repayable within three months	**2**	5
- Repayable on demand	**3,678**	5,571
	3,680	5,576
International Monetary Fund SDR allocation	**6,439**	6,390
Others:		
- Repayable on demand	**274**	458
	10,393	12,424

Amounts include:

	2000 Lm'000	1999 Lm'000
By currency		
Maltese liri	**2,846**	4,019
Foreign	**7,547**	8,405
	10,393	12,424

17. Foreign liabilities

	2000	1999
	Lm'000	Lm'000
Amounts payable under banking arrangements		
- Repayable within three months	**3,655**	-

18. Other liabilities

	2000	1999
	Lm'000	Lm'000
International Monetary Fund Non-Interest Bearing Notes	**18,549**	18,989
International Monetary Fund current accounts	**16,673**	15,966
Liabilities arising from monetary policy instruments	**-**	12,000
Others	**2,215**	2,507
	37,437	49,462

19. 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.

20. 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.

21. Reserves for risks and contingencies

Reserves for risks and contingencies are maintained in terms of Section 24 of the Central Bank of Malta Act, 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.

22. Cash and cash equivalents

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

	2000	1999
	Lm'000	Lm'000
Cash and bank balances	**4,598**	35,312
Treasury bills maturing within three months	**2,388**	-
Placements with banks maturing within three months	**99,058**	136,444
Other foreign currency assets maturing within three months	**-**	1,922
Deposits maturing within three months	**(49,268)**	(89,545)
Foreign liabilities maturing within three months	**(3,655)**	-
	53,121	84,133

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.

23. Financial instruments

The nature of the Bank's operations implies that financial instruments are extensively used in the course of its business. The Bank is potentially exposed to a range of risks and hence operates a risk management strategy with the objective of controlling its exposures. Besides the risks relating to a central bank's role which are referred to in note 21 above, the principal categories of operational risk faced by the Bank are credit risk and currency risk.

Credit risk

The Bank has in place internal control structures to assess and monitor credit exposures and risk thresholds. 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.

Currency risk

Investments 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.

23. Financial instruments - continued

Currency risk - continued

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

	2000	1999
	%	%
USD	**24.39**	23.69
GBP	**22.73**	22.91
EURO	**52.37**	52.89
Others	**0.51**	0.51
	100.00	100.00

Fair values of financial assets and liabilities

The carrying amounts of the following financial assets and liabilities approximate to their fair value: cash and bank balances, treasury bills, placements with banks together with deposits by banks, the Government of Malta, public sector corporations and other similar entities.

The following table summarises the carrying amounts and market values of those financial assets not presented on the Bank's balance sheet at their market value:

	Carrying value		**Market value**	
	2000	1999	**2000**	1999
	Lm'000	Lm'000	**Lm'000**	Lm'000
Foreign currency investment securities	**189,225**	217,656	**194,900**	217,459
Malta Government Stocks held for dealing purposes	**6,452**	5,681	**6,485**	5,700
	195,677	223,337	**201,385**	223,159

24. Contingent liabilities and commitments

	2000	1999
	Lm'000	Lm'000
Contingent liabilities		
Guarantees and letters of credit	**34,985**	28,067
Commitments		
Repayment of foreign loans received by the Bank on behalf of the Government under Financial Conventions	**20,182**	22,080
Total	**55,167**	50,147

By remaining maturity:

Guarantees and letters of credit

	2000	1999
	Lm'000	Lm'000
- Five years or less but over one year	**14,384**	14,113
- One year or less but over three months	**3,878**	349
- Three months or less	**16,723**	13,605
	34,985	28,067

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

	2000	1999
	Lm'000	Lm'000
- Over five years	**8,908**	10,995
- Five years or less but over one year	**9,007**	8,876
- One year or less but over three months	**2,105**	2,053
- Three months or less	**162**	156
	20,182	22,080

25. 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.

26. 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. Up to 31 December 2000, an amount of Lm1,521,090 of this currency note was claimed by the public. In accordance with Section 42(6) of the Central Bank of Malta Act, 1967, the balance of the above mentioned demonetised currency note not claimed by the public after one year from date of demonetisation will be recognised as profits of the Bank.

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 2000, such claims amounted to Lm216,681 (1999: Lm263,960).

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 2000, the value of unpresented demonetised currency notes amounted to Lm2,353,507 (1999: Lm2,570,188).

26. General - continued

(b) Average number of employees

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

	2000 Number	1999 Number
General and Deputy General Managers	**7**	6
Heads and Executives	**65**	65
Supervisory and clerical staff	**182**	186
Non-clerical staff	**50**	54
	304	311

(c) Assets held in custody

At 31 December 2000, assets held in custody by the Bank in terms of the Insurance Business Act amounted to Lm30,587,000 (1999: Lm28,522,000)